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Cooperative Conversions, Failures and Restructurings: An Overview

Murray E. Fulton*

Brent Hueth†

*University of Saskatchewan, murray.fulton@usask.ca

†University of Wisconsin-Madison, hueth@wisc.edu

Cooperative Conversions, Failures and Restructurings: An Overview

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The cases assembled in this special issue provide a rich setting for an examination of a number of cooperative conversion and restructurings that have occurred over the last 10 years. The cases also provide some lessons on the larger cooperative problems and questions in which cooperative researchers have been interested. The cases suggest that some of the conversions and restructurings are due to what can simply be called poor management, something that is not unique to co-ops, but is in fact common to all business enterprises regardless of their structure. At the same time, the cases also point out that common structural problems associated with cooperatives – such as lack of capital, property right problems and portfolio problems – do have an impact on the structure chosen by cooperatives and their members. Finally, a number of case-study authors point to increasing capital requirements in industrialized agriculture as a significant challenge for cooperatives seeking to integrate along the supply chain.

Introduction

Cooperatives are an enduring institution in the farm and food economy. Yet, the beginning of the 21st century appears to mark an important period in the history of agricultural cooperatives. Starting in 2000, critical structural changes began to occur among agricultural co-ops in the United States and Canada. A number of large co-ops filed for bankruptcy or converted to investor-owned firms (IOF) to remain financially viable.¹ Conversions and restructurings also occurred for other reasons, including the need for the co-op to obtain additional capital, the need to reduce members' production and price risk, and the desire by members to be able to access their equity or realize the market value of the co-op. Are these isolated events or an on-going trend? What can be learned from these events that can be useful to other cooperatives?

Murray E. Fulton is professor, Johnson-Shoyama Graduate School of Public Policy, University of Saskatchewan. Brent Hueth is associate professor, Department of Agricultural and Applied Economics, and Director for the Center of Cooperatives, University of Wisconsin-Madison.

The cases considered in this special issue were assembled to shed light on these and other questions. The case studies are the work of twenty-two researchers from across the United States and Canada with a keen interest in offering explanations as to why some agricultural cooperatives have failed while others have persevered and thrived through the various challenges that the agricultural industry has faced over the last decade.

While the included cases represent only a portion of the co-ops that were involved in some kind of restructuring, they do capture many of the types of restructuring that occurred and address many of the factors involved. As we will outline in this overview, a number of common themes and issues appear throughout the cases. The identification and illumination of these common themes through in-depth case studies was one of the objectives of this special issue.

To ensure that common themes were identified, the case studies were conceived of as research cases, rather than decision cases. Thus, instead of presenting the details of a case and asking – “What should the manager do when confronted with this situation?” – the approach taken was to identify a conceptual framework through which the case could be examined and understood. These conceptual frameworks are drawn from the economics of cooperatives literature and include property rights issues, life cycle theories, agency problems, market power, free rider issues and horizon problems. A comparison of the conceptual frameworks used to analyze the various cases allows common themes to be identified. This comparison also allows at least two bigger issues to be examined regarding the stability of the cooperative business form.

The first of these involves one of the key questions that runs through economics, namely the nature of the optimal form of business structure. For the economic analysis of cooperatives, the issues are specifically whether the co-op business form is efficient and whether this form will be eventually replaced by the investor-owned business form. By explicitly examining the restructuring of co-ops to other business forms (and vice-versa), the articles in this special issue are uniquely placed to assist in addressing this long-standing question of interest. While all the case studies implicitly consider this question, a number of them explicitly raise the question of whether the cooperative failure or restructuring was due to unique co-op features, or whether these changes in business form occurred because of what could be called business factors – i.e., problems such as poor management which can occur in any firm.

The second, and related, question that a comparison of the elements found in the conceptual models can shed light on is whether something structural has happened to agriculture in the last 20 years to make cooperatives less organizationally stable. The obvious source for a structural change is the so-called “industrialization of agriculture.” Numerous authors have speculated that agricultural industrialization will,

by removing what has historically been the foundation of agricultural cooperatives, namely the independent farmer, create a situation where co-ops are not required to solve the market failures and informational problems that they had previously addressed. As we will argue below, the structure of agriculture does appear to have played a role, although perhaps not in the way that has traditionally been argued.

Conceptual Framework Themes

Among the co-ops examined in the case studies, there are four examples of failure (defined as bankruptcy, start-up failure, or business closing), five examples of conversion to investor-owned companies, and four examples of significant restructuring (alliances, innovations in capitalization, and chapter 11 restructuring). One way to classify the cases is to group them into three broad groups: (1) those that went into bankruptcy or converted to an IOF because of poor financial performance; (2) those that converted to an IOF because of a need to acquire additional capital or a desire to access market value; and (3) those that were in the process of forming or were re-engaging in the market (for example, after bankruptcy). Table 1 provides a list of the co-ops examined in the case studies and the group to which they belong.

