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# Support for Farmers' Cooperatives

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## *Case Study Report* **Internal Governance of Cooperatives**

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Ger van der Sangen  
Jos Bijman

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# Support for Farmers' Cooperatives

## *Case Study Report*

## **Internal Governance of Cooperatives**

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## **Preface and acknowledgements**

In order to foster the competitiveness of the food supply chain, the European Commission is committed to promote and facilitate the restructuring and consolidation of the agricultural sector by encouraging the creation of voluntary agricultural producer organisations. To support the policy making process DG Agriculture and Rural Development has launched a large study, “Support for Farmers’ Cooperatives (SFC)”, in order to provide insights on successful cooperatives and producer organisations as well as on effective support measures for these organisations. These insights can be used by farmers themselves, in setting up and strengthening their collective organisation, by the European Commission, and by national and regional authorities in their effort to encourage and support the creation of agricultural producer organisations in the EU. Within the framework of the SFC project, this case study report on the internal governance of cooperatives has been written.

In addition to this report, the SFC project has delivered 32 other case study reports, 27 country reports, 8 sector reports, 6 EU synthesis reports, a report on cluster analysis, a report on the development of agricultural cooperatives in other OECD countries, and a final report. In this case study report on internal governance of cooperatives, we made several cross-references to other SFC reports and their conclusions.

The authors would like to thank all the participants of the eRNAC Conference June 2012 in Helsinki, in particular for sharing their thoughts and insights, as well as the members of the project team of the SFC study, providing detailed input and case reports.

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## List of abbreviations

APO	Agricultural Producer Organization
BoD	Board of Directors
DG	Directorate-General
EU	European Union
ICA	International Co-operative Alliance
OECD	Organization for Economic Co-operation and Development
PO	Producer Organization
SCE	Societas Cooperative Europaea
SFC	Support for Farmers' Cooperatives Research Project

# 1. Introduction

## 1.1. Research topic of the case study

The imbalances in bargaining power between the contracting parties in the food supply chain have drawn much attention, also from policy makers. The European Commission is committed to facilitate the restructuring of the sector by encouraging the creation of voluntary agricultural producer organizations. DG Agriculture and Rural Development has launched a large study, “Support for Farmers’ Cooperatives” (SFC), that will provide the background knowledge that will help farmers organize themselves in cooperatives as a tool to consolidate their market orientation and so generate a solid market income.

In the framework of this study, this report provides information on the internal governance of cooperatives. The relationship between internal governance and economic performance has been studied in the EU Synthesis Report on “An EU wide analysis of internal governance” (Hanisch and Rommel, 2012). Other aspects of internal governance have been dealt with in the reports “An EU wide analysis of Legal Aspects”, “An EU wide analysis of social, cultural and historical influences on agricultural cooperatives”, and “An EU wide analysis of policy support measures”.

In these reports, several interesting aspects concerning the internal governance of cooperatives have been addressed, such as the correlation between size, organizational structure, the existence of professional management, the presence of holding structures and the use of subsidiaries, the amount of transactions with non-members and the presence of outside investors and the performance of cooperatives. On the basis of the results so far available, one might conclude that the findings are not completely in line with earlier results of academic scholarship on corporate governance. From a legal point of view, some irregularities have been identified, e.g. with regard to the accountability of board’s strategic decision-making towards members. Also, the question has been raised whether in large cooperatives, using holding structures and subsidiaries, the members are still in charge over the core decision-making processes, how formal decision control rights – as one might aspect to be adjudicated towards the members as residual claimants – are attributed in practice, but also whether members still perceive the internal governance as effective control.<sup>1</sup> From the report on social, culture and historical influences, we learned that other factors than pure economic and legal may be important with regard to the question whether the internal governance of a cooperative is perceived by its members as being effective. Also, insights from agency theory and transaction costs economics seem to indicate that the role of organizational culture and trust are important factors that might explain the efficiency of complex internal governance structures.<sup>2</sup>

## 1.2. Objectives of the case study

The objective of the case study is to shed more light on existing successful and unsuccessful internal governance structures of cooperatives. In particular, we will assess how law in general

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<sup>1</sup> H. Hansmann (1996), *The ownership of enterprise*, The Belknap Press, Harvard University Press, Cambridge, Massachusetts / London, England, 1996, p. 11; and G. van der Sangen (2012), *Support for Farmers’ cooperatives. An EU wide comparative analysis of legal aspects*.

<sup>2</sup> P. Ollila (2009), *Principles of Institutional Economics. With Applications to Cooperative Enterprises*, Helsinki University, Department Economics, Working papers no. 56, Marketing, ISBN 987-952-10-5282-8.



and business organizational law on cooperative organizations in particular supports or precludes effective internal governance. We will address the issue of the success of large cooperatives on the perceived effectiveness of their internal governance. How do these cooperatives manage, despite their often complex internal governance system and far-reaching delegation of decision management rights to the corporate bodies, to adhere to the cooperative principles, notably of democratic decision making? Also, there is the issue that the complexity of the internal governance structure causes additional agency costs. The EU Synthesis Report on “An EU wide analysis of internal governance” seems to suggest a positive correlation between size, the use of holding structures and subsidiaries and transactions with non-members with the performance of cooperatives. Reversely, it raises the question under which conditions the members ‘contract’ for adjustments of the internal governance.

This case study will deal with a number of issues related to internal governance and the success of the cooperative. Compared to the EU Synthesis Report on “An EU wide analysis of internal governance”, this case study will take a more qualitative and reflective perspective. Comparisons among countries and sectors will be elaborated, as well as comparisons among clusters of cooperatives. The emphasis in this report will be on a legal analysis of internal governance frameworks and their application in practices, asking the pivotal question: “Does law matter?”<sup>3</sup>

### 1.3. Hypotheses

Given a specific internal governance structure of a cooperative mandated by law and adjusted to the economic needs of the members, the internal governance of cooperatives is viewed as efficient although agency costs may arise and may cause additional organizational costs. The status quo is only considered inefficient in case of external factors that disrupt the existing ‘agreement’ between members, breaking down homogeneity between members. We also assume that the internal governance of a cooperative follows changes in strategy and structure and not vice versa. In this respect, we expect legal arrangements of governance to play only a minor role. However, the detection of irregularities in the legal framework might be important because they have been reported for some member states where cooperatives seem to be a regional phenomenon. In these cases, the initial internal governance structures and their irregularities may inhibit and preclude the sound development of first stage cooperatives and their future development.<sup>4</sup> This supports the hypothesis that the law should provide for best practices on

