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Factors behind the Fonterra Shareholders' Rejection of the Board's Capital Restructuring Plan of 2007

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Abstract:

The New Zealand dairy cooperative Fonterra is one of the largest in the world. In 2007, its Board presented a capital restructuring proposal with the aim of reducing the equity redemption risk, solving members' portfolio problems, and acquiring capital for the cooperative. The proposal indicated that external owners would be allowed, but that members would own most of the stock. The shareholders rejected the proposal. This analysis of why the proposal failed shows that two specific characteristics of Fonterra were primarily responsible: The shareholders considered the Fair Value Share to be instrumental in securing full member control and the Shareholders' Council effectively channeled members' opinions.

Keywords: Fonterra, New Zealand, cooperative, dairy, Shareholders' Council, Fair Value Share

Introduction

In recent decades, several agricultural cooperatives in Western economies have undergone a process of conversion, failure, and restructuring (Gunnarsson Myrelid 1999; Fulton and Hueth 2009; Lamprinakis and Fulton 2011; Boland and Cook 2013; Hess, Lind and Liang 2013). This study presents a case where the shareholders succeeded in preventing restructuring.

In 2007, members of the large New Zealand dairy cooperative Fonterra rejected a proposal by the Board to change the ownership structure of the cooperative. The Board proposed introducing a publicly-listed entity that would hold the operating assets of the cooperative. The intention was that 85% of the listed entity would be held by a 100%-owned cooperative, with ownership linked to supply. However, this entity was not implemented due to a fear among farmers that they would lose control.

Major changes in Fonterra's capital structure occurred thereafter in 2009 and 2012. The stakeholders succeeded in finding solutions to raising more capital, including external sources, while at the same time securing

member control and preventing the redemption risk to the cooperative (Fonterra 2009). Shadbolt and Duncan (2014, p. 443) describe the innovations as: "...allowing members to hold more shares than required and the unbundling of payout to farmers into a dividend on shares and a milk price on milk solids supplied" and "... introduction of outside equity, not to purchase and become owners in the cooperative, but to purchase 'economic rights' from members and trade them in a separate listed exchange."

The present study explores whether two specific characteristics of Fonterra, its Shareholders' Council and its Fair Value Share, influenced the decision by members to vote against the Board's capital conversion proposal in 2007. These characteristics are interpreted in terms of the construct of cooperatives' vaguely defined property rights. Fonterra's later capital reforms are not analyzed.

The next section describes the core characteristics that Fonterra possessed in 2007, when the restructuring plan was proposed. The following sections describe the methodology used for data collection and the information obtained. The data are then subjected to theoretical interpretation. In a final section, conclusions are drawn.

Background

Fonterra Cooperative Group Ltd

The dairy industry is New Zealand's largest export earner. The major dairy processor is Fonterra, which is one of the world's largest dairy processing firms, exporting about 95% of its production and handling approximately 95% of New Zealand's milk production. Fonterra accounts for more than 30% of the world's trade in dairy products. It also represents more than 20% of total New Zealand merchandise exports and 7% of its Gross Domestic Product, making it New Zealand's largest company. Fonterra is owned by more than 11,000 New Zealand farmers. Its main products are milk powder, cheese, butter, and casein. Important export markets are the USA, Japan, the Philippines, Mexico, and Southeast Asia.

Fonterra was formed in July 2001 after a merger between the government organization, the New Zealand Dairy Board, and the country's two largest cooperatives, the New Zealand Dairy Group and Kiwi Cooperative Dairies (Nilsson and Ohlsson 2007). To allow for an almost monopsony, the government required the introduction of a

“Shareholders’ Council”. Before the merger, the performance of the various processors was compared based on the margins they added to the Dairy Board’s payout (Bayliss 2003). Since this practice would no longer be possible after the merger, the government demanded the introduction of a “Fair Value Share”. Furthermore, it demanded that Fonterra be an open membership cooperative, fully owned and controlled by farmers, with its main objective being adding value to its shareholders’ milk.

The Shareholders’ Council

Fonterra’s Board has 13 directors. Under the Constitution, nine are elected from the shareholder base for a three-year period. The remainder are appointed by the Board and approved by shareholders at the Annual General Meeting. Fonterra has no executive directors.

To ensure that the needs of shareholders would be recognized by the Board after the merger, the Shareholders’ Council was established. It operates independently of Fonterra, and is made up of 35 elected shareholders, one from each of the cooperative’s wards.