As will be seen, these groupings are useful in examining the factors that appear to be at work in the cooperative restructurings that were examined. Not all of the factors, however, lined up with the groupings – there were a number of factors that cut across the groupings. The next three subsections examine insights that emerge from considering the factors that correspond with the groupings, while the remainder explore those issues that cut across groups.

Management and Oversight

Not surprisingly, all the co-ops that belong to the first group were identified as suffering from poor management and/or a failure to modernize their operations (this includes relocating geographically as production and marketing patterns shifted) – after all, poor financial performance is almost by definition the result of poor

Table 1. Co-op Case Groupings

Group 1	Group 2	Group 3
Tri Valley Growers	Dakota Growers Pasta Co.	West Liberty Foods
Rice Growers Assoc.	Agricore United	Amer. Native Beef Co-op
Lilydale	Diamond Walnut Growers	N. Amer. Bison Co-op
SK Wheat Pool	Pro-Fac	United Producers Inc.
	FCStone	

management. Rather than re-focus on core values in response to tight markets, the managers of the cooperatives in these cases sought refuge in bold new strategies that were sold as significant new investment opportunities. It is intriguing that in two of these cases, Rice Growers Association (RGA) and Tri Valley Growers (TVG), the failing firms were survived by sister cooperatives – Farmers’ Rice Cooperative (FRC) and Pacific Coast Producers – within the same industry who managed to survive by maintaining a focus on service to members. These instances suggest that poor management may simply reflect a normal business outcome, and not the outcome of some flaw in the cooperative business model.

It is interesting to note that most of the co-ops that were identified as having poor management were also identified as having significant agency problems (e.g., lack of effective oversight by the board). This latter observation is important because it may shed some light on the reasons behind the poor management decisions and the consequent reduction in financial viability.

While most of the case studies only hint at why poor management may go hand in hand with problematic agency relations, the case study on the Saskatchewan Wheat Pool (SWP) suggests one reason – management overconfidence and hubris. The SWP case sketches out a complex relationship between management overconfidence and lack of board oversight, with overconfidence affecting oversight and vice-versa.

A useful avenue for future research would be to dig more deeply into the various behavioral relationships that exist in cooperative management and governance and to try and identify the root causes of poor management decisions and a lack of oversight. Regardless, however, of the mechanisms by which lack of oversight and management performance are connected, the case studies make it clear that this is an issue to which cooperatives need to pay particular attention if they wish to remain financially viable.

Cooperative Benefits and Objectives

It would seem self evident that a cooperative that converts to investor ownership (either with the support of management or via a hostile offer from investors directly to members) with full member support is furthering the economic interests of members. But is it? If members are treated differently as a result of conversion and, in particular, if over the long run markets become less competitive, then perhaps not. Just as investors considering the purchase of a given set of assets will carefully examine their long run earnings potential under investor ownership, cooperative members should attempt to value those same assets from a patron perspective when they are used by a cooperative. Unfortunately, little is known about “cooperative

valuation”; most work on corporate finance and valuation presumes an investor focus.

The case studies that comprise group 2 shed some light on these issues. Specifically, the cases nicely point out the issues that emerge when cooperatives reorganize to access additional capital or to realize market value.

First, it needs to be pointed out that reorganizing to access additional capital and reorganizing to realize market value, while conceptually distinct, are closely related and can often not be separated. It is for this reason that the various cases in group 2 have been grouped together. While it is perhaps clear in the FCStone (FCS) case that the members undertook a conversion to realize the considerable value that was present in the company, even here the desire to access additional capital to fully capitalize on the market opportunities available was identified as a factor behind the conversion. In the other cases considered, however, the separation cannot so easily be made. For instance, in both the Dakota Growers Pasta Company (DGPC) case and the Diamond Walnut Growers (DWG) case, the conversions occurred in part to provide older members with access to their accumulated equity. The value that could be realized for this equity, as well as the capital that was available for the co-op, depended critically on the financial structure chosen by the co-op.

