The governance of cooperative federations, a first insight

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Abstract

Cooperative federations have a specific ownership structure: they are cooperatives of cooperatives and can be considered as closely held organizations, as cooperative federations generally include less than 10 member cooperatives. As such, their governance is characterized by the vaguely defined property rights of cooperatives and the specific features of closely held organizations. In this research, we use the cooperative theory and the corporate governance literature to examine the pros and cons of this particular ownership structure. Our goal is to contribute to fill the lack of theory for thinking about the governance of cooperative federation.

Key-words: cooperative federations**;** corporate governance; ownership structure; closely held organizations

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Introduction

Cooperatives in western countries have had to respond to several strategic challenges: legislative reform, market concentration and internationalization (Bijman et al, 2014). However, as they are limited in capital issuance by their core governance characteristics, they have to rely on strategic alliances with other cooperatives or IOFs (Cook, 1995). In this context, merge of cooperatives or federations of cooperatives appear as solution to address the issue of size.

In France, there are 1,883 cooperatives and 346 cooperative federations. If we consolidate different figures given by the HCCA (Haut Conseil à la Coopération Agricole), it appears that about 55% of these federations appear as the main market access for their member cooperatives. Two of them are in the top-five of French cooperatives. It comes that even if merges have largely contributed to restructure the cooperative industry, the cooperative federations still appear as governance structures which may reconcile the need for operating at a global scale or facing giant retailers and preserving a governance grounded on the local community of cooperative members. However, in the extent of our knowledge, there is no theory of governance of cooperative federation. This research is a first attempt to fill this gap.

If we consider the lifecycle approach of Cook (1995), cooperative federations appear as an alliance between several cooperatives which have contributed to make them pass over the "turning point" of maturity. One important feature of cooperative federations is that they are cooperatives. They follow the three principles that define organizations as cooperatives: user-owner, user-control, user-benefit (Bijman et al, 2014). More specifically, cooperative federations (also named second-tier cooperatives) are cooperatives of local cooperatives (also named first-tier cooperatives), i.e. an organization with "vaguely defined property rights" (Cook, 1995) concerned by the five governance issues which need to be addressed by cooperative): (1) the free-rider problem, (2) the horizon problem, (3) the control problem, (4) the portfolio problem and (5) the influence cost problem (Cook, 1995).

As cooperatives of cooperatives, the members are cooperatives and not farmers. Moreover, their membership scarcely includes more than 10 members. These two features lay the ground of our examination of the corporate governance literature to draw up some insights on the governance of cooperative federation. Indeed, regarding the corporate governance literature and the characteristics of membership in cooperative federations, the most comparable IOFs with cooperative federations are firms owned by multiple large shareholders or blockholders. Indeed, as firms owned by blockholders or multiple large shareholders, cooperative federations are generally owned by several cooperatives which have strong incentives to commit in the governance of the cooperative federations. The governance of closely held firms is a topic of corporate governance since the pioneering works of Pagano and Roel (1998), Gomez and Novaes (1999) or Bennedsen and Wolfensohn (2000). Since then, this topic has been handled by theoretical as well as empirical research, resulting on a strong corpus we propose to mobilize in order to draw up propositions on the governance of cooperative federations. In this perspective, the question which needs to be addressed is whether a governance characterized by a closely held ownership of cooperatives performs better than centralized cooperative with a dispersed ownership.

This paper is organized in three sections. In the first section, we review the governance issues of cooperatives. The second section focuses on the effect of cooperative federation, as governance structure, on the property rights' issues of cooperatives, enlighten by the literature on the governance of closely held corporations. In the third section, we discuss the empirical implications of the preceding sections and examine the cooperative federations in practice. Then we conclude.