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<sup>3</sup> With regard to listed firms, there has been a debate on the question whether corporate governance rules have a positive or negative effect on corporate governance. See B. Cheffins, *Does law matter? The separation of ownership and control in the United Kingdom*, ESRC Centre for Business Research, University of Cambridge, Working Paper No. 172, September 2000 and J. Winter (2011), *The financial crisis: does good corporate governance matter and how to achieve it*, DSF Policy Paper, august 2011, <http://ssrn.com/abstract=1972057>. Good corporate governance, not only for listed firms, involves to ability within the legal framework to adapt to innovative needs and demands. See McCahery & Vermeulen (2008) with regard to non-listed firms, in particular with regard to private companies and partnership and hybrid organizational forms, like joint ventures, private equity and venture capital structures. This question has never been raised explicitly in relation to the internal governance of cooperatives in this debate. See e.g. the European Commission’s Green Paper, *The EU corporate governance framework*, Brussels, 5.4.2011 COM(2011) 164 final. See however Fici, A. (2012), *Cooperative Identity and the Law*, European Research Institute on Cooperative and Social Enterprises, Working Paper N. 023/12, p. 12-15, linking the ICA-principles to governance structures of cooperatives, however not providing explanations why the ICA-principles should be leading in developing cooperative governance frameworks that support the efficiency and performance of cooperatives in general.

<sup>4</sup> Van der Sangen (2012), SFC Synthesis report on legal aspects, p. 24 and 25.

cooperative governance, either by way of flexible statutory default regulations or by way of model codes. It is assumed that the average business organizational framework consists of mandatory and default provisions, questioning the ability for members and their cooperative to adapt to new circumstances and innovations.

Therefore, a second hypothesis would be that the law should provide for a business organizational law framework with regard to cooperatives that is able to take into account the different stages of the evolution of a cooperative and that legal statutes are flexible enough for members to adjust the internal governance rules to new internal governance needs. New governance needs may include the introduction of proportional voting, rewarding members proportionate to their transactions, the introduction of equity raising schemes, the introduction of professional management, and the changes in the composition of the Board of Directors. The policy implication could be that the one-size-fits-all approach currently used in the SCE-Regulation needs to be carefully examined and possibly adjusted. The SCE-Regulation is meant to have a harmonizing effect on the national statutes. Yet, it is questionable whether the SCE-Regulation is able to take into account the stages of development of cooperatives in the different member states.

The restrictions or possibilities that national regulations on cooperatives provide will be studied in more detail, seeking to understand the impact of flexible versus inflexible legislation on cooperative performance.<sup>5</sup> Other issues to be studied in this case study are the need to look at internal governance from a systemic (or complementarities) perspective. This means that by changing just one element the whole system may become unstable. This is particularly important with regard to the internal governance of cooperatives, because the legal development of cooperatives in the different member states has been described as highly path-dependent.<sup>6</sup> In other words, changes in internal governance will be the result of a coordinated effort from stakeholders that pursue different political, economic and social interests. In this respect, it would be interesting to assess the influence of interests group. It is questionable whether the top-down and 'one size, fits all' approach in the SCE Statute provides the practical internal governance model for transnational and international cooperatives.

#### **1.4. Research Questions**

The key question proposed in this case study is the following:

*What is the connection between internal governance rules and the economic performance of agricultural co-operatives?*

The following detailed research questions will be addressed in this case study:

1. What do we know about the relationship between internal governance and cooperative success?

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<sup>5</sup> A difficult aspect is how to measure these differences. The evidence provided will be more anecdotal than conclusive.

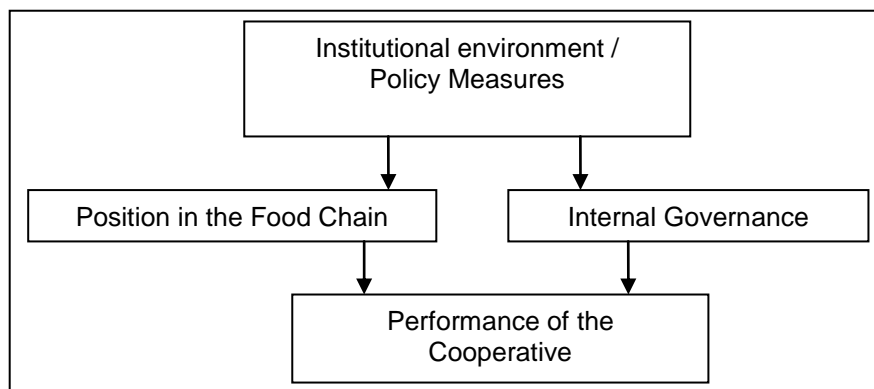
<sup>6</sup> To support this claim, we refer to "An EU wide analysis of legal aspects", "An EU wide analysis of social, cultural and historical influences on agricultural cooperatives", and "An EU wide analysis of policy support measures".

2. What distinctions can we find among countries, regions and sectors in terms of internal governance elements, as well as changes in these elements?
3. How can we link internal governance choices and options to the size and the life cycle of the cooperative?
4. How do cooperatives, through internal governance choices, deal with the increasing heterogeneity in membership?
5. What best practices for internal governance can we find among agricultural cooperatives in the EU?
6. What is the evolution of internal governance models among agricultural cooperatives in the EU?
7. What is the evolution of regulation on internal governance in the EU?
8. What are the new elements of internal governance and why do they appear in some countries and sectors and not in others?

