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United Producers Inc. Chapter 11 Restructuring

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Cooperatives have been used as examples of successful collective action activities. However, member free riding within cooperatives and other collective action groups continues to be a challenge. The board of directors and management of United Producers Inc. confronted the member free riding issue when creating a restructuring plan after their Chapter 11 bankruptcy filing. The plan integrated three strategies which have been proposed to mitigate free riding in large groups; coercion, a federated organizational structure, and selective incentives. This article compares Mancur Olson's theoretical framework for addressing free riding behavior with United Producers Inc. restructuring plan.

Introduction

United Producers Inc. (UPI) is a livestock marketing cooperative headquartered in Columbus, Ohio and has approximately 45,000 members. The cooperative owns and operates 42 facilities in Ohio, Illinois, Indiana, Missouri, Kentucky, and Michigan that serve as sites for weekly livestock auctions, collection points, and direct movement of livestock. It provides local market outlets for approximately 3 million head of beef cattle, dairy cattle, replacement heifers, hogs, sheep, and goats. The cooperative also provides farmers access to price risk management and production consulting services, and maintains a direct producer loan portfolio of over US$50 million through Producers Credit Corporation, a wholly owned subsidiary.

UPI was created in September 1999 through a merger of Producers Livestock Association (PLA) and Missouri Farmers Association (MFA) Livestock Association. The original parent cooperative, Producers Livestock Credit Association, was formed in 1932 to provide financing to farmers and ranchers for operating expenses and the purchase of breeding and feeder livestock. PLA was formed in 1934 as a marketing cooperative, and Producers Livestock Credit Corporation became its subsidiary.

Dennis Bolling became PLA's president and chief executive officer in 1989, and quickly realized that the cooperative needed to grow geographically and increase its market presence to remain a viable organization. PLA was involved in a high volume, low margin segment of the livestock industry. The livestock industry, as well

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as the structure of the marketing system, was changing rapidly. The meat packing sector of the industry was consolidating and seeking reliable access to larger lots of livestock with consistent quality attributes. This initiated a transition towards an increased use of marketing and production contracts, as well as put pressure on the traditional marketing channels to streamline operations.

The merger of PLA and MFA Livestock Association allowed the newly created UPI to expand and diversify geographically, increase its membership base, and expand the services offered to members. One important position taken within the merger process was that UPI would not own livestock directly, but rather would serve as a marketing outlet, provide risk management and consulting services, and supply needed financing for livestock producers.

In early 2000, Interstate Producers Livestock Association (IPLA), based in Peoria, Illinois, approached UPI to explore the potential of a second merger. UPI began relations with IPLA through a management agreement concerning IPLA facilities. The resulting operations suggested that a merger of the two organizations would not create the efficiencies desired by UPI. Instead, UPI chose to purchase selected assets from IPLA rather than pursue a full merger. This allowed UPI to once again expand its membership base and geographic reach without taking on under-utilized assets. It also allowed UPI to expand its hog contracting division.

In June 2000, UPI began discussions with Southern States Cooperative (SSC) to operate the latter's livestock marketing division. In 1998, SSC merged with UPI-competitor Michigan Livestock Exchange, which had facilities in Michigan, Indiana, Ohio, and Kentucky. UPI leased selected assets from SSC in December 2000 before purchasing them in early 2001.

In approximately 18 months, UPI had doubled its size, significantly increased its geographic coverage, and expanded its membership base. The core business strategy was working, but the expansion pace was greater than expected.

The George Young and Kathleen McConnell Fraud Problems

Before the merger of PLA and MFA Livestock Association, the latter passively owned 75 percent of MFA Livestock Services, LLC (limited liability company). Professional Business Services, Inc. (PBS), jointly owned by George Young and Kathleen McConnell, owned the remaining 25 percent and was the managing entity of the LLC. After the merger that created UPI, the name of the LLC was changed to United Livestock Services, LLC. UPI remained a passive investor and was not involved in United Livestock Services' regular business operations. In August 2001, PBS closed abruptly and subsequently filed for Chapter 7 bankruptcy protection.