1. A review of the governance issues of cooperatives

Cooperative federations, as cooperatives of cooperatives, are ruled by the three rules of cooperative governance: user-owned; user-controlled; user-benefit (Dunn, 1988). They also follow the democratic principle, one member, one voice, and the non-transferability of shares. All these characteristics put the cooperative federations in the category of ownership structure with vaguely defined property rights (Cook, 1995). We propose to review the issues that a proper governance device is supposed to tackle.

a) The problems inherent to collective action

The first issue is linked to the fact that cooperatives are, by nature, collective action: as belonging to a group, some of the cooperatives of the federation can free-ride, i.e. they are prompt to take the benefits of the collective actions but do not provide the efforts supposed by an even distribution of costs; others can seek to gain influence on the decision making in order to defend their own interests. This can engender sub-optimal decisions and costly conflicts. Their negative effects are considered as influence costs. Two questions have to be addressed: are cooperative federations more or less affected by the risk of free-riding than the centralized cooperatives? Do they contribute to a reduction or do they increase the risk of conflicts between the different groups of cooperative members? This latter one can be reformulate according to the terminology of cooperative theorists: do they reduce the influence costs?

b) The control problem

The second issue is linked to the agency relationship between the managers and the owners. This topic is central in the corporate governance literature. Two key-elements of the agency relationship is the degree of information asymmetry between the managers and the owners and the incentives of the owners to monitor the managers. The board of directors (and, specifically to cooperatives, the "*bureau*") can be seen as an institution which makes the management meet the representatives of the owners. In this perspective, the board of directors is a key-institutions which reflect the distribution of power at the top-level of the firm. The challenge is to determine which governance structure provides the best access to information and the best incentives for directors to provide a rigorous monitoring.

c) The risk-bearing and the horizon problem

The third issue is related to the behavior of directors regarding the risk-taking and the long term interests of cooperative members. Indeed, many researchers in corporate governance provide evidences of a misalignment of risk perception between managers and shareholders. The main reason relies on the fact that the position of managers is related to all the adverse events that a firm can face, the total risk, while shareholders, as holders of diversified portfolios, take into account only the non-diversifiable risks for investing and influencing the course of actions of firms. On this point, cooperatives differ largely from the corporations as the cooperative members are not deep-pocket investors. Therefore, because of their stake in the cooperatives, they are exposed to the specific as well as the non-diversifiable risks of the cooperatives. Cook

(1995) assumes that those who accept more risk than they prefer will pressure the cooperative's investment portfolio, even if the reduced risk portfolio means lower expected returns. This appeals to compare the governance options according to their effect on this bias toward a too high risk aversion which can reduce value creation in the long run.

There are other reasons for which cooperative members can act against the interests of the cooperative in the long-run: there can be discrepancy between the investment horizon of different cooperative members, for example between the younger farmers who should benefit from the operation of the cooperatives for long and the elder ones, who could have interest to prioritize their short-term earnings and equity redemptions against the long term investment and retained earnings. This is the horizon problem which, according to Cook (1995), is particularly severe when considering investments in R&D, advertisement or other intangible assets. The point is to determine whether the cooperative federations appear as a governance device able to reduce the horizon problem or not.

2. The cooperative federation as an efficient governance device

The previous section puts forward the issues of large cooperative governances, in light of the Cook (1995) analytical framework of cooperative governance and the standard theory of corporate governance. In this section, we mostly consider the corporate governance literature to see whether the cooperative federations, as a governance structure characterized by a set of multiple large shareholders, can be considered as an answer to these issues.

a) A closely held governance which reduces the collective action problems

First, the corporate governance literature is quite clear on the effect of a closely held corporations compared to dispersed ownership: this reduces the problem of free riding (Pagano and Roëll, 1998; Attig et al, 2013). Indeed, free riding is generally related to the inability to detect and sanction the absence of efforts partly because of the number of stakeholders implied in the collective action. In the case of cooperative federations, the relative few number of cooperatives involved in the organization eases the agreement on the course of actions and the reciprocal monitoring. The risk of opportunism should be reduced by the quick observance of deviant behaviors.

The corollary problems of a concentrated ownership, for corporations, is the possible dominance of the largest shareholders which can orient the firm's strategy and investments as well as the dividend policy toward their own interests (Shleifer and Vishny, 1997). As a result, the empirical research in corporate governance has tested the impact of the presence of a dominant shareholders over a company, compared to a dispersed ownership and the presence of several large shareholders. This question has led the corporate governance researchers to focus on the impact of the distribution of power among different shareholders. Most of these studies conclude on the efficiency of an even distribution of power among a small number of large shareholders (Bennedsen and Wolfenzon 2000, Laeven and Levine 2008, Attig et al 2013): this result suggests that the democratic principle, when applied in an organizations owned by few large organizations, is an efficient governance device.