### **1.5. Methodology**

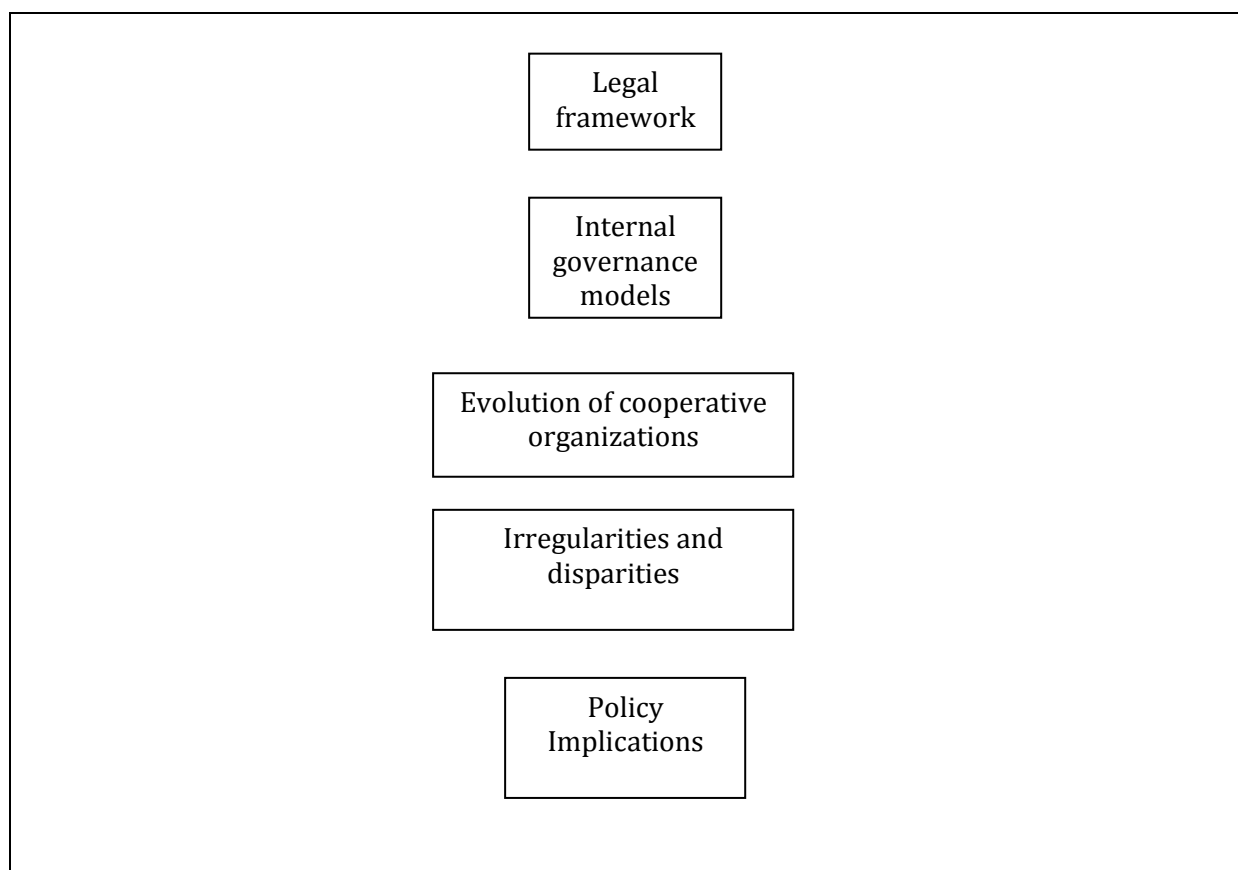
The case study will be based on currently available data on internal governance of the more than 300 cooperatives in our database, in particular on the data available on the topic of internal governance from the country reports that have been drawn-up as part of the SFC-project. The research builds therefore on the results of prior research in this project, in particular the country reports on the issue of internal governance, the EU wide analysis of internal governance and the EU wide analysis of legal aspects, as well as results on internal governance from the other case studies. In addition, academic literature on corporate governance and specifically on cooperative governance has been reviewed.

There are at least three main factors that determine the success of cooperatives in current food chains. These factors relate to (a) position in the food supply chain, (b) internal governance, and (c) the institutional environment. The position of the cooperative in the food supply chain refers to the competitiveness of the cooperative vis-à-vis its customers, such as processors, wholesalers and retailers. The internal governance refers to its decision-making processes, the role of the different governing bodies, and the allocation of control rights to the management (and the agency problems that goes with delegation of decision rights). The institutional environment refers to the social, cultural, political and legal context in which the cooperative is operating, and which may have a supporting or constraining effect on the performance of the cooperative. Those three factors constitute the three building blocks of the analytical framework applied in this study (Figure 1).



*Figure 1. The core concepts of the study and their interrelatedness*

With regard to the subject of this case study, we will elaborate further on the building block internal governance along the following research line: an analysis of the legal framework on internal governance, the analysis of models of internal governance, the evolution of cooperatives in practice, the irregularities and disparities between the former topics and the policy implications thereof.



*Figure 2. Internal governance research line*

## **1.6 Structure of the report**

In section 2, we will provide a brief overview of the literature on internal governance of cooperatives from an economic organizational as well as legal point of view. Section 3 on the internal governance of cooperatives is divided into 4 parts: a description of the current legislation on internal governance (3.1), a description of different options and models of internal governance of cooperatives in practice (3.2), an overview of trends in internal governance (3.3) and, finally, a comparison of the internal governance legal infrastructure and used models across countries, regions and sectors. Section 4 contains the analysis of the study, followed by section 5 which reflects on the main findings. Section 6 concludes.

## 2. Brief review of the literature

A cooperative is an enterprise characterized by user-ownership, user-control and user-benefit. It is user-owned because the users of the services of the cooperative also own the cooperative organisation; ownership means that the users are the main providers of the equity capital in the organisation. It is user-controlled because the users of the services of the cooperative are also the ones that decide on the strategies and policies of the organisation. It is for user-benefit, because all the benefits of the cooperative are distributed to its users on the basis of their use; thus, the individual benefit of members is in proportion to individual use of the cooperative (patronage). In this view, conceptually the members are the ultimate beneficial owners of the cooperative and therefore also entitled to the residual claim. From a formal legal point of view, there is a strong connection between the ultimate beneficial ownership and the attribution of property rights towards members. The internal governance of a cooperative operates efficiently in cases of high homogeneity of the members.<sup>7</sup> In case a cooperative uses unallocated equity, the cooperative encounters problems with regard to raising equity in case of a growing heterogeneity of members.<sup>8</sup> These problems can be tackled by introducing allocated individual property rights that are tradable.<sup>9</sup>

It is arguably whether these changes have an effect on the internal governance of cooperatives and the nature of cooperative membership. Member States' cooperative statutes generally maximize the amount of voting rights attributable to financial instruments that compensate members and – if allowed – non-members for their capital investment to the extent that members from a legal point of view are still in 'control'. Yet, what we know from the literature is that there is a correlation between the growing complexity of the cooperative, the extent of vertical integration, the separation between the associational part and the entrepreneurial part of the cooperative and the internationalization vis-à-vis the internal governance, in particular with regard to the adjustment of board models.<sup>10</sup> There are strong arguments for the introduction of professional management in case of an increase of the level of vertical integration and value-added related diversification strategy.<sup>11</sup> It is argued that the production orientation of the board of directors in traditional cooperative board models hampers innovation, supporting the case that the introduction of outside board members results in better performance. We expect the same to be true for the composition of internal monitoring bodies, like a supervisory board.

In this respect, little attention has been paid so far to the role of external monitoring, e.g. through mandatory auditors. Whether audit firms have a positive effect on the performance of cooperatives has not been identified in the literature, neither that large audit firms would be better equipped to perform the auditing task for cooperatives than small audit firms. It largely

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<sup>7</sup> Hansmann (1996).