Although conversion did allow the co-ops to access additional capital and current members to access their equity more easily (and, in some cases, to realize a significant capital gain on their equity investment), these were not the only impacts of the conversion. As an example, the DWG conversion resulted in some former co-op members facing a potential monopsonistic processor in the post-conversion period. The FCS case also examines what happened post conversion, concluding that the market for risk management services remains competitive and thus the former co-op members are not disadvantaged on that score. While the issue of post-conversion market performance was not explicitly identified for the other cases in this group, it could nevertheless emerge as an issue in these other co-ops. Indeed, there is evidence that Pro-Fac explicitly recognized this issue and negotiated long-term contracts that would reduce the opportunities for opportunistic behavior by buyers with which they are now contractually obligated to deal. As pointed out in the DWG case, however, the determination of future market structure may be difficult to do at the time of conversion.

Even without the emergence of a monopolistic market structure *ex post*, the question arises as to what should be the driving principle when producers make decisions about companies that they own. As the Agricore United (AU) case argues, continued member control, rather than the maximization of share value, is a legitimate objective and one that members should be able to pursue.

Cooperative Structure

The case studies in group 3 – by focusing on co-ops at the time they are forming or re-engaging with the market – provide insights into some of the key problems that have to be addressed in the architecture of co-ops. These problems include free rider issues (United Producers Inc. (UPI)), agency problems (managerial opportunism in the case of North American Bison Cooperative (NABC) and overall operational performance in the West Liberty case), and the inability of members to supply sufficient capital (American Native Beef Cooperative (ANBC)).

As the cases make clear, finding solutions to these problems affects the organizational structure chosen by the cooperative. In the UPI case, the co-op introduced a federated voting structure and altered membership rights and responsibilities to deal with free rider problems. Agency problems in the West Liberty case were partially dealt with through the production contracts used by members, and management monitoring is evolving in the NABC case to address potential opportunism. The NABC case illustrates how the failure to recognize capital constraints resulted in the lack of co-op formation and how a different financial structure may have allowed a producer-driven organization to develop.

In addition to providing insights regarding problems with cooperative architecture, the cases in group 3 also point to sources of cooperative advantage. In particular, although in the next section we discuss difficulties that cooperatives have in accessing capital for business operation, the West Liberty Foods case in group 3 describes how cooperative formation can be necessary to secure access to capital. In particular, by assuming ownership responsibilities (investment, risk, and managerial oversight), growers secured the capital (both from member growers and lenders) needed to continue operations for a processing facility that previous investor owners had intended to shut down.

Capital

The ability of cooperatives to access sufficient capital for their operations is, of course, one of the most discussed issues among co-op leaders and researchers. Thus, not surprisingly, this issue cut across all the groups and was explicitly discussed in many of the cases. However, although the issue was common, its manifestation was different across the cases. Since the role of capital for the co-ops in groups 2 and 3 was discussed above, the focus of this section is on the role of capital for the co-ops in group 1.

For co-ops in the first group, the capital issue emerged explicitly in terms of a rising debt-equity ratio, which eventually resulted in financial difficulties. It would be incorrect to conclude from this evidence, however, that access to additional capital would necessarily have solved the problem. As the SWP case illustrates, even

with access to large amounts of capital from its share conversion, the SWP still became too heavily leveraged; indeed, the access to relatively easy capital was one of the factors that allowed overconfident managers to take control of the co-op and to spend with virtually no restrictions.

With that caveat in place, what can be gleaned from a number of the cases – this includes TVG, RGA, and Lilydale – is that a shortage of capital, combined with a willingness by the board and management to heavily leverage their co-ops, were the factors responsible for the co-ops getting into financial trouble. As these cases illustrate, management believed that the changes occurring in their industry required them to redefine their business operations and to integrate further along the value chain. The case studies also make clear that these co-ops were unable to access sufficient capital from their members to allow the cooperative to undertake this integration. Nevertheless, management leveraged their co-op's operations so the co-ops could participate in these additional activities. The result of this strategy, however, was that the co-ops were unable to survive financially and they either declared bankruptcy or were acquired by or converted to an IOF.

The Pro-Fac case is interesting because it describes a co-op that took a different path. Pro-Fac concluded that its best strategy was not to participate in the value added processing and marketing segments of its industry, but instead to retrench and focus its activities much nearer the farm level. DWG also pursued a different strategy, opting to convert to an IOF when they had troubles raising capital through their membership for a shift into more value-added activities (e.g., the snack food sector). In contrast, the TVG, RGA, Lilydale, and SWP cases all illustrate situations in which management tried, unsuccessfully, to push their operations into areas further away from the farm gate. Further evidence for this view is also provided by FRC (it is described in some detail in the RGA case), which emerged as a strong player in the California rice industry by focusing its activities on bulk handling and processing.