The risk of influence costs, or dominance by one of the federation members, should also be reduced by the possibility for cooperatives to exert an outside options. Indeed, if one of the member cooperatives tries to deviate the course of actions of the cooperative federation in their own interests, the threat to resign by other cooperatives should be powerful enough to make the organization act in the interests of all of them. In the case of centralized cooperatives, if a particular coalition of farmers is formed to defend their own interests, the lack of established governance mechanisms can reduce the adoption of corrective actions, which provides an incentive for agents prone to form a coalition to influence the course of actions of the cooperatives toward their own interests.

These two propositions are in line with Pagano and Roëll (1998) who show that multiple large shareholders is an efficient mechanism to reduce the lack of monitoring due to free riding by small shareholders, as well as to reduce the risk of private benefits extraction by a dominant owners. In addition, Bennedsen and Wolfensohn (2000) show that an ownership structure implying several large shareholders reduce the risk of diversion by shareholders who contribute little cash flow to the winning coalition. For these authors, a governance characterized by several large owners prevents small shareholders to form a coalition with strong incentives to divert cash flows.

b) An informational asymmetry smoothed by strong incentives for monitoring

To consider the control problem, we need to separate two issues. The first one is related to the fact that cooperative federation corresponds to a structure in the downstream of the supply chain, with no direct interaction with farmers. As such, this poses a problem of asymmetric information. The second one is related to the incentive for monitoring related to the ownership structure of the cooperative federation.

The distance between the cooperative federations and the farm

The cooperative federations present one drawback: their directors are elected members of the local cooperatives. As owner-manager of their farms, they are perfectly aware of the marketing options they could have if there were no cooperative. This position makes them able to supervise and monitor the course of actions of the first-tier cooperatives (Hansman, 1988). Their informational position is not the same regarding the second-tier cooperative. Indeed, they have an experience of directors of cooperatives, but not as managers. As such, how to defend the interests of the cooperative and how to implement a successful marketing strategy in the last stages of the supply chain are not questions related to their day-to-day activities (even if they have huge consequences on the performance of the farm). As a result, the information asymmetry between the board of directors of a cooperative federation and a manager is expected to be higher than in a cooperative.

Let’s consider the case where the directors of the federations are not elected members but the managers of the first-tier cooperatives. The information asymmetry between the management of the cooperative federation and the board of directors is lower. However, this increases the information asymmetry between the managers and the board of directors in the first-tier cooperatives as there is a scope of his activities that is not easily observable. This can have an entrenchment effect that the first-tier cooperative members may seek to avoid: to be a key-agent of a cooperative federation increases the informational power of local cooperatives’ managers. Entrenchment would reduce the effectiveness of governance mechanisms aiming to align the interests of cooperative members and those of the cooperative managers.

The incentives for monitoring of the ownership structure of cooperative federation

Compared to large and centralized cooperatives, the cooperative federations appear as a governance structure characterized by a small number of large shareholders, the first-tier cooperatives itself. The corporate governance literature provides evidences that ownership structures characterized by few large shareholders provide incentives to owners for being active in the governance of their firms.

Firstly, note that the free-riding problems of dispersed ownership (as in the centralized cooperatives) concern also the monitoring effort that owners should exert on the management. Free-riding on the monitoring effort should not affect cooperative federations as they are owned by a small number of large owners.