<sup>8</sup> Royer, J.S. (2012), *Cooperative Involvement in Value-Added Markets: A Closer Examination*, Paper presented at the 2nd eRNAC International Conference on "Cooperative values in internationalized operations", Helsinki, Finland, June 14-16, 2012, describing the 'new generation' producer cooperatives in the US as an example to overcome this problem.

<sup>9</sup> Van der Sangen (1999). Cases are presented by Van Bakkum and Bijman (2007) as well as by Van Bakkum (2009).

<sup>10</sup> Bijman et al. (2012), Chaddad and Iliopoulos (2012).

<sup>11</sup> Royer (2012) and G. Hendrikse & A. van Ooijen (2004).

depends on the knowledge, familiarity and the experience of the audit firm with agricultural cooperatives.<sup>12</sup>

The function of internal governance in this respect is to provide a system that is able to regulate effective control by members over the core issues of the cooperative, at the same time providing sufficient managerial discretion to run the cooperative firm as well as providing complementary mechanisms of internal and external monitoring.<sup>13</sup> In this respect, we take a broad definition of internal governance. The focus will be on the attribution of authority to legal organs of the cooperative and the allocation of property rights.

With regard to listed firms, there has been an intensive debate on the question whether corporate governance rules have a positive or negative effect on performance.<sup>14</sup> From literature on corporate governance for listed firms, it follows that there is a strong correlation between high compliance to corporate governance rules and performance, going back the research of LSSV.<sup>15</sup> It has been argued that Anglo-American shareholder-oriented systems of corporate governance perform better than their Continental counterparts.<sup>16</sup> Yet, the general criticism on the LSSV findings is that they did not take into account cultural differences as well as the influence of case law in the examined jurisdictions. Furthermore, there is the issue that correlation does not necessarily establish causality. The immense body of corporate governance literature with regard to listed firms cannot be transferred to the analysis of cooperative governance.<sup>17</sup> Some insights from scholarship with regard to corporate governance for listed firms seem to be relevant for cooperatives with a dispersed membership structure, but not likely for small and regional cooperatives.

In this respect, the 'law matters' debate with regard to listed firms seems relatively trivial. Of course, bad sets of corporate governance rules are inclined to lead to underdevelopment of sectors, regions or member states.<sup>18</sup> However, good corporate governance is not necessarily positively related to the performance of listed firms, although it seems a precondition for their sound development. The same line of reasoning would apply to the internal governance of cooperatives. Good cooperative governance seems a precondition for the development of cooperatives, although until now no conclusive findings are available to what extent internal governance fosters performance.<sup>19</sup> However, there are some remarkable cases in which the

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<sup>12</sup> Siqueira, L.C. and Bialoskorski, S. (2012), *An analysis of external audit practices in agricultural cooperatives in Brazil*, Paper presented at the 2nd eRNAC International Conference on "Cooperative values in internationalized operations", Helsinki, Finland, June 14-16, 2012.

<sup>13</sup> Corporate governance tripod used by the Rabo Bank Group. See the case study by P.P.M. van Miltenburg, De Rabobank Groep, in: R.C.J. Galle, *Handboek Coöperatie* (2010), p. 1024.

<sup>14</sup> See Cheffins, B. (2000), *Does law matter? The separation of ownership and control in the United Kingdom*, ESRC Centre for Business Research, University of Cambridge, Working Paper No. 172, September 2000 and Winter, J. (2011), *The financial crisis: does good corporate governance matter and how to achieve it*, DSF Policy Paper, august 2011, <http://ssrn.com/abstract=1972057>. See also P. van der Schee (2011), *Regulation of issuers and investor protection in the US and EU. A transatlantic comparison of the basics of securities and corporate law*, The Hague: Eleven international publishing 2011, passim.

<sup>15</sup> La Porta, R., Salines, F.L., Shleifer, A. and Vishny, R. (1999), *Investor Protection and Corporate Governance*, June 1999.

<sup>16</sup> Hansmann, H. and Kraakman, R. (2001), *The End of History of Corporate Law*, Yale Law School No. 235, January 2001.

<sup>17</sup> See Bijman et al. (2012) for cooperatives because the performance of cooperatives cannot be measured in terms of shareholder value. See also McCahery and Vermeulen (2008) for non-listed firms.

<sup>18</sup> Barnard Black (2001), *The Legal and Institutional Preconditions for Strong Securities Markets*, UCLA Law Review, Vol. 48, p. 781-855.

<sup>19</sup> See Hanisch, M. (2012), SFC EU wide analysis of internal governance.

strategic and structural development of cooperatives have not been followed-up with an adjustment of the internal governance. A mismatch between strategy and governance structure of the cooperative has been argued as one of the main causes of the downfall of the Cebeco Group and the break-off of the planned merger between Dutch DOCKaas and German DMK GmbH, although the latter case also could be viewed as an example of effective member control. Set aside external factors that disrupt the internal cohesion and induce changes in internal governance, the internal governance of cooperatives appears to be rather stable, which raises the question why members maintain the achieved equilibrium. One reason could be that there is a strong influence of culture and trust in the sense that cooperation amongst agricultural producers through the legal form of the cooperative and the internal governance it provides, is the 'sensible thing to do'.<sup>20</sup>

Good corporate governance, not only for listed firms, involves to ability within the legal framework to adapt to innovative needs and demands of the cooperative and its members.<sup>21</sup> These questions, however, have never been raised explicitly in relationship to the internal governance of cooperatives. For example, in the European Commission's Green Paper, *The EU corporate governance framework*, no reference was made to the governance of cooperatives.<sup>22</sup> Fici has tried to link the ICA-principles to governance structures of cooperatives, however not providing explanations why the ICA-principles should be leading in developing cooperative governance frameworks that support the efficiency and performance of cooperatives in general.<sup>23</sup> Cooperative governance frameworks should also be able to take into account the stages of development of cooperatives.<sup>24</sup> The key question here is how large cooperatives maintain formal and effective control aligned.

Findings of Hanisch and Rommel in their Synthesis Report on internal governance (2012) scrutinize the existing theory on corporate governance for cooperative. Their claim is that concentration of activities is not beneficial, while diversification and the use of subsidiaries is, although this leads to a more complex internal governance and subsequent agency problems. This claim has also been made by Hendrikse and Van Ooijen (2004), *Diversification and Corporate Governance*. Hendrikse (2012) conducted a game theory model, based on which he concluded the cooperatives that when cooperatives differentiate decision rights and income rights according to the quality of delivery/input, these cooperatives would better perform.<sup>25</sup>

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<sup>20</sup> This was supported by the findings of the SFC EU wide comparative analysis of legal aspects for most members states with the exception Eastern-European member states, Poland and Portugal.

<sup>21</sup> See McCahery and Vermeulen (2008), with regard to non-listed firms, in particular with regard to private companies, partnerships and hybrid organizational forms, like joint ventures, private equity and venture capital structures.