Young and McConnell had been involved in fictitious transactions and had certified to their clients and lenders that their business owned 343,000 head of cattle, when in reality the business owned only 17,000 head. The scheme collapsed in 2001 when cattle prices declined and loan payments came due. Young and McConnell were indicted on several changes of fraud. They later pleaded guilty to these charges and cooperated with government agencies that were investigating the activities. The scheme cost individual investors approximately US$147 million and lenders approximately US$36 million. Approximately US$16 million was recovered through the sale of PBS assets and distributed to the fraud victims (*United States of America v. Young* 2005).

As a result of their passive ownership interests, UPI sustained losses from unpaid cattle sales to the LLC, as well as the basic investment losses. Furthermore, UPI was named in several subsequent lawsuits that claimed it should be held accountable for Young and McConnell's actions, even though UPI was but a passive partner and sustained its own losses due to the fraudulent activities. Attempts were made to settle the lawsuits out of court to save litigation costs, even though there was little legal grounding for the claims. However, these attempts failed. The legal expenses for fighting current and pending lawsuits were growing rapidly and placing a financial strain on UPI. In April 2005, the decision was made to file for Chapter 11 bankruptcy to protect the cooperative's remaining assets and allow time to reorganize.

The Reorganization Plan

After the decision was made to file for bankruptcy, the board of directors and senior management were confronted with the challenge of simultaneously maintaining business operations and developing a reorganization plan. A major effort was also made to keep employees informed about the source of the problems and the steps being taken to address the issues. UPI members were updated on a regular basis through newsletters and direct mailings, with extra attention paid to former MFA Livestock Association members who may have been directly or indirectly affected by the fraud activities.

UPI had been working closely with CoBank, its primary lender, and the bankruptcy court to ensure that regular business dealings with farmers would proceed smoothly immediately after the initial bankruptcy filing. However, how would the membership respond to the news of the Chapter 11 filing? Would members continue to patronize the cooperative, especially given that a large percentage of the current patrons had become members of UPI as a result of the preceding mergers and acquisitions? The first critical week of operations after the bankruptcy filing went better than expected and there was little change in gross business volume.

The next major step was to develop a restructuring plan. There were three central questions that the board of directors and senior management had to address: 1) is UPI a viable business entity if the legal issues can be resolved successfully; 2) what should UPI look like after the reorganization; and 3) how can the company rebuild its equity base?

Both an internal review and an external evaluation by a business-consulting firm indicated that UPI's core business would still be viable if the legal issues were successfully resolved. The next question concerned the structure of the business. A wide range of ideas were considered and a variety of business models were evaluated. This included converting to a corporation, a limited liability company, an employee-owned firm, a new generation cooperative, or maintaining the existing Section 521 cooperative status.

There was little doubt in the minds of the board of directors and senior management that the current membership base placed "value on the cooperative's presence in the marketplace," and that members were asking themselves what would happen if UPI were not there.[1] Feedback indicated that members recognized the value that UPI created through its ability to serve local needs and provide a competitive outlet for their livestock. Therefore, a decision was made to retain the existing cooperative structure, but reevaluate the cooperative's bylaws and membership policies. What changes could be made to members' rights and responsibilities to rebuild the cooperative's equity base?

Conceptual Framework: Cooperatives as a Form of Collective Action

Agricultural cooperatives have often been cited as examples of successful collective action efforts (Olson 1965; Staatz 1987; Hansmann 1996; Holmstrom 1999). Farmers and ranchers have utilized a wide variety of bargaining associations and alternative cooperative business structures in an attempt to create mutual and/or shared benefits. Although cooperative business objectives can and do vary, one frequently cited objective is to function as a competitive yardstick (Nourse 1922; LeVay 1983; Sexton 1986; Staatz 1987).

Producers Livestock Association, the parent cooperative of UPI, was originally formed to "provide livestock producers access to competitive markets" (*In re United Producers, Inc.* 2005). This objective continues today and is consistent with the competitive yardstick motivation for organizing cooperatives, as introduced by Nourse (1922). Nourse argued that a cooperative's primary function is to act as a competitive yardstick and ensure that local markets for agricultural inputs and production remain as close to a perfectly competitive market as possible. Under this rationale, the competitive pressure from the cooperative eliminates any potential economic rents from the local market. More competitive local markets are one example of the benefits from collective action with public goods attributes. They are non-rivalrous in consumption, difficult to exclude, and the benefits accrue directly to the individual rather than accumulate at the organizational level and re-distribute to members.