The Shareholders’ Council established Fonterra’s cooperative philosophy, which applies to Fonterra’s cornerstone activities, i.e., the collection, processing, and marketing of shareholders’ milk, to ensure that these activities remain within the true cooperative structure. The principles are (Fonterra 2002):

- Shares in Fonterra Cooperative Group can only be held by supplying shareholders.
- Fonterra’s supplying shareholders agree to the dual commitment to supply milk and invest capital.
- Supplying shareholders are issued with, and must hold, cooperative shares in proportion to their total milk solids supplied.
- Control of Fonterra is exercised by its supplying shareholders, who have voting rights in proportion to their total milk solids supplied.
- Financial benefits and obligations that arise from cornerstone activities are allocated to supplying shareholders in proportion to their total milk solids supplied.

The Fair Value Share

Shareholders' investments in Fonterra are equivalent to purchased shares. Preceding the merger, no market for trading shares in the cooperatives existed. Transactions were based on a nominal share value and therefore shareholders could not assess the value of their investments. In connection with the merger, an appreciable and depreciable share was introduced – the Fair Value Share. Its value is decided by the Board before the start of each season, based on a valuation range determined by an independent valuer appointed by the Shareholders' Council. When setting the range, the independent valuer takes the following factors into account:

- Fonterra's likely future earnings after deducting the valuer's assessment of the commodity milk price in the future.
- Projected earnings of Fonterra's separate businesses, corporate overheads, research and development, and other operations.
- Forecast volume of milk supplied to Fonterra.

The Fair Value Share reflects the value of the future return to shareholders from Fonterra's value added activities. This value represents the extra return Fonterra is able to create on top of what a business selling only basic commodity products from New Zealand can earn. Hence the value comes from sales of consumer and food service products. The shareholders hold shares in proportion to the volume of milk they supply. No dividend is paid on shares.

The Board's Proposal for Capital Structure

In 2007, Fonterra's Board suggested a change in the capital structure. The Board predicted large investment opportunities in the global dairy industry. According to the Board, Fonterra's existing capital structure had some shortcomings (Fonterra, 2007):

- "Exposing the company to unsustainable redemption risk"
- "Does not allow farmer choice"
- "Will not allow the delivery of Fonterra strategy due to insufficient capital"

The Board claimed that a redemption risk existed, as the appreciation in the Fair Value Share provided an incentive to leave the cooperative. A high value of the Fair Value Share also made it difficult for young people to get into dairy farming because of the need for a large initial investment. Furthermore, the Board claimed that shareholders wanted choice regarding their investment portfolios and that the future of Fonterra depended on its growth strategy, which would require capital. The Board reviewed the existing capital structure when assessing whether the capital structure would serve its strategy and solve the issues of redemption risk and members' investment choices.

According to the Board's proposal, the supplier cooperative would remain as Fonterra Farmer Co-operative and a second company, Fonterra, would be created (Fonterra, 2007). All the assets and liabilities in the cooperative would go into Fonterra. Fonterra would be listed and hence the stock market would determine the value of the shares. After listing, farmers would own approximately 65% through the Fonterra Farmer Co-operative and around 15% through individual shareholding. The public would hold the remaining 20%. In legal terms, Fonterra would be a subsidiary of Fonterra Farmer Co-operative.

Approach

Data for the present analysis were collected in January 2009 through personal interviews with 12 individuals with insights into Fonterra. These included individuals who advocated conversion and individuals who worked to prevent it, and they were divided into four groups: Board members, Shareholders' Council members, dairy farmers, and individuals outside Fonterra with insights into cooperatives. An interviewee often suggested another person worth interviewing. The different positions of the interviewees provided broad perspectives.

The interviews were carried out using a structured question guide focusing on the Board's capital restructuring proposal. The questions were open, and in some interviews, led to further questions. The interviews lasted for about an hour each. Eleven of the interviewees permitted audio-recording of their interview, and the recordings were transcribed.

The next section presents the views within the four groups of interviewees and examines the extent to which the shareholders' reactions to the Board's proposal may be related to the two government stipulations made in connection with the formation of Fonterra.

Information obtained through the interviews

The Shareholders' Council

The Board is responsible for the governance of the company, while the Shareholders' Council works with regional representation. The 35 wards elect one councilor each.

This is quite good because even though you get elected through an election process, you never want to mix up your roles between representation and governance. As a governor it is your obligation to run the business in the best interest of all shareholders. The Shareholders' Council plays the representative role and should also help inform the Board of issues faced by the farmer shareholders. (interview with Jim van der Poel, Board member)

With only nine farmer directors, the Board's communication with shareholders is limited. However, the Shareholders' Council can carry out the function of explaining what is going on in Fonterra. Since each ward has one councilor, a network is created.

Most farmers just want to be dairy farmers and do not take an interest in what happens at the Board level. The councilors are living in the district they represent, and people generally know them. (interview with Jim van der Poel, Board member)

Many non-elected directors are said to have no knowledge of cooperatives. A concern is that some Fonterra directors are not committed to keeping Fonterra as a cooperative. One interviewee argued that Fonterra should bring in external directors with knowledge about cooperatives. Another comment was that business advisors lack knowledge about cooperatives.

