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Governance costs and the problems of large traditional co-operatives

Introduction

Many large traditional agricultural co-operatives in the Western economies have run into serious financial problems during the past few decades. In many cases, co-operatives have been acquired by other firms or merged with other co-operatives. Others have ceased operation. The acquired/merged co-operatives often adopt a non-traditional, or hybrid, co-operative form, whereby the collective ownership that characterises traditional co-operatives is replaced with more clearly defined property rights held by either members or external financiers. Thus, they may abandon collective governance or “non-proportional voting rights” (Chaddad and Cook, 2004). The hybrid co-operative no longer has only unallocated capital and member shares that are collectively controlled. Many co-operatives adopt individualised control rights and property (residual) rights, rather than having residual claims in proportion to their patronage.

However, the hybrid co-operatives may still keep to the general understanding of co-operative principles: “In a cooperative, the user is the focal point, with the direct status of user, owner, and control vested in the same individual” (Dunn, 1988, p. 85). The ownership rights may become tradable and redeemable or partly include outside financiers of one kind or another, and the residuals may be received by members or outside investors in relation to their investment. Proportional voting may be introduced, external directors may be appointed and outside investors may have some influence (Chaddad and Cook, 2004).

There are many examples of co-operatives that have converted from their traditional co-operative form. Farmland Industries was a second-tier agricultural co-operative with 1,700 member co-operatives containing more than 600,000 farmer-members throughout North America (Kenkel and Hagen, 2004). However, it made very large investments at a time when its finances were highly leveraged and the capital markets were fluctuating. In 2002, it went bankrupt. Another large US second-tier co-operative was Agway, whose member co-operatives had an aggregate membership of more than 200,000 farmers. Because the member co-operatives had no investments in Agway, the management was not subject to strict control. After a few large and risky investments, Agway became insolvent in 2002 (Anderson and Henehan, 2001).

Lamprinakis and Fulton (2011) present the case of the Canadian dairy co-operative Dairyworld, which borrowed much capital in order to expand into more lucrative markets, but in 2001 the price of the acquisitions turned out to be too high. Another failure happened to Saskatchewan Wheat Pool, which was Canada’s largest grain co-operative. It was restructured in 2003 after it had failed with a capital expenditure programme that was meant to compete with the multinational grain handlers (Lang, 2006). A large number of other co-operative demises in North America are described by Fulton and Hueth (2009).

On the European scene, one example is Swedish Meats, which had a market share of 63 per cent in 2006 but had to be sold one year later. It was a result of a nation-wide merger of meat co-operatives, but integration of the operations was prevented by conflicts between the merging partners (Nilsson and Lind, 2015). In Ireland, four Irish dairy co-operatives transferred their business operations to corporate firms listed on the Stock Exchange in the late 1980s, because the members realised that the operations were run inefficiently (Nilsson and Gunnarsson, 2000). In all Finnish agricultural co-operatives, the farmers share the ownership together with external financiers (Pyykkönen and Ollila, 2012). Other co-operative failures in European Union countries are reported by Bijman et al. (2012).

Many researchers have suggested theoretical explanations for the challenges for co-operatives, applying a variety of approaches in their analyses. Using a macro-sociological approach, Bager (1994) explains that as co-operatives expand, they mimic investor-owned firms in terms of management models. According to Cook (1995), co-operatives have a built-in desire for expansion, even though expansion gives rise to problems of "vaguely defined property rights", which sooner or later force traditionally organised co-operatives to convert into another organisational form. According to Fulton (1995), the locus of power has shifted to other links in the agro-food value chain, so the ability of co-operatives to provide large volumes of high quality raw products is no longer the key to success. Holmström (1999) presents a corporate governance explanation, claiming that capital market mechanisms are distorted in traditional co-operatives. Hogeland (2006, 2015) suggests that cultural changes have taken place, creating a chasm between farmers and agro-food processing firms, including co-operatives. Nilsson et al. (2012) claim that the amount of social capital perceived by farmer-members shrinks as co-operatives expand.

These theoretical explanations concern a macro level, i.e. why traditional co-operatives in general run into problems. In contrast, the present study focuses on the micro level, which concerns what happens within a co-operative organisation. It deals with the internal governance of a co-operative, i.e. "… decision-making processes, the role of the different governing bodies, and the allocation of control rights to the management (and the agency problems that go with delegation of decision rights)" (Hanisch and Rommel, 2012, p. 6).