Secondly, each cooperative benefits from a real authority in the governance of the federation. Indeed, the existence of the federations is jeopardized if one of its members resigns. By contrast, the individual member of a centralized cooperatives cannot exert such a power. This power provides an incentive for monitoring: the directors representing the member cooperatives know that they can rapidly change the course of actions of the cooperative federation if its policy does not optimally serve their interests. This point is stressed out by Shleifer and Vishny (1997): "large shareholders address the agency problem in that they both have a general interest in profit maximization, and enough control over the assets of the firm to have their interests respected." On the empirical side, Leaven and Levine (2008) and Edmans and Manso (2011) provide evidences that the ownership by multiple blockholders increase firms' value. This argument pleads in favor of cooperative federations. Laeven and Levine (2008), Attig et al (2013) or Dhillon and Rossetto (2015) empirically confirm the efficiency of a governance including multiple blockholders, whose activism in firm decisions is supported empirically and by survey evidence (Dhillon and Rossetto, 2015).

c) The closely ownership structure as an incentive to take informed decisions

The ability of cooperative federation to value the long term benefits over the short-term interests

Edmans (2009) shows that a dispersed ownership does not provide incentives to inform about the real situations of a firms. As a result, the smallholders may be willing to reduce the immediate losses, sometimes in the detriment of the long-term value. The sanction in the quoted corporations is directly related to the sell by the minority shareholders and, thus, a decline in the stock price. Thus, managerial myopia is motivated by the minority shareholders' misunderstanding of the long-run strategy requirements. For cooperatives, this behavior is very similar to the horizon problem as reviewed by Cook (1995) even if their determinants are different: it is caused by knowledge and cognitive discrepancies in Edmans (2009) and the date of membership termination for cooperatives. In the two cases, the result is a policy which puts the short-term interests before the value creation in the long run. In both cases, the manager has interest to apply the policy which is in the short-term interests of the organization owners. In the case of corporations, small shareholders can sell their shares and so reduce the equity value of the firm. In the case of cooperatives, cooperative members can vote against the renewal of appointment of directors in general assembly, or obstruct the implementation of new strategies and ultimately resign their membership in the cooperative.

For Edmans (2009), blockholders appear as a solution to managerial myopia. Indeed, they have strong incentives to gather costly information about the firm's fundamental value, that is, to learn whether weak earning result from low firm quality or desirable long-term investment.

"Owing to their sizable holdings, they have the incentive to ask questions first and not automatically sell upon losses." As cooperatives own sizable holdings when belonging to a federation, we expect a similar effort to be fully informed before taking decisions: the threat of membership termination incites the management to pay attention to the opinions of the directors appointed by the cooperatives; this power over the federation course of actions provides an incentive to gather information before taking a decision.

The ability of cooperative federation to reduce the bias toward conservative policies

A weak governance may lead to a low corporate risk taking (John et al., 2008), which can be suboptimal. A dispersed ownership let the power to managers who bear the total risk of the firms and not only the non-diversifiable risk, as shareholders (Jensen and Meckling, 1976; Shleifer and Vishny, 1986). As a result, they adopt conservative policies which do not optimize shareholders' value. Mishra (2011) shows that while the presence of a dominant shareholder is associated with a low corporate risk taking, the presence and voting rights of multiple large shareholders are strongly associated with a higher corporate risk taking. The effect of the multiple large shareholders on corporate risk taking is strongly positive in family dominated firms (as opposed to non-family dominated firms). They help promote a more optimal non-conservative policy. By analogy, the presence of several cooperatives with a strong incentive to control and contest the dominance of the largest cooperative may result in reducing the risk aversion of the management of the cooperative federation.

3. Discussion

In this section, we discuss the main ideas of our literature review. Then, we discuss some empirical phenomenon which can be discussed in light of this analysis.

a) A governance which gives power and incentives for learning and monitoring

Our review of the corporate governance literature provides strong arguments in favor of a governance characterized by several large owners with an even distribution of power. This corresponds to the broad characteristics of cooperative federations as opposed to large centralized cooperatives which can be viewed as structures with a dispersed ownership. In particular, it is worth to be noted that the pioneer model of Bennedsen and Wolfenzon (2000) consider that the sale of shares by large shareholders is not possible, just as cooperative belonging to cooperative federations.