The Shareholders' Council must ensure that Fonterra follows the Constitution. The councilors interviewed here pointed out that it is important never to forget these obligations. If the Shareholders' Council is able to perform its duties, trust from the shareholders will be strengthened. The Shareholders' Council also has the role of monitoring the Board, but does not have the authority to make any business decisions. However, it

can call a special meeting with the Board to solve problems. The relationship between the Board and the Shareholders' Council occasionally becomes strained. According to the interviewees, the Shareholder Council's most powerful tool is to criticize the Board behind closed doors.

Fonterra's General Assemblies are conducted by video-conference, whereby the Chairman of the Board gets a better opportunity to control the meeting. Anybody demanding change has to act in advance. The Shareholders' Council acts to ensure that farmers are represented on the Board. Because the Shareholders' Council represents the shareholders in dealings with the Board, it has also created less direct involvement than when shareholders attend meetings.

As companies get bigger, the Board becomes less concerned with shareholder issues and more with business management. Hence there was a need for an organization to truly speak on behalf of the shareholders. (interview with Keith Holmes, dairy farmer)

At one time, more open communication existed between the directors and members, but fewer members now ring up their local director and complain. Some members feel that going to a meeting is a waste of time. Members rarely see the Board members and the executives and farmers are concerned that the Board and executives do not understand the business of farming. A further concern is that some directors will not permit challenges from potential new directors and will hold power at any cost.

25 years ago when I was farming in Taranaki and supplying milk to Kiwi, if there was a dairy meeting (we were sort of on the main road) everyone would pass us to go to the meeting. And farmers were a lot more involved when the company was smaller and they could relate to it better. There is certainly not that involvement now. (interview with Tom Mason, dairy farmer)

Most members know little about Fonterra's international operations. The Shareholders' Council has to make sure that the information it provides to the shareholders accurately reflects what is happening. A problem mentioned by one interviewee is that it is difficult

to find skilled candidates for the Shareholders' Council. The Council also mitigates the tension between the members and the Board and organizes debates in village halls.

Fonterra has become big and complex; hence the issues have become difficult to grapple with. As a result, there has been a certain amount of passing the buck to the Shareholders' Council. (interview with Keith Holmes, dairy farmer)

The media has sometimes criticized the councilors when they support the Board. Among the farmers interviewed, there was also an element of mistrust in the Shareholders' Council. Some members feel that the Shareholders' Council listens too much to the Board and members feel powerless (interview with John Luxton, dairy farmer).

Instead of being a watchdog on behalf of the shareholders, the Shareholders' Council has become a puppet for the Board. (interview with Catherine Bull, dairy farmer)

In general, however, farmers think that the Shareholders' Council protects the shareholders. When Fonterra appears to be in trouble, the Council realizes that it has to get in touch with the Board. A concern expressed by one member is that it may be difficult to find Board members that represent the membership. The members' best opportunity of disciplining the Board is through the Shareholders' Council.

The councilors interviewed claimed that it is a privilege for the farmers to have a group of people who have access to more information than the average member. However, due to the fact that the Shareholders' Council represents farmers to the Board, there is a risk of less involvement by members than would be the case without the Council.

A lot of the farmers abdicate the responsibility for involvement in Fonterra to the Shareholders' Council or a council member. (interview with Blue Read, Council member)

During the capital restructuring process, the councilors attended meetings convened by the Board and formed opinions about the new direction the Board was proposing. However, the Shareholders' Council

adopted a neutral stand until information had been collected from the members by formal surveys and discussion groups. This information indicated to the Shareholders' Council that the members were not happy with the proposal.

We were not promoting or negating the proposal, but we were making sure that people understood the particular new parts of the proposal. (interview with Campbell Shearer, Council member)

When dealing with complex matters such as capital restructuring, the Board and the Shareholders' Council may have secret debates. The Shareholders' Council later informs the farmers and reports back to the Board about members' opinions. Disputes between the Board and the Shareholders' Council may be destructive, damaging members' trust in both parties. A councilor interviewed here pointed out that if no council was in place to convey the information to the members, groups of self-appointed people trying to effect change in their own interests would emerge. In Fonterra, the term "ginger groups" is used.

During the capital restructuring process, the Shareholders' Council commissioned a report about what farmers thought about the proposal. The response was overwhelmingly negative. The Board realized the proposal was not as good as management thought and at one stage brought in a mediator to try to relieve the tensions between management and the Board.