The aim of the study is to explain the governance problems of expanding traditional co-operatives. In particular, it examines the effect of organisational expansion on farmer-members' costs of governing a traditionally organised co-operative. The analysis is conducted in terms of governance costs as explained by Hansmann (1996). He specifies four types of governance costs:

> Some of these costs [ownership costs] are what might be called "governance" costs: they include (i) the costs of making collective decisions among the owners, (ii) the costs of monitoring managers, and (iii) the costs of the poor decision and excessive managerial discretion … Another cost is (iv) the risk bearing associated with receipt of residual earning. (Hansmann, 1996, p. 21; numbering added here).

The analysis considers the following questions about co-operative conversion from the traditional, collectivistic form to a more individualised, hybrid form:

1. Is the conversion of many traditional co-operatives caused by mistakes, made by the decision-makers within the co-operatives?
2. Does the conversion of many traditional co-operatives benefit the farmer-members?
3. Is the conversion of traditional co-operatives inevitable on competitive markets, or could traditional co-operatives preserve this organisational form?

Each of the four subsequent sections discusses the types of governance costs listed by Hansmann (1996), as applied to expanding traditional co-operatives. In this case the actual governance of these co-operatives is taken over by the professional management, the objective of which is to expand the co-operative business firm even further. A discussion of the findings is then provided, followed by some conclusions.

Costs of making collective decisions

The costs of collective decision-making depend on the size of the group. If all the members of a N-sized group were to have contacts with each other, the number of contacts would be N(N-1)/2. For example, a group of 50 members would require 1,225 contacts (49+48 … 2+1). If, on the other hand, a series of two-party negotiations were required, the number of contacts would be only N-1. i.e. 49 in a group of 50 participants. If there are possibilities for the members to form coalitions during the negotiation process, the coordination task will require even more contacts. This is an argument for having co-operative memberships hierarchically organised and under centralised governance. The governance costs also increase with the degree of heterogeneity (Höhler and Kühl, in press). Thus, as co-operative memberships grow, the Board of Directors and the CEO (Chief Executive Officer) are likely to gain more power.

In a heterogeneous membership, many investments do not benefit the entire membership (Kalogeras et al., 2009). Members often dislike investments that benefit other member categories (a portfolio problem) or future members (a horizon problem). Therefore, members may use resources in attempts to influence decision making. This type of governance cost may be high in heterogeneous memberships.

Due to the unclear property rights in collective organisations, the members have weak incentives to contribute to the governance. It is possible to receive benefits from a collective organisation without contributing to the governance, i.e. members may be free-riders (Cook, 1995; Nilsson and Svendsen, 2011). However, if all members were free-riders, an organisation would not be governed. It would not even be established. Olson (1965) proposes some ways to overcome the misalignment between individual and collective interests, namely "group size", "coercion", and "by-product". All of these involve governance costs for the members.

The "*group size*" argument applies when collective organisations are established and governed by a core group that is so small that the group members have low governance costs, while at the same time the core group members may benefit more than the rank-and-file members. The leading figures may want to have a large number of rank-and-file members. For example, a large membership will provide economies of scale and scope to the organisation, and will mean more benefits for the leaders. Moreover, being a leading figure in a large organisation gives prestige. It is likely that if the group of leaders wants to remain in control, whether as directors or as CEO, they will want the organisation to expand. In studies on co-operatives, Hind (1997, 1999) states that the professional management extends its power, already large co-operatives have a tendency to become even larger.

Olson (1965) also mentions a "*coercion*" argument, i.e. the use of power. Under certain circumstances, some actors have possibilities to induce others to become involved in a collective action organisation. Ruling out physical coercion, it is likely that social force may be used to persuade members to be active in the governance of co-operatives. For example, members often attend general assemblies in order to socialise with each other. Being a director is generally considered to give prestige among fellow farmers. Financial reward is also a powerful incentive to convince members to serve as elected representatives (Kronholm and Staal Wästerlund, 2013).

