The underappreciated advantage of attracting long-term, loyal shareholders

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DECEMBER 3, 2020

For at least the past 50 years, the focus of shareholders has been on what size return the investee-company can give to its shareholders. Professor Lawrence A. Cunningham's *Quality Shareholders* has flipped the question to ask what sort of shareholders a company can cultivate to improve the company's performance.

Cunningham's thesis is that "Quality Shareholders" — which he defines as shareholders who buy and hold large stakes for a long time — will, in the long run, significantly improve the financial return to the shareholders.

Quality Shareholders, Cunningham concludes, provide numerous comparative and competitive advantages for companies and their managers, including a longer runway to execute business strategy and a loyal cohort against adversity.

Cunningham, a student of Berkshire Hathaway and Warren Buffett and a professor of law at George Washington School of Law, is a prolific and graceful writer. His argument is that a company benefits from attracting and keeping "Quality Shareholders" — a term Buffett coined.

Quality Shareholders are equally committed to a company's long-term success and typically invest more than short-term dollars into the business. In addition to concentrating much of their investments in a company and staying for the long haul, they offer careful analysis, calculated suggestions, and a long-term focus to improve the company.

Quality Shareholders, Cunningham concludes, provide numerous comparative and competitive advantages for companies and their managers, including a longer runway to execute business strategy and a loyal cohort against adversity.

Cunningham's research of public companies and their investors demonstrate the formidable benefits that attracting or becoming Quality Shareholders provide to companies and shareholders alike.

The book includes numerous examples from public companies, but its lessons may be at least as valuable for closely held companies, family offices, institutional investors, and their advisors.

The trick is to modify behavior — of the company or yourself — to create an environment where Quality Shareholders can thrive. Cunningham presents the roadmap to achieve that behavior modification in his book.

PROFESSOR CUNNINGHAM'S CONCLUSIONS ARE BUTTRESSED BY YEARS OF RESEARCH THAT HE PRESENTS IN A STRAIGHTFORWARD MANNER.

Perhaps the majority of the preparation for *Quality Shareholders* was spent not on the writing process, but rather on the research process. Before Cunningham could conclude what he presumably suspected based on Buffett's lived experience — that Quality Shareholders are incredibly valuable — and before he could state with confidence how to become and attract Quality Shareholders, he studied an immense amount of data.

Cunningham started the Quality Shareholder Initiative as part of the Center for Law, Economics & Finance at the George Washington University Law School to research and report on advantages and disadvantages of different types of shareholder and corporate behavior.

Through this initiative, he and his colleagues conducted original empirical research as well as supplemented and corroborated their results with secondary research. As Cunningham shared at a recent Fordham University Gabelli School of Business event, the thought behind his book was years in the making.

He may have hypothesized what he would find, but Cunningham could not have written so assertively with meaningful conclusions without the focused research housed within the Initiative.

The result is that Cunningham's detailed research backs his book with confidence. Cunningham's artful presentation of the research spares his readers from convoluted analysis but provides ample reasoning to back his statements.

Throughout the book, Cunningham appears to predict when a reader might question his statement and appropriately provides his reasoned support. Readers enjoy the benefit of reviewing the results and the rational thought process without the strenuous labor of compiling and analyzing the raw data.

Cunningham presents some specific research results throughout the book and includes more details in the end in an appendix. This presentation supports an easy flow of the book while also providing readers with a one-stop-shop for examples and results in several different topical areas.

Cunningham's research appears successful in achieving its purpose: determining what kinds of shareholder behaviors benefit companies and what companies can do to attract those shareholders.

ALTHOUGH PROFESSOR CUNNINGHAM FOCUSES MAINLY ON PUBLIC COMPANIES, HIS LESSONS ARE BROADLY IMPORTANT FOR PUBLIC AND PRIVATE COMPANIES ALIKE.

Cunningham's research, and his book, focuses primarily on public companies. Public companies in the United States are those with shares that trade freely on a stock exchange or the over-the-counter markets. Ownership of companies is divided among many different shareholders.

Public companies have disclosure requirements under the law, so several variations of relevant data was readily available for Cunningham and his colleagues to dissect. During his explanation of the importance of Quality Shareholders, Cunningham includes tips on what companies can do to attract them in a way that provides a roadmap for public company decision-making.

Nonetheless, nearly all of Cunningham's suggestions for attracting Quality Shareholders are useful for private companies as well. Private companies have more closely held ownership. The shares do not trade on a stock exchange or the over-the-counter markets, and they are not subject to comparable disclosure requirements.

Unlike public companies, privately held businesses can decide who joins as a shareholder. Still, like public companies, managers of private businesses need to make decisions that can affect the types of shareholders interested in joining in their ownership ranks.

Although Cunningham does not present this idea, one could argue that management of private companies can make an even greater difference in their companies by adopting Cunningham's preferred techniques. They can be careful to pick out only Quality Shareholders, as desired, and shape their shareholder base accordingly.

Further, becoming a private shareholder naturally takes more commitment and energy than becoming a public shareholder. Anyone can purchase shares of a public company without prior research. Contrastingly, becoming a shareholder of a private company takes significant investment of time, energy, and commitment.

Private companies should demand such an investment, essentially requiring their shareholders to be Quality Shareholders. Thus, Cunningham's advice for attracting Quality Shareholders is important for private companies too.