However, the public goods nature of more competitive local markets combined with the voluntary open membership policies of most cooperative business structures makes the free rider problem a significant issue for many cooperatives (Staatz 1987; Cook 1995). As local markets become more competitive, there is less incentive for individuals to patronize and/or invest in the cooperative. If a significant number of the cooperative's patrons switch their dealings to competing firms, the viability of the cooperative may be jeopardized.

Confronting the Free Rider Problem

Olson (1965) is credited with initiating a paradigm shift in the study of the challenges facing collective action organizations. Olson argued that group benefits that are difficult or impossible to exclude allow individuals to access these benefits, even though they have not contributed their proportional or appropriate share of the resources needed to supply the benefits. And, if an individual decides to contribute resources, everyone within the group would share any additional benefits resulting from these contributions. These combined conditions create weak direct incentives for individuals to contribute required resources towards group action, or provide individuals an incentive to free ride on the contributions of others.

Olson (1965) went on to argue that the dynamics within large groups were different from those of small groups. In small groups, a greater portion of the total group benefits is available to each individual, it is easier for group members to observe and/or detect changes in resource contributions relative to a large group, and it is less expensive to organize and coordinate the activities of a small group.

However, large collective action groups face a different set of conditions. In large groups, a very small portion of the total group benefits go to each member, and it is difficult, if not impossible, to detect when a group member alters their resource contributions or stops contributing. The costs of creating a large group are also greater than those for a small group. As a result, it is either very difficult or, at times, impossible for large collective action groups to organize and/or sustain the provision of difficult to exclude collective benefits.

Olson (1965) proposed three general strategies for mobilizing large collective action groups: 1) coercion; 2) a federated organizational structure; and 3) selective incentives. Coercion refers to a required or mandated contribution that could be administered by an external force, like the state, or internally by the organization. A common example of coercion within agriculture is the mandatory check-off process used by many commodity organizations for general market promotion and research activities.

A federated organizational structure divides a large group into smaller sub-groups, which increases the visibility of individual actions and enables the sub-groups to use social inducements to enhance participation. Many agricultural cooperatives, commodity groups, general farm organizations, and civic groups utilize a federated structure to keep local chapters or sub-groups small while still capturing potential economies of scale at the larger state, regional, or national levels.

Selective incentives include additional or supplemental incentives used to reward collaboration or punish non-collaboration, and target individuals who do not work towards the common interests of the group.[2] Olson (1965) provided two examples for the general concept of selective incentives. The first are social incentives available to small groups, such as prestige, respect, and friendship. These incentives are especially viable for small groups because of the close interaction of the participants. Social incentives are less effective for large groups because it is difficult for each member to know all other members.

The second example is "by-product" benefits used by large lobbying organizations or professional associations. The by-product theory points to a "joint offering or 'tied sale' of a collective and noncollective good that could stimulate a rational individual in a large group to bear part of the cost of obtaining a collective good." (Olson 1965, pg. 134). In this instance, a separate excludable private good is offered as a reward for contributing resources towards the supply of the non-excludable collective good. One specific example is access to a trade magazine or professional journal as a reward for paying membership dues to an association that emphasizes lobbying activities.

The Joint Products Model

Cornes and Sandler (1984; 1994) provided a model of consumer behavior that captures the concepts contained in the by-product theory. Within this model, an individual has a choice between purchasing either a pure private good or a commodity that generates a dual output (i.e., a public good output and a private good output). The purchase of this second commodity results in a joint product. This model is a generalization of the basic public goods model that contains a single pure public good and a single private good.

The joint products model integrates two attributes important for private collective action organizations like cooperatives. First, an individual's contribution towards the provision of a collective good can provide joint products in the form of a private good output and a pure public good output. Second, the individual's utility maximizing decision is still dependent upon the actions of others because the total provision of the public good results from the combined contributions of many individuals. The interdependence in the supply of the public good, then, is maintained.