According to one of the interviewees, reports from the Shareholders' Council are more informative than reports from the directors. It seems that the Shareholders' Council plays an important role, especially in protecting the smaller farmers. Fonterra's members are both family farmers and corporate farmers. This diversity creates tension, since corporate farmers want changes on economically rational grounds, whereas family farmers also have a community perspective.

The Shareholders' Council is a wonderful voice for farmers to make their views known to the Board, and it is inevitable that members are more involved because of the Shareholders' Council and if it was not there, Fonterra would probably have been demutualized by now. (interview with Alan Robb, independent financial commentator)

The Shareholders' Council expresses an opinion on all constitutional matters. The Board has never gone to the farmers with a proposal that the Shareholders' Council did not support. However, one interviewee expressed a worry that the Board will tell the Shareholders' Council that its public statements harm the cooperative.

As the Board was forming its view regarding the capital restructuring proposal, the Shareholders' Council awaited the voice of the farmers before revealing its view. A possible reason is that the Shareholders' Council thought the proposal was "too hot to handle" (interview with Earl Rattray). If the Shareholders' Council had formed a negative view of the proposal, the Board would probably not have taken the proposal to the members.

The lesson for Fonterra here is that you cannot go to a vote if you do not have the Shareholders' Council's support. You also cannot put a proposal in front of the members if you do not have the Shareholders' Council's support. (interview with Earl Rattray, former Board member)

Telephone surveys showed that 85% of the members did not like the proposal, so the Board postponed the vote. However, members believe that the Board still wants to change Fonterra's capital structure. Thus members feel that Fonterra is not always honest with them and that the communication from the Board is not always sufficient.

The next thing in the media is that the proposal is off the agenda because the shareholders do not want it. Then you read in the paper that the Chairman of the Board is saying it is back on the agenda, which means he has ignored the voice of the shareholders. (interview with Catherine Bull, dairy farmer)

The farmers interviewed feared the capital restructuring proposal would lead to the cooperative being listed on the stock exchange. Some did not think a cooperative could stay partially demutualized. Other farmers agreed with the Board that members have to be given a choice as to whether they want to take part in the business outside the core business or not. Furthermore, they believed that the core business had to remain a cooperative. Farmers wanted to own the processing plants and the infrastructure to get their product to the market.

A worry expressed by one farmer interviewed was that New Zealanders had difficulty in understanding that other cooperatives, for example in Europe, had been demutualized step by step. Hence, New Zealand farmers could not see what a new capital structure would entail.

The Fair Value Share

The valuation of the Fair Value Share is quite complex. It is partly based on the cash value, mainly coming from the value-added part of the business. The valuation also includes market multiples, where the valuer makes comparisons with other international firms. When setting the value of the Fair Value Share, the independent valuer considers Fonterra's ten-year business plans and projections. On such bases, the valuer comes up with a value, discounted into the current value of the cooperative.

Some members might not understand the function of the Fair Value Share, while others do not believe the growth stories. Members worry when the share price sometimes drops.

Most farmers just want to be farmers – they want to get up and milk their cows and make sure the tanker is coming and that the check comes in the mail every 20th of the month. They want to be confident that they have an outlet for their milk and that they get a fair milk price. (interview with Jim van der Poel, Board member)

According to the interviewees, an issue is that the way the Fair Value Share is calculated can give the larger members with large production volumes exorbitant amounts of money. Due to the large-scale structure of New Zealand dairy farming, a number of members operate several farms of considerable size that they no longer run themselves. The large milk quantity thus created entails a large number of shares. According to one of the interviewees, the 200 largest members control 50% of the milk in Fonterra.

A disconnect is growing between these large shareholding farmers and farmers with smaller herds and fewer shares. Small producers are also marginalized within the existing voting system, where shares, and thus the number of votes, are in proportion to the farmer's milk solids.

A fear today, and it is not far away for Fonterra, is where the shares are in the hands of too few. (interview with Campbell Shearer, Council member)

Conflicts of interest between different member categories are increasing, because some New Zealand farmers are buying sheep farms and converting them to dairy farms. They compare the price of a dairy farm with what it would cost to convert the sheep farm, what the share price is, and how much they can afford to pay for the sheep farm. In times when the price of the Fair Value Shares is low, they pay more for the sheep farm. Thus farmers who sell their sheep farms benefit at the expense of long-time Fonterra members, who have to contribute to the establishment of new dairy plants.

One reason for the proposed capital restructuring was as a way to acquire more equity for the cooperative. The Board has a duty to align the interests of shareholders and the company. If the Board wants to secure Fonterra's business with its customers, it has to make the firm grow with its customers. Ten customers in different parts of the world take half of Fonterra's production. When Fonterra had simple business operations, the cooperative could even have shares with a nominal, non-appreciable value. However, once Fonterra progressed beyond being a simple business, the nature of the capital requirements changed (pers. comm. Margolis, Executive director, New Zealand Cooperative Association).