For example, Cunningham argues that to attract Quality Shareholders, companies should employ shareholder engagement activities strategically to exemplify a focus on the long-term success of the company.

While it may be difficult to change at first, corporate mission statements, shareholder letters, shareholder meetings, and other outreach should be timed and themed with Quality Shareholders in mind.

Importantly, the data communicated to investors, whether from public or private companies, should be consistent from year to year. Cunningham states succinctly that "[c]ompanies attract and keep QSs by having the courage to report the same items about the same core sources of value creation year in and year out."[1]

In addition to attracting Quality Shareholders, keeping them is critical for both public and private companies. Throughout the book, and especially when discussing comparative advantages of Quality Shareholders, Cunningham emphasizes how these shareholders best support management.

When management is faced with overzealous activist shareholders, or shareholders who aim to make specific waves in the company, he writes,

"[s]hareholders who understand and appreciate a company's business model are attractive, especially for those companies following a structure or strategy that bucks prevailing fashions… having a substantial contingent of [Quality Shareholders] helps managers navigate the pressure, creating both time and options."[2]

Overzealous activism may appear at first like a problem more typical of public companies, but management of privately held businesses of varying types — whether family owned or private equity held — are routinely confronted with shareholders with different goals who are determined to change management's mind (or, failing that, to perhaps change management).

Nonetheless, surrounding a business with shareholders that appreciate a company's business model is attractive for all businesses. Such shareholders can better advise management within the existing bounds of any business because they are committed, educated on the business and its goals, and ready to stick through building periods to get to the more prosperous periods.

Ultimately, Cunningham's specific advice can be boiled down to this takeaway for both public and private companies: create an environment that rewards long-term and concentrated thinking and investing. Such an environment will attract

Quality Shareholders who will aim for long-term company success, and Cunningham's book provides specific, useful, and feasible tips to get there.

IN ADDITION TO PROVIDING ADVICE FOR COMPANIES, *QUALITY SHAREHOLDERS* CAN SERVE AS A TOOLBOX FOR INDIVIDUAL INVESTORS OF ANY EXPERIENCE LEVEL.

Foundational to the discussion of Quality Shareholders is the point that there are several types of shareholders.

In addition to Quality Shareholders, who are committed in the long-run with a substantial portion of their overall investments in the company, Cunningham points to the personalities of a) traders or transients, who trade quickly and with a short-term focus to try to strategically make a quick buck; b) activists, who buy enough shares in a company to influence management in a significant different direction for relatively short-term gains; and c) indexers who invest small amounts in many companies and aggregate their decisions by analyzing any change in the context of the entire portfolio of assets.

Whether an investor is new or experienced, any individual should behave strategically. This overview of investing personalities is a useful framework within which investors can determine how they want to position themselves in the market.

By presenting the traits of the different types of shareholders, Cunningham motivates readers to align their behavior with Quality Shareholders.

He explains that the population of Quality Shareholders has been shrinking as indexing rises; however, a major goal of his book is "to enlarge the cohort of [Quality Shareholders], to continue the education of current practitioners, and to add to the elite group of companies and leaders who attract them." (Page 8). He stresses, "QSs are a shrinking group. But their time is now."[3]

To inspire readers to behave as Quality Shareholders by investing into companies not only their money, but also time, energy, opinion, and expertise, Cunningham presents practical tips for the investors throughout his book.

His tips can guide individual investors to make calculated decisions about which companies to invest in, what characteristics to look for, and how to behave as a shareholder to help maximize the long-term success of the company. Most tips are highly accessible for all levels of investors, and some tips are tailored towards more experienced investors.

For example, any reader can understand the importance of demanding honesty, consistency, and detail in regular shareholder communications. An investor at any level can appreciate Cunningham's discussion of director selection and shareholder voting.

At the same time, more experienced investors can further appreciate his discussion of the importance of capital allocation and separation transactions, including tracking stocks ("trackers") and spin-offs ("spins").

By studying Cunningham's discussion of shareholder types and advice to companies to increase their fraction of Quality Shareholders, individual investors learn what to focus on to become a Quality Shareholder.

ALTHOUGH PROFESSOR CUNNINGHAM ESSENTIALLY DEVELOPED A 'HOW-TO' BOOK, HIS WRITING STYLE SEPARATES IT FROM MOST GUIDES AND THE RESULT IS AN ENJOYABLE, INTERESTING READ.

Without question, *Quality Shareholders* is interesting for anyone curious about investing and corporate successes. The ideas that Cunningham presents are fascinating and new, but he presents them carefully as unsurprising and attainable rather than overwhelming. In other words, Cunningham provides all of the background anyone might need to follow his thought process closely.

Following the prologue, the rest of the book follows suit. The ideas are presented in an order and with a cadence that flows so well that readers are led with hindsight to wish they had predicted the lesson themselves.

Cunningham's approach is simultaneously conversational and technical. He uses tables when helpful, but the book is not styled as a textbook. Catchy examples draw the reader into every chapter, and exemplary transitions make for a quick read.

Ultimately, Cunningham's normative judgment, strongly backed by his intensive research, provides any type of company and investor with goals and the tools for reaching them.

Notes

1 Page 94

2 Page 36

3 Page 163

This article was published on Westlaw Today on December 3, 2020.

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