A key-factor of the efficiency of cooperative federation is related to the impact of exit by each member cooperatives on the immediate future of the federation. The detrimental effect of the exit is central in the model proposed by Claessens (2009) or Claessens and Manso (2011). Indeed, no individual member of large centralized cooperatives is able to orient the course of actions of cooperatives: their voice is only a vote in the general assembly; and exit, as long as it does not concern a large number of members simultaneously, can have an only marginal impact on the cooperative business. Their formal as well as their real authority on the organization are weak. In contrast, the member cooperatives of a federation have a voice in the federation and this voice is likely to be listened as their exit is detrimental to the federation activities. The impact of exit on the ex post value of the business is significant as the decisions to federate often implies investments which can lead to overcapacities if one of the partner defects: because of the geographic nature of agriculture as well as yield and price risks, the defection of one cooperative can have detrimental effects on the value of the assets implemented by the federation.

Moreover, the exit acts as an efficient governance mechanism also because this is a credible threat. Indeed, cooperatives are generally large enough to access market. Note that this mechanism protects the member cooperatives from the dominance of one or a coalition of them and from the possible control by managers as well.

The corporate governance literature provides another argument in favor of the cooperative federation: models where the vote structure is endogenous conclude on the efficiency of an even distribution of power. The standard explanation is that an even distribution of power is a way to reduce the risk of expropriation by dominant shareholders (Shleifer and Vishny, 1997). Bennedsen and Wolfezon (1999) provide another reason for the efficiency of an even distribution of power. Their model considers initial owners of firms raising equity capital. They have interest in minimizing cash diversion by coalition of shareholders. It comes that they should privilege an ownership structure characterized by few large shareholders to reduce the incentive of small shareholders belonging to coalition for diverting cash flows from larger shareholders. In this case, the even distribution of power reduce the risk of influence activities. The democratic principles would appear as an efficient governance device.

As a result, it comes that cooperative federations, as governance structures, give cooperatives both formal and real authorities (Aghion and Tirole, 1997) on the course of actions of the federation. The corporate governance literature shows that this power provides incentives to undertake learning process and to provide a tight monitoring of management. There are empirical evidences of the positive impact of closely held ownership structure on these two key-factors of value creation. There is no reason that they are not effective for cooperative federations as well.

b) For a detailed examination of the directors' skills and incentives for control

As stated by Fama (1980), the firms have been able to solve the risk of governance failure related to dispersed ownership via the separation of management and control, the control being exerted in the board of directors. Indeed, if the management is in charge of initiation and implementation of decisions, the directors are responsible for ratification and monitoring. A key-factor of efficiency is that directors have strong incentives for efficiency as they evolve in a competitive markets for their position. Another advantage of the separation of management and control is the transparency requirement for directors and thus, shareholders. Thus, the board of directors appears as an efficient institutional arrangements to make the Chandlerian firms efficient.

This approach, which corresponds to the standard theory of corporate governance, implies two questions: do we have people responsible for the ratification and implementation monitoring of decisions at the top-level of the organization? Do they have incentives for exerting this control function in the long run interests of all investors (we can include agents bringing assets other than financial assets)? Our literature review shows that the answer is yes for closely held corporations.

We suppose that the analogy with cooperative federation is relevant. However, there can be dissimilarities which undermine this assumption. Let's focus on the directors themselves. As employed by the large shareholders (either financial or not corporations), the directors of closely held corporations are fully involved and efficiently skilled to perform in this function. The situation is possibly different in cooperative federations where the directors are elected members of the first-tier cooperatives. If the monitoring and learning incentives related to the effective impact of their decisions on the cooperative federation should act as efficient governance mechanisms, they do not benefit from the expertise of large shareholders' appointed directors in performing this function. Plus, this function is not a full-time job as this can be the case for representatives of large shareholders. The current issue of training for board directors in cooperatives, stressed by policy makers (Coop de France and the Haut Conseil à la Coopération Agricole), suggests that this can be a weakness for the governance of large cooperative organizations.