The pattern described above suggests that a structural shift may have indeed taken place in agriculture, one with which it is increasingly difficult for cooperatives to deal. As agriculture becomes more industrialized, the need for capital at the processing and marketing levels increases. The question raised by the case studies assembled in this special issue is whether cooperatives are able to access sufficient capital from their members to be able to effectively compete in these market levels.

It has long been noted that co-ops are typically located near the farm gate level and that they have had trouble moving up and/or down the supply chain. Indeed, this inability has been seen as problematic, since it indicates that co-ops may be unable to integrate to the point in the supply chain where market power is an issue. Nevertheless, some co-ops have been able to move beyond the bulk handling of commodities and into processing. The interesting thing about the case studies

assembled is that there is now some indication that even those co-ops that had been able to successfully adopt this strategy in the past (e.g., TVA, RGA, Pro-Fac, DWG) are now finding it difficult to do so.

Property Rights and Portfolio Problems

The cases also highlighted the various property rights problems that have been argued to affect cooperative structure and performance. Included among the problems that were discussed were the horizon problem, the free rider problem and cross-subsidization through price pooling arrangements. The portfolio problem was also discussed in a number of cases. As has been often argued in the literature and as is seen in the case studies, one of the important impacts of these problems is on capital availability.

The horizon problem was explicitly identified in the DWG case, where it was argued that one of the factors leading to DWG's conversion was the significant member resistance to the increased crop retains that were required when DWG entered the snack food market. The horizon problem in this case may have been exacerbated by a board that represented older growers. Similar concerns were hinted at in other cases. In the Lilydale and the SWP case, for instance, it was argued that older members held a significant share of the equity, and that numerous co-op decisions were designed to ensure that these members were able to access their equity.

The DWG case also provided an example of the free rider problem – in this case, the new members were able to free ride on the investments made by the existing members. The result, particularly when combined with the horizon problem, was a reluctance by the existing members to making investments in the co-op. The free rider problem was also identified in the UPI case, where, as was discussed above, a federated voting structure and altered membership rights and responsibilities were introduced to deal with the problem.

Cross-subsidization across commodities was identified as a problem in the TVG case where tomato and olive growers received higher payments than they would have received in stand-alone pools (fruit producers, in turn, received a lower price). Although cross-subsidization often has the effect of lowering member commitment among those members who produce the product whose returns are being siphoned off, in the TVG case this effect was relatively small (because of few outside options, the fruit growers stayed with the co-op). Instead, the problem that emerged was that TVG continued to invest in tomato processing, even when this market segment was not doing well financially. Thus, cross subsidization served to mask market signals and to keep TVG in an operational rut that eventually bankrupted the co-op.

Finally, the portfolio problem was viewed as being important in the TVG, DGPC, West Liberty and ANBC cases. Contracting with the co-op exposes members to various degrees of both production and price risk, while investment in the co-op results in investment risk. The ability or inability of producer members to take on these risks was identified as being an important factor in the co-op's organizational structure decision.

Discussion and Concluding Comments

The cases assembled in this special issue provide a rich setting for examining both the details of a number of cooperative conversion and restructurings, and general lessons on the some of the larger cooperative problems and questions. They also provide the jumping off point for additional research and investigation.

One of the questions that has long intrigued cooperative researchers is the question of the efficiency and efficaciousness of the cooperative business model. The cases that have been assembled shed light on this question. They suggest that some of the conversions and restructurings are due to what can simply be called poor management, something that is not unique to co-ops, but is in fact common to all business enterprises regardless of their structure.

At the same time, the cases also acknowledge that the common structural problems associated with cooperatives – namely lack of capital, property rights problems, and portfolio problems – do have an impact on the structure chosen by cooperatives and their members. In this regard, the conversion examples arguably are the most illuminating about the unique challenges that face cooperative businesses.

Cooperatives can be viewed as symptomatic of an underlying problem with investor ownership. They exist in the economy to fill gaps in the provision of goods and services, and to counteract market power. According to this view, the cooperative business structure is a corrective measure, but also a costly one to be avoided if it is not needed. They are costly because they must be financed and governed: just as there is no need for consumers to form a cooperative to purchase (or possibly produce) pins and needles, neither should we expect farmers to form a cooperative to buy or sell goods and services that are conveniently and competitively available from investor-owned firms.

This view suggests at least two potential causes of pressure to convert from cooperative to investor ownership. First, the existence and structure of any given market evolves over time with changes in technology, consumer preferences, the institutional framework supporting the market (e.g., antitrust enforcement), and relevant state, federal, and international policy that may affect supply and demand conditions. If the underlying problem with investor ownership is, to some extent, remedied by these changes, a cooperative operating in this market may lose its rel-

evance. The conversion at Lilydale and DGPC, and perhaps to a lesser extent, the hostile takeover of AU, fit this category of cause for conversion. Where at one time early in their history these cooperatives each were a source of competitive pressure in strongly oligopolistic markets, they each had become just another buyer in increasingly competitive world markets for poultry and grain, respectively.