The free rider problem continues to be a concern because an individual can still access the public good output without contributing appropriate resources. However, given the assumptions of the model, the presence of joint products does enhance the provision of resources and mitigates the influence of free riding.

The joint products model has similar characteristics to Olson's (1965) by-product theory. The broader by-product theory proposes tying access to a private good with resource contributions needed to supply non-excludable collective goods. The more specific joint products model suggests that an individual's purchases or resource contributions will simultaneously generate a public good and private good output. The key difference seems to be the underlying assumptions regarding the production relationship between the collective good and the private good.

Multiple Benefits Available to UPI Members

Attributes from both the joint products model and Olson's (1965) propositions for large groups can be found in adjustments made to UPI's bylaws and membership policies. First, there are multiple member benefits realized from UPI's business activities. Some of these are analogous to pure public goods, such as more competitive local markets for livestock, while others are private goods. Even these private goods can be separated into those that accrue directly to a specific individual member, such as reduced transportation costs through delivery to local receiving stations rather than delivery to competing facilities farther away, and those that accrue at the cooperative level, such as the margins gained by pooling deliveries from several producers to create larger lots that can be supplied to a processor at a premium. The cooperative level benefits are retained by the cooperative for a time and then returned to members based upon a measure of patronage.

Access to private benefits that are either joint and/or tied to a benefit with public goods attributes can provide an incentive great enough to encourage member patronage and resource contributions. Peterson (1992) demonstrated this by presenting a net cash flow investment analysis framework and decision making rules for member investment in cooperatives. Peterson argued that both the cash flows generated from the cooperative's assets (e.g., patronage allocations) and the cash flows from farm assets as a result of doing business with the cooperative must be included when estimating the total value from cooperative membership. The discounted value of the combined cooperative membership cash flows are compared to the discounted cash flows from an investment in other assets plus the farm level cash flow as a result of patronizing a non-cooperative firm. If the combined cash flows from cooperative patronage and investment are greater than the combined cash flows from non-cooperative patronage and other investment alternatives, an individual will have an economic incentive to become a cooperative member.

However, this framework does not distinguish between member level benefits that are unique to the individual (a private benefit) and those that have public goods attributes and are available to everyone. Individuals may or may not place full value on those benefits that have public goods attributes.

Adjustments to Member Rights and Responsibilities

Two major changes were made to the existing set of UPI member rights and responsibilities. The first was the addition of a per unit capital retain for every head of livestock sold through one of UPI's auction facilities or receiving stations. A per unit capital retain is a fixed fee that is withheld from the sales check as a member's contribution to the cooperative's equity capital. A US$0.75/head capital retain for cattle, US$0.25/head for swine, sheep, and goats, and US$0.50 head for any other species marketed was incorporated. This equity contribution does not bear interest or receive a dividend. After a five-year period, retained equity, both per unit capital retains and allocated retained net income, is returned to the member at book value on a revolving basis.[3] An upper limit of US$2,500 per member (U.S. dollars) was also included on total accumulated retained investment at any time during the five-year period.

The accumulation of per unit capital retains, in addition to the existing policy of allocation and distribution of annual cooperative net income, increased the level of available equity capital and provided the opportunity to rebuild UPI's financial base. This can also be viewed as a form of coercion (enforced by the cooperative), as Olson (1965) proposed. If a farmer or rancher sells livestock through one of UPI's facilities, a portion of the sales price is automatically withheld as a contribution to equity. The member does not have the discretion to determine how much will be withheld or when it will be redeemed.

The second major change introduced a second class of membership called a preferred member (as opposed to a general member). To become a preferred member, a producer must pay an annual US$20 preferred membership fee.[4] Preferred membership allows access to: 1) a discount on tariff schedules at auction facilities; 2) direct, or non-auction, marketing services; and 3) management and consulting services, risk management services, producer training and certification, and financial services. Additional fees are charged to perform the marketing, management, and training services, but they are only available to preferred members. The preferred membership fee is automatically subtracted from the first livestock sales check of the year. If a producer does not want to be a preferred member, they must formally request a refund.