Many of the shareholders do not know the scope of the business that they are in. (interview with Jim van der Poel, Board member)

The Board believed that Fonterra needed capital to address the redemption risk. The Fair Value Share means that Fonterra's members are entitled to some of the growing wealth as the cooperative expands. However, Fonterra must have funds available for returning capital to exiting members. Since the cooperative is responsible for the remaining members, the exiting members must not receive more than they are entitled to, or expose the remaining members to risk.

A stipulation from the government at the foundation of Fonterra was that a certain percentage of the milk Fonterra collects should be sold at cost price. This demand was established to enable competing dairy companies to start up. This practice is now becoming an issue for Fonterra, since new investor-owned firms (IOFs) have been formed in

New Zealand. Fonterra pays the same transfer cost across the country, while the IOFs have based themselves in intensive dairy areas and hence are able to pay more than Fonterra. Thus Fonterra's redemption risk is increasing.

The only way to obtain equity capital used to be retaining earnings or issuing a subscription of new shares from members. Refraining from payout to members would make the Fonterra cooperative vulnerable, because more recent members might leave. A likely occurrence is that perhaps 60% of farmers would agree to Fonterra retaining their earnings to invest. However, when a company like Fonterra is pursuing an investment strategy, it cannot afford to disappoint 40% of its members. The other reason why retention of earnings has not been applied in the past is that Fonterra has experienced constant growth. One concern with issuing a subscription of new shares is that New Zealanders do not want to stimulate dairy production much more, because land is being lost to alternative uses such as wine or kiwifruit production. Another concern is that farmers have other options; with new IOFs, emerging farmers no longer depend on supplying Fonterra.

When formulating its restructuring proposal, the Board stated its belief in the value of keeping the core business integrated. It also believed that the only way of dealing with redemption risk was by cutting the business long-ways, meaning that the core business would stay untouched, but external investors would be allowed to contribute equity to other parts of the business. This strategy would bring in capital and farmers would still own the core business. One interviewee said that according to a well-known accounting firm, New Zealand cooperatives have no difficulties in raising external capital. The Board feared that there would be tension if it allowed outside investors or individual farmers to gain ownership that was disproportionate to their milk supply. If the milk price were to be set transparently, there would be less tension (interview with Mark Cessnay, dairy farmer).

Farmers disliked the Board's proposal because they were afraid of losing control. Investment in their farms relied on obtaining a good price and market for their milk. They saw Fonterra, or at least its manufacturing part, as an extension of their farm. A high share value also makes it difficult for young farmers to enter the business and those who manage to enter make a loss if the share price falls. A high value of the Fair Value Share also becomes an incentive for members to redeem their shares and

find another dairy processing firm. However, members reported that if Fonterra just treated them as owners and performed better than other companies, there would be no reason to leave. A further issue with the Fair Value Share is that farmers are exposed to high financial risk when a large part of their wealth is in one type of asset rather than spread in a larger portfolio.

A very important issue is that we are not in it for the investment or for a return on our shares. We are in it for a return on our milk. (interview with Doug Bull, former dairy farmer)

Having control of Fonterra is important to all New Zealand farmers because they depend on having their milk picked up every day. Apart from that, they all have a different approach to farming in terms of herd size, level of debt, and the image of a dairy cooperative's functions. Through membership in Fonterra, they are guaranteed collection of any quantity of milk. According to our interviewees, if the dairy processing function were to be owned by IOFs, the dairy industry in New Zealand would decline.

What I want from Fonterra can be quite different to what someone else wants. (interview with Tom Mason, dairy farmer)

The interviewees noted that some members seem to be confused by the value of the Fair Value Share going up and down and the lack of understanding of the valuation methodology. A risk exists of faulty decisions being made by members who do not understand farming. The personal view of one Shareholders' Council interviewee was that the valuation methodology was a mistake. The value of the Fair Value Share is also heavily affected by factors beyond the control of the cooperative, such as exchange rates and global commodity prices.

I do not think farmers wanted the Fair Value Share at all, because 90% of the value is represented in your farm and the facilities that the factories have. Not in the value-added parts of the business. (interview with Blue Read, Council member)

Some members have made large investments in Fair Value Shares and then lost money. Altogether, farmers have lost close to 2.5 billion NZ

dollars in two consecutive valuations. This occurrence will differentiate farmers. Some will be opposed to Fonterra making investments outside the core business while others have been asking for a chance to contribute, but there has been no opportunity for farmers to contribute capital for a specific investment purpose.