Second, once a cooperative is in place with physical assets and operating capital, it is natural for its management team to pursue growth in scale and scope of operation. In a canonical setting for cooperative emergence where there is clearly an absent market or severe market power abuse, managing a cooperative profitably and sustainably is a matter of competent administration, logistics, and accounting. However, as markets evolve and cooperatives find themselves competing intensively for member patronage, management is apt to take a more proactive and offensive approach in setting strategy. With a good management team, and some luck, it is possible to generate significant firm value in following whatever strategy is put place.

Paradoxically, success of this sort can be the downfall of a cooperative. As soon as a cooperative tries to provide members with liquidity through some form of earnings distribution, it is inevitable that members seek and expect continued earnings. With a focus on “earnings,” a cooperative loses its essential character to focus on patron value. Additionally, without carefully designing equity management policies that maintain primary control and equity stake in the hands of current patrons, it is easy to end up with an intergenerational conflict, where members who are nearing retirement want to cash out their ownership stake. Alternatively, if the market value of a cooperative’s assets exceed book value by a sufficient amount, it may be feasible to get near unanimous support for conversion. The Diamond Walnut, DGPC and FCStone cases seem to fit this description.

The case studies also shed light on a related question of interest to cooperative researchers, namely whether the structure of agriculture might affect the structure and nature of cooperatives. The inference to be drawn from the cases is that, yes, there may be a relationship. One of the hypotheses to emerge from the cases is that the capital requirements of industrialized agriculture have increased to such a degree that it is becoming increasingly difficult for co-ops to operate much beyond the farm gate. One of the implications of this hypothesis is that co-ops may find themselves increasingly unable to integrate up to the point of the key market failures (e.g., overly concentrated markets). If this is the case, then the ability of co-ops to provide the “yardstick of competition” may be in jeopardy. The loss of such a role could have a myriad of implications, including lessened support for an exemption from antitrust rules.

At the same time, the case studies also suggest another link between the structure of agriculture and the structure of co-ops. As the West Liberty case illustrated, the formation of a co-op was associated with a significant shift in the structure of the

contract between the grower and the processing facility. Further work is required to determine if this linkage holds in the other direction – i.e., if shifts in the nature of the contractual relationships in agriculture, as seen in agricultural industrialization, have impacts on the structure of co-ops.

The case studies also suggested other areas of fruitful research. Understanding the motivations of managers, for instance, as they increasingly leverage their operations, would appear to be important. Was such behavior due to overconfidence and hubris, as suggested in the SWP case, or was it due to other factors such as a need to satisfy the needs of particular member groups?

One issue that did not receive mention in the discussion above is fraud and financial misreporting. As the cases make clear, cooperatives are not immune from this problem – this was an issue in at least three of the co-ops examined (RGA, TVG, UPI). To date very little work has been done on this issue in co-ops, although it has been receiving attention in the business literature. This lack of research may be particularly significant at the international level, where co-ops in developing countries (and even in some developed countries) are known to be focal points for corruption and government intervention.

To conclude, we would like to thank the authors for their work on these cases. When the idea of a collection of case studies on cooperative conversions, failures and restructurings was first proposed, the interest by authors was immediate and overwhelmingly positive. The authors shared our view that the case histories of a number of the co-ops had to be completed while key individuals associated with the co-ops were still available for interviews and while events were still relatively clear in participants' minds. A special thanks is due those individuals who participated in interviews.

The authors' initial enthusiasm was followed up with a commitment to getting articles written and reviewed – the deadlines that were set were all met and the special issue came out on time. We were also pleased that many of the authors were able to present their cases at the November 2009 NCERA-210 Annual Meeting in St. Paul, MN. The conference discussion was very useful in shaping the form of publication and in providing the authors with feedback.

Notes

1. Included in this group were Tri Valley Growers (TVG), Rice Growers Association (RGA), Agway, and Farmland Industries Ltd in the United States, and Saskatchewan Wheat Pool (SWP), Agricore, Dairyworld, and Lilydale in Canada. TVG and RGA filed for bankruptcy in 2000, followed by Agway and Farmland Industries in 2002. In 2001, Agricore was acquired by United Grain Growers and Dairyworld was purchased by Saputo. Both SWP and Lilydale converted to IOFs in 2005.