This is an example of linking resource contributions used to create group benefits (e.g., preferred membership fee and minimum sales volume) with access to private benefits (e.g., discounted tariff fees, direct marketing and related services). Initiating the annual US$20 preferred membership fee for each of the approximately 45,000 members generates an additional US$900,000 in gross revenue.

Voting rights within UPI are also limited to preferred members who have marketed a minimum of 20 head per fiscal year through the cooperative. Eligible members can elect and serve as district delegates, who are the legal voting members of the cooperative. The district delegates, who represent defined trade areas, have the authority to elect the cooperative's board of directors and vote on changes to the cooperative's articles of incorporation and bylaws. Both district delegates and the board of directors serve three-year revolving terms and maintain a one vote per member policy.

This district voting structure establishes a federated voting configuration. So, while UPI does not have a formal federated business structure, where individuals are members of independent cooperatives, which are, in turn, members of a larger federated cooperative, there is a federated representation system.

An Emerging Program

In late 2008, UPI introduced a pilot intuitive in Michigan called the Community Markets program. This program allows a member to invest directly through preferred stock in their local auction facility to improve facilities, reduce debt, and provide a working capital buffer for the local facility. In return, the member gains the opportunity to receive dividends on the preferred stock that accrue from the facility's profits and benefit from the enhanced efficiency of their local auction. This program initiates an alternative form of federated structure. The member can directly invest in the specific local auction facility that will generate the greatest individual member benefits rather than invest in the parent cooperative as an integrated entity.

The Community Markets program is still under development and has not yet been fully implemented. However, the concept is an important component of UPI's long-term strategy, and will be expanded to other states if successful in Michigan.

Conclusions

Although there were initial concerns about member response to instituting per unit capital retains and a preferred membership structure, the changes did not generate a significant amount of negative feedback. UPI has been able to rebuild the member equity base and enhance member commitment to the cooperative. The Chapter 11 reorganization progressed rapidly and was approved by the bankruptcy court, without the assignment of a creditors committee, approximately six months after the initial filing. The outstanding legal proceedings were eventually dropped and UPI was neither connected to nor held accountable for the actions of Young and McConnell.

The two major changes to membership rights and responsibilities are consistent with the conceptual framework discussed above. First, combining per unit capital retains and patronage allocations diversifies the equity sources for the cooperative and ensures that each patron contributes some equity capital towards the provision of group benefits. Second, preferred membership links access to private benefits with essential resources needed by the cooperative, and these resource contributions simultaneously produce both public and private benefits to members. While the linkage of resource contributions with access to private benefits does not completely eliminate the incentive to free ride in the provision of collective benefits, it does significantly reduce free riding activities.

In addition, the district delegate voting system and the pilot Community Markets program introduce elements of a federated structure. These are intended to strengthen the tie to the local facility while offering an ability to capture economies of scale from a larger cooperative organization.

The challenge facing UPI's board of directors and senior management was to continue to provide their members access to competitive local markets and desired services while creating appropriate incentives for members to provide essential resources needed by the cooperative. This challenge is shared by many cooperatives around the world. The recognition that cooperatives can be a successful form of collective action with multiple member benefits created, with both public and private goods attributes, may provide insights into the design and implementation of member rights and responsibilities that provide stronger incentives for participation and contribution.

Notes

1. Personal correspondence with Dennis Bolling, president and CEO of United Producers, Inc.

2. Selective incentives were defined as "an incentive that operates, not indiscriminately, like the collective good, upon the group as a whole, but rather selectively toward the individuals in the group. The incentive must be 'selective' so that those who do not join the organization working for the group's interest, or in other ways contribute to the attainment of the group's interest, can be treated differently from those who do." (Olson 1965, pg. 51, emphasis in original).

3. According to UPI's bylaws, the only time that per unit capital retains and retained allocated patronage are not returned at book value is when net business losses are in excess of the unallocated reserves and member equity is required to offset the loss.

4. The preferred membership fee was recently increased to US$35 per year.

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