Olson's (1965) "*by-product*" argument implies that at least some individuals involve themselves in the governance because of private incentives. For example, farmers may be caught by power ambitions, or they may value the economic compensation for being directors. Fulton and Hueth (2009) found cases where co-operative directors acted for conversion because it allowed them to receive cash payment for their shares. Staatz (1984) uses transaction cost theory to explain why co-operative leaders find their task rewarding:

> Once a cooperative is in business, its assets generally become fixed, in the sense that the return to them in the cooperative exceeds the return they could earn in alternative uses. This is particularly true for the human capital of managers and board members, who often receive important pecuniary and psychological rewards from their involvement in the organization. Owners of these fixed assets therefore attempt to maintain the organization even though the conditions that initially gave rise to it may have changed, perhaps because of the activities of the cooperative itself. (Staatz, 1984, p. 206)

Costs of monitoring management

The owners of an organisation of a certain size and complexity need the help of qualified leaders who have better knowledge of how to run the firm (Jensen and Meckling, 1976). Due to information asymmetry and divergent interests between a principal and an agent, the principal will have agency problems (Cook, 1995; Hakelius and Hansson, 2016). These agency problems are aggravated in collectively owned organisations, because in the absence of clearly defined property rights neither the members nor outside observers have a strong incentive to supervise the agent. A traditional co-operative's performance is not subject to evaluation by financial markets (Bijman et al., 2013; Mamouni Limnios et al., 2016). External examinations by stock analysts and business media seldom pay attention to the performance of co-operatives. Among IOFs (Investor-Owned Firms), such scrutiny disciplines the leadership.

Agency problems may exist in the entire chain of agency relations, for example between the members and elected representatives at different organisational echelons, and between the board and the CEO. All measures that members may conduct to prevent others from being fraudulent are resource-demanding. Therefore, the members cannot fully prevent fraud. They face a trade-off between the preventative costs and the losses.

The literature on co-operative governance indicates serious agency problems. A contributing factor is that co-operatives have a complex goal structure. In case where the amount of social capital within the membership is low, there are conflicting interests within the membership, whereby the managers have possibilities to advance their own interests by allying themselves with specific member categories. The more heterogeneous the membership, the lower the likelihood of the amount of social capital being sufficiently high to keep the governance costs limited.

One class of agency costs relates to the principal monitoring the agents (Nilsson, 2001). The members must use resources to regulate and monitor the leadership's actions. This may be done by establishing a contract and by controlling and ensuring fulfilment of that contract. Co-operative members may use partly the same instruments for monitoring the leadership as are employed by IOFs, i.e. independent auditing, policy documents, annual reports and general assemblies. Owners of IOFs often implement interest-aligning salary schemes and stock options, but these measures do not function in co-operatives, where the residual earnings depend on the amount of payment to members.

Costs of poor decisions and excessive managerial discretion

Because members cannot completely monitor the leadership, the leaders are in a position to extract at least some rents and thus the members will suffer residual losses. "[I]t is the agent who is able to direct the organisation so that its surplus may be smaller and so that he personally may usurp some of the surplus" (Nilsson, 2001, p. 334). One other category of agency costs is bonding expenditure on the part of the agent. "In order to reassure the principal that he is acting in accordance with the interests of the principal, the agent must employ a certain amount of resources" (Nilsson, 2001, p. 334). Due to the information asymmetry, the leaders are sometimes able to conceal usurpation of residual earnings and use of bonding expenditure.

Likewise, the leaders may be able to conceal important information, thereby convincing members about their skills. Because the contracts between the co-operative and the directors and CEO are by necessity incomplete, the power relation is skewed. For example, co-operative leaders often want expansion of the business operations, even though members may be sceptical. Couchman and Fulton (2015, p. 2) observe that when co-operatives are on the brink of failure, they often involve themselves in a "series of acquisitions, mergers, and restructuring … portrayed as bold and ground-breaking by management". However, such actions are contrary to the members' interests in reducing their risk-taking, and already poor balance sheets become even poorer.

Member control is affected by social relationships. On the one hand there may be camaraderie, meaning that directors or the CEO build up a network of supporters within the membership. On the other hand, there may be social control if directors want to establish and maintain a good reputation within the membership, provided that some members are willing and able to control the leadership. If so, there may be opportunities for functional control and good business operations. Both the directors and the CEO are likely to want a good reputation and to continue in their positions.

Costs of risk bearing associated with receipt of residual earnings

The principal of an organisation is entitled to receive the residual earnings that result from the operations of that organisation. When a part of an IOF's residual earnings is added to the funds of the company the stockholders' wealth increases. However, when a traditional co-operative pays only part of its profits to the members as patronage refunds, the situation is different. The additions to the unallocated capital are money lost from a member perspective. Unless co-operatives do not have tradable and appreciable shares existing members lose and future members gain because the co-operative will have a stronger financial position.