In this perspective, the comparison between the cooperative federation with large and centralized cooperatives requires a focus on the initial skills and incentives provided to the directors for performing in their monitoring function. For example, it seems that the governance of centralized cooperatives, with regional section, makes the appointment process of directors not different from the ones of directors of cooperative federation: they are elected members from a groups of farmers at the local level. There could be a policy of directors' training in centralized cooperatives which could be more difficult to set up in cooperative federations. All these elements are important to understand why different governance practices can coexist in the same environment.

c) Cooperative federations in practice

Nowadays, there are 346 cooperative federations in France over a total of 1,883 cooperatives. According to the HCCA, 191 of them can be considered as the extension of cooperatives. The others can be considered as a legal structure to pool activities which do not encompass the core business of the member cooperatives. Among these two types of federations[2], a variety of ownership structure can be found.

In Vivo, the largest cooperative in France, is a cooperative federation with more than 216 member cooperatives. As such, the membership makes In Vivo a dispersed ownership structure. Tereos, the third largest cooperative in France, is a federation of 11 cooperatives. This corresponds to a closely held governance structure. However, the internal governance of Tereos is a bi-partite system, with a supervisory board, including the representatives of the member cooperatives, and a management board. As such, there is a clear distinction of management and control. This could be a way to reduce the influence activities which could arise in a board of directors. The drawback is that the directors are not hands-on the decision initiation and implementation. Reversely, Cristal Union is formally a centralized cooperative but the organization includes three cooperatives with a board of directors for each of them. These three cases show that the assessment of cooperative federation as a governance device requires a careful consideration of the possible interactions with other mechanisms of internal governance.

We can add that the wine industry may be particularly informative on the advantages and disadvantages of cooperative federations as a governance device. Indeed, there were strongly used by policy makers to implement vineyards restructuring and to access the in-developing supermarket distribution in the 70's. Many of them have not survived to the several wine crisis and internal governance problems, being absorbed by another federation or simply

[2] We thank Chantal Chomel, expert on cooperative governance in France, for having suggested this distinction.

disappearing. Some of them are real success in terms of market access and value creation. Others have led to merge. It is worth noting that cooperative federations appear as a possible efficient structure for the cooperative industry in wine. Indeed, in 2010, cooperative federations have been seen by the Bordeaux wine policymakers as a way to face the power of the supermarkets (CIVB, 2010). According to our knowledge of the sector, one challenge that the cooperative federation has to face is the lack of commitment of cooperative members: the federation can be seen as a distribution channel without a real strategic role in terms of market access and development.

Conclusion

Our literature review of the corporate governance shows that closely held corporations appear as an efficient governance device. We propose an analogy with cooperative federations which leads to formulate propositions to be discussed both on the theoretical and empirical sides.

In our perspective, cooperative federations appear as an efficient governance device as this prevents the risk of dominance by a particular coalition of members. It also prevents agents willing to make the organizations act in their particular interests to form coalition. In other words, cooperative members can have a voice in the organizations through the member cooperatives.

It reduces free riding as the little number of organizations implies a reciprocal monitoring which is impossible in organizations with dispersed ownership. The reciprocal monitoring is encouraged by the fact that each cooperative members have their skin in the game.

A powerful governance mechanism is related to the impact of exit on the whole organization by each cooperative. Indeed, exit by a member cooperative is both credible (i), as cooperatives are large enough to access markets by themselves, and sanctioning (ii) for the cooperative federations as this can lead to costly overcapacities if industrial investments have been made by the federation, or the impossibility of market access if there is an issue on the volume delivery. In turn, this real power on the whole organization implies commitment of the representatives of member cooperatives in the decision-making process, thus reducing the problem of management control, and encourage learning. These two key-factors of value creation have proven to be particularly effective in closely held corporations.

Another striking results of our literature review is that an even distribution of power among small large organizations appears as an efficient governance device. This is formally the case due to the democratic principle in the cooperative federation. This idea can explain the merges of cooperatives belonging to a larger federation, or the merges of cooperatives which are likely to reach a federation in a near future.

This advocacy for cooperative federations need to be confronted to the real practices of cooperatives. Indeed, first, we have to recognize that the consolidation of the industry has gone through merges rather than federation. Second many cooperative federations have become centralized cooperatives. Federation can be viewed as the first step of a merging process. A consequent question is: why cooperative federations, although all their advantages in terms of governance, are not more used by cooperatives willing to respond to the challenge of size through alliances with other cooperatives?

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