<sup>22</sup> European Commission's Green Paper, *The EU corporate governance framework*, Brussels, 5 April 2011, COM(2011)164 final.

<sup>23</sup> Fici, A. (2012), *Cooperative Identity and the Law*, European Research Institute on Cooperative and Social Enterprises, Working Paper N. 023/12, p. 12-15.

<sup>24</sup> Bekkum, O.F. van (2009), *Cooperative Champions or Investor Targets? The Challenges of Internationalization & External Capital*, Study commissioned by Landbrug & Føddervarer, December 2009 and Bekkum, O.F. van, and J. Bijman (2007), *Innovations in Cooperative Ownership: Converted and Hybrid Listed Cooperatives*, in: S. Rajagopalan (ed.), *Cooperatives in 21st Century. The Road Ahead*, Hyderabad, India: Ifcai University Press, pp. 34-56. as well as F. Chaddad & C. Iliopolous, *Ownership and Control in Agricultural Cooperatives*, Paper prepared for the *International Conference on Cooperative Responses to Global Challenges*, Humboldt University, Berlin, March 21-23, 2012.

<sup>25</sup> Hendrikse, G., Liang, Q. and Huang, Z. (2012), *Quality Provision and Governance Structure Variety: IOFs versus Cooperatives*, Paper presented at the 2nd eRNAC International Conference on "Cooperative values in internationalized operations", Helsinki, Finland, June 14-16, 2012.



Most studies on the internal governance of cooperatives relate to the internal governance of the cooperative as a legal person, assessing the interrelatedness between the board of directors, the general meeting and its supervisory committee, if existing. Studies have also looked into the introduction of different tiers or layers of member representation as answer to regain effective control by members, notably in the case the cooperatives has separated the associational part of the cooperative from the entrepreneurial part. As a result, the internal governance becomes more complex with increasing agency costs. There is, however, little insight into the costs of democratic control in these cooperatives.<sup>26</sup>

Fama and Jensen's conceptual framework that formed the basis of the nexus of contract theory, makes a distinction between decision control, involving monitoring and ratification, and decision management, involving initiation and implementation of the strategy. From their theory, the basic rule follows that those within the company have decision control rights, are also the ultimate beneficial owners and residual claimants of the company. Yet, in almost all cases, even in case that there is homogeneity of member interests, decision control rights not only have been assigned to the general meeting, but also to the board of directors to which decision control rights have been delegated for efficiency reasons. From the research by Bijman, Hendrikse and Van Oijen,<sup>27</sup> we learn that in The Netherlands decision control effectively lies in the hand of the management, in case of diversification and the use of sub holding structures. This questions the merits of the legal traditional model as well as raises questions with regard the legal possibilities to regulate these internal governance constellations.

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<sup>26</sup> Pozzobon, D.M. and Zylbersztajn, D. (2012), *Democratic costs in member controlled organizations*, Paper presented at the 2nd eRNAC International Conference on "Cooperative values in internationalized operations", Helsinki, Finland, June 14-16, 2012 and Pozzobon, D.M., Zylbersztajn, D. and Bijman, J. (2012), *How can cooperatives reduce democratic costs without incurring excessive agency costs?*, Paper presented at the 2nd eRNAC International Conference on "Cooperative values in internationalized operations", Helsinki, Finland, June 14-16, 2012.

<sup>27</sup> Bijman et al., 2012.

### 3. Internal governance of cooperatives

#### 3.1. Current legislation on internal governance

An efficient system of cooperative governance should reflect effective control by members over the core issues of the cooperative, leave sufficient managerial discretion to run the cooperative firm and be complemented by mechanisms of internal and external monitoring.<sup>28</sup> Elements of cooperative governance involve amongst others the division of powers in the cooperative, the attribution of property rights, the flexibility in designing board models, the introduction of a council of member representatives, the question who sets the strategy, the division of activities between the cooperative and its subsidiaries, techniques for internal and external control, the professionalism of board members, their accountability towards members, and the differentiation in voting rights.

The European scenery of cooperative legislation is characterized by path dependency and across member states one encounters a variety of legal profiles of the internal governance of cooperatives. Yet, as will be elaborated below, the overall view is that the internal governance legal and formal structure does not influence the functioning of the cooperative negatively, quite the opposite is the case. In some member states, these rules are supported by corporate governance codes, especially designed for cooperatives, however lacking the legal mandate to comply with them.<sup>29</sup> From an international perspective, there is some evidence that differences in internal governance may hamper cross-border mergers between cooperatives of different member states.<sup>30</sup>

In practice, different degrees of complexity of cooperatives are reflected in the internal governance, ranging from the basic pattern for a small-sized primary cooperative, where members still are in the position to monitor the board of director directly, to large cooperatives with numerous members, creating the necessity of delegation of decision control to the board of directors as well as the necessity to introduce member representation bodies.<sup>31</sup> Within this model, a cooperatives overtime has evolved into a – although legally still a unitary organization – multilayered organization, in particular in case the cooperative has been divided into an associational part and an entrepreneurial part, notably when the cooperative has delegated the control over the business activities to a sub holding entity, commonly a private company limited by shares.<sup>32</sup> Taken to the extreme – and several cases are available to support this –, the cooperative organization combines a multilayered associational part as well as a multilayered entrepreneurial part (see Figure 3).

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<sup>28</sup> Corporate governance tripod used by the Rabo Bank Group. See the case study by P.P.M. van Miltenburg, De Rabobank Groep, in: R.C.J. Galle, *Handboek Coöperatie* (2010), p. 1024.

<sup>29</sup> The corporate governance enforcement technique of ‘comply or explain’ for listed firms have been backed-up by semi-mandatory rules to be disclosed in the consolidated accounts.

<sup>30</sup> Madsen, O.O., and Nilsson, J. (2007), ‘Issues in cross-border mergers between agricultural cooperatives’, *Journal of Co-operative Studies* 40(3), p. 27-38.