The Fair Value Share was established to make Fonterra function like a public company where members could exit by selling their shares. The intention was to have a “fair” value, but whether it is fair or not really depends on the calculation mode. Instead of basing the value on expected earnings, it could be based on the value of Fonterra’s assets. Hence the Fair Value Share gives exiting farmers a larger share than the remaining farmers could get if Fonterra’s business were to be liquidated and all members were paid proportionally.

The Fair Value Share becomes an investment with an expected increase in value, whereas with a nominal share the invested amount is seen as a contribution to capital needs. (interview with Alan Robb, independent financial commentator)

Analysis

The Problems of Vaguely Defined Property Rights

The development in Fonterra can be explained in terms of the vaguely defined property rights problem, which is a widely used construct in the literature on cooperatives. A point of departure is the definition of cooperatives suggested by Vitaliano (1983, p. 1079):

A cooperative can be defined as an economic organization whose residual claims are restricted to the agent group that supplies patronage under the organization’s nexus of contracts (i.e. the member-patrons) and whose board of directors is elected by this same group.

As collective organizations, cooperatives’ residual claims are thus not openly tradable, a feature which is claimed to lead to some problems (Cook 1995; Hendrikse and Feng 2013). These problems may become sufficiently severe to cause a cooperative to be dissolved. However, their severity depends on various characteristics of the cooperative.

A cooperative that has an open membership will suffer as new members may enter without contributing accordingly, and so they become free riders at the expense of the existing members. This is the so-called *internal free rider problem* or *common property problem*.

An *external free rider problem* occurs because an open membership cooperative cannot avoid non-members enjoying some externalities created by the cooperative. For example, if a cooperative succeeds in raising the product price level for member-suppliers, competing firms will have to pay at least the same price, to the benefit of non-members. This mechanism is often called the competitive yardstick effect of cooperatives. However positive it is for farmers at large, it is negative for cooperative members.

A *portfolio problem* is associated with collective ownership because the residual claim owners have no access to any capital market. The members cannot adapt their investments in the cooperative to their individual preferences as regards risk levels and return demands. The decisions concerning the allocation of the cooperative's assets are made by a collective body, the Board of Directors.

The *horizon problem* appears as the present generation of members may want to reap as much benefit as possible, thereby threatening the survival of the cooperative and also their own future benefits. Both the horizon problem and the portfolio problem are aggravated in cooperatives with substantial unallocated capital and complex business operations. Then members have little attachment to the organization. In problem-laden cooperatives, members may even induce the board to pay prices that are higher than the cooperative can afford. A large membership means heterogeneity and thus "multiple, sometimes conflicting, social or economic objectives" exist (Hogeland 2006, p. 68).

Low member involvement contributes to the *influence cost problem*. A large and heterogeneous membership and sizeable and complex business operations may cause members to lose interest in the cooperative (Österberg and Nilsson 2009; Feng, Friis and Nilsson 2015). Hence, the membership at large will be characterized by low involvement, low trust, and low amounts of other social capital (Nilsson, Svendsen and Svendsen 2012). When the membership shares can be transferred only at par value, the members have little reason to consider the long-range consequences of the cooperative's investment decisions.

Because the residual claims are not traded on the market, they are not subject to scrutiny by financial analysts, the mass media, and other external parties (Holmström 1999). The members at large are most often neither competent nor interested in analyzing the annual reports issued by cooperatives (Gaurwitsch and Nilsson 2010). The consequence is a *control problem* or *follow-up problem*. The board and the CEO may make investment decisions that are not the best decisions for the membership.

Associated with this is the *decision-maker problem*, whereby the leadership of a cooperative has difficulties in judging what the members consider to be in their best interests. Thus although the representatives may desire to fulfil the members' wishes they are not able to do so, especially as the membership also constitutes a heterogeneous body.

The Shareholders' Council

Even though Fonterra was already a large and complex cooperative when it was established, it does not seem to suffer much from the vaguely defined property rights problem. This may be explained by the Shareholders' Council and the Fair Value Share.

The Shareholders' Council has the purpose of safeguarding member interests in relation to the Board, while the Board is responsible for the business operations. This arrangement is a matter of division of labor, which requires good coordination between the two organizational units.

The Shareholders' Council helps to reduce the members' influence cost problem. To the extent that the members have trust in the councilors, they do not need to spend much time and effort in supervising the Board. This observation is supported by the interviewees. It is also in the councilors' interest to make sure that the members have trust. All this is fully clear to the Board members. They recognize the power of the Shareholders' Council, and hence the directors tend to listen to the councilors. It is likely that the Shareholders' Council also alleviates the control problem, although none of the interviewees mentioned this.

As in most other countries and agricultural industries, dairy farming in New Zealand is undergoing a process of concentration. However, farmers with small and large operations alike are members of Fonterra on equal terms, and the Shareholders' Council must defend the

rights of every one. It seems that the family farmers are in need of more attention than the corporate or large-size farm operations. Again, the Shareholders' Council is reducing the influence cost problems for the membership in its entirety.