Agency costs may arise because the equity capital of traditional co-operatives is not subject to market forces, but collectively decided upon by the General Assembly and the board. Without appreciable equity shares, it is impossible to know whether a co-operative's amount of capital corresponds to what it would have been under market conditions. It is unclear whether the allocation of capital between the individual members and the co-operative society is optimal. These imbalances are immanent in the traditional co-operative business form because of high asset specificity (Staatz, 1984). The leadership has an interest in the co-operative holding a large amount of capital.

The members gain access to the assets of traditional co-operatives only in cases when these assets are subject to a market assessment, for example when a co-operative is acquired by another firm or dissolved. In such cases, the value of the co-operative could deviate widely from the aggregate value of the members' nominal shares, depending on how the cooperative has been managed.

Discussion

As the analysis above indicates, there may be a misalignment between the strategies and governance structures of many large traditional co-operatives. Many co-operatives expand vertically in order to reach more lucrative markets (Fulton and Gibbings, 2006). However, such a strategy requires large financial investments and the members have weak incentive to invest. Vertical integration also requires advanced management skills, whereby the leadership gains much power. Likewise, traditional co-operatives expand horizontally, often through mergers, in order to reap economies of scale in terms of production and financing. Due to increasing membership heterogeneity, the members have weak incentives to participate in the governance and "… as membership commitment wanes, so does the financial and organisational health of the organisation and with it its ability to provide goods and services to the members" (Fulton and Giannakas, 2007, p. 93). On this basis, it is appropriate to speculate about some implications of the common tendency for traditional co-operative to convert into a hybrid co-operative form.

1) The conversion of many traditional co-operatives is not caused by mistakes made by the decision-makers within the co-operatives. Given that members seek to satisfy personal interests, they act rationally when not investing in a large traditional co-operative and not participating in member control. This member passivity means that the board is not representative of the membership and it receives unclear signals. Thus the directors acquire much power, but they are not aware of their difficulties in monitoring the co-operative. Because this development takes place incrementally, the process of a failing co-operative is hardly discernible. Each decision is reasonable at the time it was made, even though the aggregated decisions lead to conversion into another business form (Nilsson et al., 2009, 2012). The problems of large and complex co-operatives are built into the nature of their organisational model, with a collectively owned and run organisation with sizeable, complex operations (Cook, 1995; Fulton and Giannakas, 2007).

2) It is unclear whether the conversion of many traditional co-operatives benefits the farmer-members. The members' patron role declines in importance as they take on a stronger ownership role and if external investors become co-owners (Pyykkönen and Ollila, 2012; Nilsson et al., 2014). Nevertheless, if they adopted the alternative of no longer having a co-operative trading partner, their position might be even more weakened. Likewise, when a co-operative converts to an individualised ownership structure and becomes larger and more complex, the members' control role is weakened. They get less influence, but their influence is in a stronger firm.

3) The conversion of traditional co-operatives is not inevitable. The fact that many agricultural co-operatives have incorporated more individualistic attributes in their business form indicates that the development is here to stay. Thus co-operatives are likely to expand further (Chaddad and Cook, 2004; Chaddad and Iliopoulos, 2007; Pyykkönen and Ollila, 2012; Hess et al., 2013; Ollila et al., 2014). However, this does not mean that all traditional co-operative will be converted. Provided that a small co-operative is able to defend a lucrative market niche, it has no reason to consider being converted (Feng et al., 2016).

Conclusions

This paper discusses the governance of traditionally organised co-operatives with large and complex operations and sizeable and heterogeneous memberships. It argues that the members have high governance costs in such co-operatives. In their user role, the members act on the basis of personal interests, while their control and ownership roles presuppose collective action. The misalignment between the roles raises the members' governance costs. First, the members have high *costs of making decisions*, as it is difficult to coordinate a large and heterogeneous group of members. Second, the members have high *costs of monitoring the management.* Third, with weak member control of the management, it is likely that the members will have *costs resulting from poor decisions and excessive managerial discretion.* The managers will then reap undue benefits for themselves. Finally, the fact that collective capital is not subject to market forces means that the allocation of capital in the co-operative system is probably not optimal, so the members will have high *costs of risk bearing, not getting full residual earnings.*

When the members' governance costs become high, the managers tend to proceed with their ambition to expand the co-operative even further. To achieve this, many large traditional co-operatives in Western economies incorporate individualistic traits. For example, members are given individual ownership, external board members are recruited or capital from external financiers is invested.

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