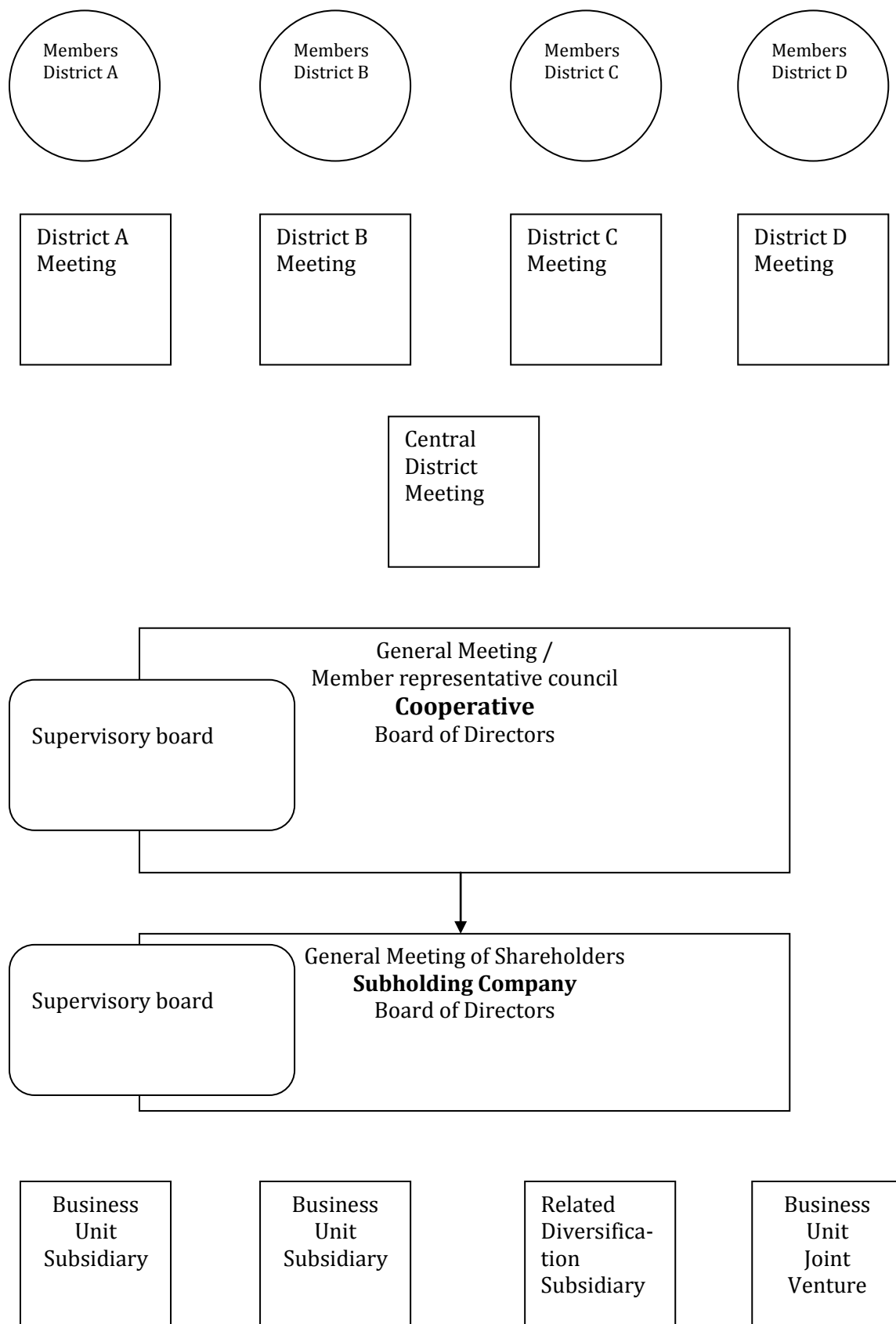
<sup>31</sup> Bijman et al. 2012.

<sup>32</sup> In this respect, we rather not speak of an IOF because the sub holding subsidiary under normal circumstances performs as an extension of the cooperative firm under full control of the cooperative. This does not mean that in practice the sub holding might effectively operate as an IOF-like enterprise, disregarding cooperative principles.

In these cases, the members are formally still in control over the cooperative and indirectly over the subsidiaries. However, several problems arise with regard to the question whether members are effectively still in control. In the first place, in these cases the pool of members shows increased heterogeneity and possibly an increase in members as well. These cooperatives seem to mimic the ownership structure of dispersed ownership as once described by Berle & Means for listed companies and move into the direction of the management-managed firm. Delegation of control rights from the members to the board of directors is a necessity for obvious efficiency reasons. However, it creates at the same time the subsequent agency problem of effective monitoring of the board of directors. In case the cooperative has adjusted its internal governance to the extent that the entrepreneurial part of the cooperative is conducted through a subsidiary, the internal governance problem and agency problems are doubled. Research on the evolution of board models in Dutch cooperatives show these developments as well as some answers with regard to the question how to regain effective member control, e.g. via the introduction of member representative bodies. However, several questions remain unsolved: the function and the role of a separate supervisory board at the level of the cooperative becomes unclear, since the board of directors monitors the board of the sub holding to which the decision control over the entrepreneurial part of the cooperative group has been delegated. Furthermore, the question becomes pivotal who is in charge of strategic decisions. Looking for example at Dutch law, the answer in the cooperative statute is not very clear and depends heavily on the attribution of formal rights in the bylaws of the cooperative as well as the sub holding.

To summarize, changes in strategy induce changes of the structure and consequently changes in internal governance and not vice versa. The cases presented here seem to contradict the classical framework of the division of control rights developed by Fama and Jensen: the decision control rights become dispersed over several tiers while at the same time increasing agency problems and inducing additional agency costs to solve them. To give an example, we refer to the organizational structure in Figure 3. It should be noted that it reflects a theoretical case, although it also reflects to some extent the case of large Dutch agricultural cooperatives, like Cosun, FrieslandCampina, Coforta/The Greenery and the ForFarmers Group.

Figure 3. Complex internal governance structure of a multi-layered cooperative (primary cooperative)



From a legal point of view, this configuration of the cooperative with a separation of the associational part from the entrepreneurial part should be irrelevant, as long as the cooperative remains in control over the (sub holding) subsidiary, enabling the cooperative to implement its strategy and the management of the economic activities with its members (patronage) on this subsidiary. The cooperative operates as a parent and holding company and has the right and the obligation to direct its subsidiary, implement its strategy on it and account for the results of the subsidiary towards its members through the annual, in this case, consolidated accounts. In this respect, legally the (sub holding) subsidiary is primarily instrumental to the patronage of the cooperative. However, cooperatives and/or their sub holdings generally are given the authority in their bylaws to set-up other subsidiaries as well that may have a subordinate role or function with regard to the primary function of the cooperative. Save for small cooperatives that are exempt from disclosure obligations on the basis of the 7<sup>th</sup> Company Law Directive on consolidated accounts, the cooperative is mandated to consolidate its subsidiaries under their control.