Likewise, the councilors are aware of the power that they have as a consequence of the members' trust. The fact that the Shareholders' Council did not react immediately to the Board's capital restructuring proposal relates to the councilors being eager to preserve their position among the members. The Council conducted investigations until it became clear what the members would think about the proposal.

This division of labor effectively reduces the property rights and horizon problems. Hardly any risk of social concerns is being considered in the business decisions. The Shareholders' Council is not involved in any business decisions. Members cannot promote short-term and selfish interests through the Council. Hence, the Council is instrumental in curbing the influence of the so-called ginger groups, which consist of self-selected members who are able to reach out with critical opinions about Fonterra. They have thus no legitimacy for the membership at large, so they could create damage to Fonterra if they were to succeed in promoting benefits to themselves. A positive consequence of the ginger groups is that they make it even more important to have councilors with good information, thereby reducing the members' influence cost problems.

Since the exit options are limited for most members, a well-functioning cooperative will have the effect of reducing members' transaction costs (Valentinov, 2007). However, the expansion strategy of Fonterra's management is not in harmony with the members' user interests, since its members do not perceive this strategy to be reducing their transaction costs. The Shareholders' Council is not opposed to expansion, but it has the task of informing the members and balancing the Board, i.e., providing some solution to the decision-maker problem.

The members' feeling of identity with Fonterra is thus not an expression of cooperative ideology (Morfi et al. 2015). Rather, the members are loyal because they have made large investments in their farm operations and in Fonterra, and they are eager to keep an open membership cooperative which guarantees their delivery rights. Without such a cooperative, many members would have difficulty reaching the market with their milk.

Fair Value Share

The Fair Value Share was established as a way of mitigating internal free rider problems. The members are obliged to own such shares in proportion to their milk volume. When Fonterra uses the capital to invest in adding value to members' milk, members are not reluctant to invest in Fonterra. As regards investment in processing non-members' milk, however, members are less interested. Processing of non-members' milk by Fonterra has created tensions between members and the Board. Nevertheless, the Fair Value Share has created a positive view among the members at large, because the Fair Value Share has increased in value.

Fonterra's growing milk supply and growing assets explain why members were not asked for investment capital before the Fair Value Share was introduced. Considering investments regarding processing non-members' milk, members did not seem to be interested in contributing capital. Hence, Fonterra did not have a major internal free rider problem. However, the Fair Value Share may give rise to some kind of free riding in adjacent industries. One interviewee said that lamb or beef farmers, for example, may be external free riders, because when the Fair Value Share price is low they get a higher price for their land. The sheep farmer has contributed nothing, but sells the land to a dairy farmer and receives more money.

The high value of the Fair Value Share means that some farmers may hesitate to buy shares in Fonterra. Instead, they may deliver their milk to IOFs, where no entry fee is required. Some dairy farmers deliver to Fonterra on a contract without buying shares. The Fair Value Share's high value creates incentives not to enter Fonterra and to exit and cash in. Even though such behavior may create financial problems for Fonterra, this cannot be characterized as free riding, because these farmers would have to accept higher risks as regards milk price and delivery conditions.

The Fair Value Share is appreciable (and depreciable), although the price is not a market price but is decided on administrative grounds. Due to Fonterra's valuation principles, the value that members obtain on leaving the cooperative is higher than the value they would receive if the cooperative were to be liquidated. Hence when exiting members get their shares redeemed, Fonterra is subject to asset stripping. In the event of a large number of exits and if Fonterra's operations did not yield good capital returns, the cooperative would be threatened. In that case, the

exiting members would be internal free riders. A positive side of the members' possibility to exit and get the value of the Fair Value Shares redeemed is that the horizon problem gets an effective solution.

Compared with a nominal share with a lower value, the Fair Value Share contributes to a portfolio problem. Members have to make a large payment, but the Board's risk preference probably does not match that of the individuals. When supplying large quantities of milk, the farmer has to buy many shares and membership becomes risky. To some extent the Fair Value Share can also be said to mitigate the portfolio problem, because the appreciation might make it more profitable than any other investment opportunity. However, since the valuation method is not clearly understood, the extent to which this is actually happening is uncertain.

Farmers are Fonterra members in order to have a secure market channel for their milk. However, their large investments make Fonterra resemble an investor-owned firm. Hence, there may be a misalignment of the farmers' interests and those of the Board and management. A problem is that the valuation of the Fair Value Share is difficult to interpret in the absence of similar investment opportunities. No objective way is available of assessing the change in the share value and deciding what measures to take. The Fair Value Share adds to the gulf between the members on one hand and the Board and management on the other. Thus, the members have an influence cost problem, although this is largely mitigated by the Shareholders' Council.