The basic pattern of internal governance of cooperatives in the statutes of European member states includes the division of powers between the members, commonly represented in the general meeting, and the board. In all member states, this legal division of powers is mandated by law. The board in this respect means the executive board or administrative board or managing directors.<sup>33</sup> With respect to the question whether cooperative statutes also mandate the introduction of a supervisory board, the picture is clearly mixed. In some member states, the creation of a supervisory board has been regulated by way of default provisions, in others no rules with regard to a separate supervisory board have been articulated in the statute. However, this does not necessarily mean that in these member states cooperatives and their members are not allowed to introduce a separate supervisory board or on the board several non-executive members, like in the Anglo-American one-tier board system. However, the absence of default rules with regard to internal monitoring may explain the detected accountability gap in some member states. Reversely, mandatory provisions to have a supervisory board in case of small cooperatives may be inefficient.

In the Synthesis Report on Legal Aspects (Van der Sangen 2012), the legal aspects related to the internal governance of cooperatives have been assessed, in particular the question whether members remained in control over their cooperative. Although, all member states adhere to the ICA-principle that a cooperative is a member-owned and member-controlled enterprise and cooperative statutes reflect the attribution of core property rights to the members as a whole – represented in the general meeting –, the formal attribution of property rights does not mean that members perceive that they have formal control.<sup>34</sup> In practice, the diversity in board models across and even within countries is immense, as well as the techniques through which cooperatives try to solve the problem of a lack of effective control by members, by introducing a new body corporate, like a representative council of members or the territorial division of member representation bodies.

While commenting on these developments – assuming that members are not in control or perceive not to be in control –, one should take into account that the development and growth of

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<sup>33</sup> Using the terminology of the SCE Statute, article 36: in a two-tier system, a management organ and a supervisory organ; in a one-tier system, an administrative organ.

<sup>34</sup> Introducing ‘formal control’ and the attribution of legal or contractual control rights versus ‘effective control’. See H. Hansmann, *o.c.*, p. 11.

a cooperative needs to be aligned with certain changes in the internal governance structure because the prior *modus operandi* has proven to be inefficient. From a legal point of view, changes in the internal governance structure of a cooperative will commonly involve the creation of new corporate bodies or the attribution or withdrawal of certain rights. It is a general rule of cooperative law that major changes in the cooperative statutes can only be invoked on members after alteration of the bylaws. Democracy in cooperatives may also include the alienation of a minority part of the members. Voice and exercising voice on the core issues of the cooperative is and remains essential. However, with regard to major strategic decisions, the rights of members to be consulted or to be asked prior approval are generally ill-defined in law and depend heavily on the way these issues have been dealt with in the bylaws.<sup>35</sup>

In the report on legal aspects, the hypothesis was tested EU-wide whether the way cooperatives organize their internal governance was too cumbersome from a legal point of view. In that report, the issue was also addressed whether the internal governance structure in itself is a factor that hampers efficient decision-making. The overall conclusion was that the internal governance legal frameworks in the member states were not considered to be cumbersome. Furthermore, on average, the internal governance structure in force in a specific member state in itself was not considered to be a relevant factor that hampered efficient decision-making. These findings from the EU wide comparative analysis of legal aspects correspond with the overall findings of the 2010 SCE-report on the implementation of the SCE-Regulation. This report contained country reports mapping the internal governance legal frameworks. With regard to national cooperative law, the main purpose of the 2010 SCE-report was 'to ascertain whether and what legal obstacles to the development of cooperatives, if any, exists in the countries covered by this research.'<sup>36</sup> Several legal problems have been identified, but what is important is that in this overview no reference was made to any problems with regard to the internal governance system in force.

A preliminary conclusion could be that the formal attribution of authority to the legal bodies of the cooperative – although highly path-dependent and diverse across the EU – does not hamper the promotion or evolution of cooperatives in general. However, we have to take into account that the SCE-report only made an assessment – though very meticulously – of the legal form of the cooperative and does not provide insights in whether in practice the internal governance is perceived by members leading to effective member control.

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<sup>35</sup> The matter is not dealt with in the SCE Statute itself, but article 48 refers to the statutes of the SCE where transactions should be listed that need prior authorization of the supervisory organ/ administrative organ or the general meeting, however not indicating which major decision should be enunciated.

<sup>36</sup> From the summary, *Study on the implementation of the Regulation 1435/2003 on the Statute for European Cooperative Society*, 5 October 2010, Euricse/Cooperatives Europe/Ekai, p. 90-112 and p. 133/134, the following legal problems were reported: the absence of specific legislation (Denmark), the mandatory 'one man, one vote'-principle (Estonia, Hungary, Poland and Portugal), the complexity of the cooperative legislation and the central role played by special laws (France and Greece, may also be the case for Spain), the legal status of employees in rural cooperatives, the absence of a specific regulation on accountancy as the currently applicable one is onerous, particularly for small cooperatives (Poland), the non-admissibility of non-users (investors) members (Portugal).

### *International cooperatives*

International cooperatives in this report are defined as cooperative having sourcing activities with non-members in other member states. With the ambiguity of the data of Latvia, Malta and Portugal taken into account, cooperatives in all member states are free to set-up subsidiaries to operate as a corporate group. From a business organizational point of view, no restrictions in this respect were reported. With regard to the question whether cooperatives are restricted by law to organize their cooperative as a cooperative group with the cooperative as the parent company, member states do not impose any restrictions on cooperatives. However, setting up subsidiaries may have negative effects on the taxation of cooperatives and trigger a loss of tax facilities especially designed for cooperatives. Secondly, organizing a cooperative as corporate group may result in practice in a decrease of *effective* control of members. However, this conclusion could not be deducted from the answers of the questionnaires nor the existence of poor decision-making processes and an increase of agency costs of delegated management.

Considering that the national laws of the member states do not restrict the use of subsidiaries directly, on the basis of the current strand of case law with respect to the freedom of movement, a cooperative may exercise the freedom of movement in using the legal business forms available in other member states. Combined with the absence of legal restrictions on memberships from other member states, from a business organizational point of view a cooperative could well properly function as a transnational *and* international cooperative without having to establish an SCE. The question remains why there are so few international cooperatives that are willing to accept foreign suppliers as members of the cooperative and becoming a transnational cooperative. From the case study report on transnational cooperatives follows that members of international cooperatives are afraid the admission of foreign suppliers as members will lead to a dilution of the existing ownership rights. Consequently, the increasing use of international cooperatives does not lead to changes in the internal governance. We assume that the reason for this primary is the lock-in of members stemming from their high investment in these cooperatives.

However, there is some discussion about the nature the international cooperative whether they represented a 'true' cooperative or operate more or less as an investor-owned firm, because with regard to foreign suppliers, the cooperative does not operate as a cooperative to the extent that those cooperatives do not adhere to the ICA-principle of open membership. However, from a legal point of view, most member states do not mandate open membership and leave this matter to the discretion of the incorporators or members of the cooperative respectively.