In summary, the Fair Value Share solves some problems caused by the vaguely defined property rights. However, it also causes a free rider problem and a portfolio problem, although Fonterra members do not seem to perceive unidentifiable property rights as a problem.

The Capital Restructuring Proposal

According to the interviewees, the capital restructuring proposal put forward in 2007 was a product developed by the management and approved by the Board. The leadership cared mainly for the company and less for the cooperative structure. A reason might be that the managers regarded Fonterra as any other company, hence seeking expansion. The leadership had not investigated the members' opinions and failed to inform the members.

The proposal may thus be seen as a result of influence cost problems, decision-maker problems, and follow-up problems, which might have become serious had the Shareholders' Council not existed. The process that followed after the proposal was presented can also be explained in the same property rights context.

The members' opposition to the capital restructuring proposal would not have been possible without the existence of the Fair Value Share. The members' strong involvement was most likely a consequence of their large investments in their farm enterprises and in Fair Value Shares. The members' assets might have been threatened if Fonterra did not remain fully in the hands of the members. Due to the conditions prevailing in the New Zealand dairy industry, the farmers' considered the existence of an open membership cooperative that grants delivery rights to be indispensable. Without such a cooperative, the members considered that their transaction costs would become very high.

Even though the system for evaluating the Fair Value Share is often subject to criticism and difficult to understand, the share provides a guarantee for full member control. Accepting external investors in the operations working with non-member milk was seen as a first step towards demutualization, and it might be followed by further steps.

The existence of the Fair Value Share contributed to create member involvement in connection with the capital restructuring proposal. The Fonterra members' influence cost problem and control problem were reduced thanks to the fact that the Shareholders' Council has the task of following up on management. If members know that the Shareholders' Council is safeguarding their interests, they might have weaker incentives to remain highly involved. The way that the Shareholders' Council is organized and operates gives rise to members having trust in the Council. Thus in the case of the capital restructuring proposal, the Council was able to mobilize the membership fairly easily, once it had analyzed the proposal and investigated member opinions.

The redemption risk was an issue considered by the Board when it developed its capital restructuring proposal. The members' rejection of the proposal left this issue unresolved. The interviewees in the present analysis did not express any major concerns about the equity redemption risk.

Conclusions

In 2007, the Board of Directors of the New Zealand dairy cooperative Fonterra presented a capital restructuring proposal aimed at reducing the cooperative's equity redemption risk, addressing members' portfolio problem, and acquiring capital for the cooperative's future growth. External owners would be allowed, but members would own most of the stock.

The proposal was rejected by the members. This event attracted international attention, because on many other occasions when a cooperative board has proposed a similar reform, the members have accepted it. Contributing to the attention for Fonterra was the fact that it had succeeded in becoming one of world's largest dairy cooperatives without ever having external owners.

The present analysis suggests that the members' rejection of the capital restructuring plan is related to two specific characteristics of Fonterra, namely its Fair Value Share and its Shareholders' Council. These constitutional elements were government requirements for permitting the merger that resulted in a market-dominating cooperative in the New Zealand dairy industry.

The Fair Value Share can be criticized because the value appreciation is calculated in a complicated administrative way and is not a consequence of a market for the shares. The calculation mode is not understood by all members. As Fonterra has expanded, the Fair Value Share has risen to a level where it is costly for new dairy farmers who want to become members. Nevertheless, the Fair Value Share is important to the Fonterra shareholders.

The Fair Value Share system means that the members have so much money invested in the cooperative that they are reluctant to embark on any new path. The farmers have full ownership of the cooperative through their possession of Fair Value Shares. Hence the share is a guarantee of full member control. Sharing the ownership of Fonterra with external investors could be a step towards demutualization, which would be a major threat to the dairy farmers. Only a cooperative could be a secure outlet for all the milk that they might produce. The Board's proposal was not a result of any crisis and the members did not consider a capital restructuring plan to be necessary. The members had confidence in the ownership structure with Fair Value Shares.

Another explanation for the members' rejection of the capital restructuring proposal was the parallel governance of Fonterra. The cooperative's Board of Directors has the task of developing the business operations. The Shareholders' Council is the members' voice in relation to the Board and has the task of defending the members' interests. Hence there may be conflicting interests. In connection with the capital restructuring proposal, the Council acted to mobilize the membership and it succeeded. The members have great trust in the councilors. This is especially true for small dairy farmers, whose interests may be more threatened by strategies put forward by the Board. Likewise the Shareholders' Council has an important role to play when it comes to balancing the influence of groups of shareholders attempting to reap benefits for themselves.

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