### *Key findings on legal aspects of internal governance*

In the Synthesis Report on Legal Aspects, the legal aspects related to the internal governance of cooperatives have been assessed. In particular, whether members remain in control over their cooperative. Theory suggests that cooperatives in general as an organizational solution create inefficiencies in their internal governance and decision-making process, reflected in cumbersome procedures for corporate decision-making. Question is whether this assumption can be verified on the basis of the data of the questionnaires. It is a given fact that in most members states the cooperative is commonly used to organize agricultural producers. According to the evolutionary organizational theory of survivorship,<sup>37</sup> it would suggest that cooperatives

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<sup>37</sup> See H. Hansmann, *o.c.*, p. 22.

vis-à-vis IOFs are viewed as significantly more efficient as the organizational model for POs. However, this is not to say that the internal governance of cooperatives could produce inefficiencies stemming from their legal environment, notably their formal attribution of control rights and their decision-making procedures according to business organizational law.

However, assessing the legal structures of the internal governance of cooperatives, we cannot draw the conclusion that the way the national statutes regulating cooperatives dictate the structure of corporate bodies of cooperatives, their responsibilities and the level of accountability of the management board towards their members, produced – from a legal point of view – significant inefficiencies. On the contrary, on the question in the questionnaires whether the overall corporate governance structure of the cooperative was considered to be flexible or cumbersome, for all member states the national experts reported that it is flexible, with the exception of Portugal, where the corporate governance structure was viewed as being rather petrified with mandatory provisions, having no facilities to include professional managers on the board except for the appointment of an executive officer under full responsibility of the management board and having no rules on a supervisory board, which according to the national expert leads to a lack of accountability towards the members, providing the members with too little information. In this respect, the internal governance in Bulgaria was considered to be too flexible, because of the strong position of the CEO leading to potential problems of moral hazard. Yet, no accountability gap has been reported. Although, the overall internal governance of German cooperatives was considered from a legal point of view flexible, reference was made to the fact that members in large cooperatives with diversified activities and acting as a corporate group may experience a lack of effective control. There were no data on this issue available for Ireland.

In several occasions, reference was made to the internal governance structure for small cooperatives: although the governance structures was not viewed as an impediment for the functioning of small cooperatives, questions were raised whether for small cooperatives a one-tier board would be more efficient, although not available, because the division of powers over a two-tier governance model was viewed too cumbersome, while others pointed out that for small cooperatives the appointment of professional managers or supervisory board members is too expensive (Hungary), given that all members are in the position to be involved in the bodies corporate of a small cooperative, as a result of which no accountability gap exists (Bulgaria, Cyprus). The argument presented here underscores the need for flexible statutes on cooperatives that are able to meet the demands of agricultural producers, relative to the evolutionary stage of their cooperative.

Several member states, like Denmark, Germany, The Netherlands and Sweden, have rules on the participation of employee representatives on the board. However, these rules on co-determination do not seem to hinder the members of the cooperatives, since no reference was made to any problems in this respect by the national experts.

As indicated above, we also made an assessment whether the legal structure and rules on supervision of the management board was viewed as being effective with respect to the accountability of the management board towards members. A negative answer to this question indicated the existence to some extent of an accountability gap. In 22 member statutes, we found no evidence that the rules on internal governance lead to an accountability gap. However, as two national experts pointed out, the actual effectiveness of the internal governance as a technique for accountability towards members will largely depend on the quality of the members of the



management board and the supervisory board. The existence of an accountability gap has been reported for Greece, Portugal, Spain and the United Kingdom. The situation for Portugal has been described in the previous paragraph. In Greece, there were no rules or mandates to have a supervisory board, while at the same time the law precluded professional managers as members of the management board, similar to the situation in Portugal. Although the overall internal governance for Spanish cooperatives was viewed flexible, several restrictions were reported. In Spain, there are no rules that mandate the installation of a supervisory board except for the officers called '*intervenors*', which cannot be considered to have a legal position that allow them to properly function as a supervisory board. Secondly, reference was made to the laws of autonomous regions that did not allow professional managers, while in general there was no guarantee that professional managers would be elected due to the procedure of secret voting by the general meeting. The level of accountability of the management board towards members in the United Kingdom was viewed as problematic, because there are no provisions in the Industrial and Provident Society Act that mandates the formation of a supervisory body.

In the Synthesis report on legal aspects, there was also an assessment with regard to the question whether the composition of the management board was viewed flexible, in particular whether the national cooperative statute provided facilities to have professional managers on the board. In nineteen Member States, the management board may have one or more professional managers. In this respect, Estonia is exceptional because all the members of the management board and the supervisory board may be composed exclusively by non-members. Luxembourg mandates that only members can be elected as members of the management board of the agricultural association, contrary to the rules for cooperatives. In Bulgaria, Cyprus, the Czech Republic, Greece, Malta, Portugal and Slovakia, the members of the management board have to be members of the cooperative. With regard to the supervisory board, sixteen Member States provided the possibility to have non-members to be elected on the supervisory board in order to increase the level of knowledge and professionalism. Three Member States (Greece, Spain and the UK) did not mandate the creation of a supervisory board or an equal body corporate. Seven Member States precluded non-members from being elected on the supervisory board (Bulgaria, Cyprus, the Czech Republic, Italy, Poland, Portugal and Slovakia). A remarkable finding in this respect is that the absence of the possibility to have professional managers on the board did not lead to an accountability gap in Bulgaria, Cyprus, the Czech Republic, Italy, Poland or Slovakia. We assume that most of these cooperatives are small and regionally operating, leaving members themselves in the position to actively monitor the management board.

### **3.2. Different options and models**

Over the last 20 years, agricultural cooperatives in the Netherlands have developed a division of labour between the Board of Directors taking responsibility for decision control (ratification and monitoring) and the professional management being responsible for decision management (initiation and implementation). This division of labour has been institutionalized in new board models. Besides the traditional model, which has been around for more than 100 years, two new corporate governance models can be distinguished: the management model and the corporation model. In the management model, the management of the cooperative firm also forms the Board of Directors (BoD) of the cooperative association. In this model there is no longer a distinction between decision-making on and executing of the strategies and policies of the cooperative. The

BoD has been professionalized, and the supervisory committee supervises association and firm at the same time. In the corporation model the BoD of the cooperative association has become the supervisory committee of the cooperative firm. A legal separation between association and firm has been established, turning the cooperative association into a 100% shareholder of the cooperative firm. This structure provides the management with relatively most autonomy.

Cooperatives have shifted to another corporate governance model because of changes in the competitive environment. In order to develop appropriate strategic and tactic responses to competitive pressures, cooperatives felt the need to strengthen the autonomy of the management, to reduce member influence on operational decisions, to find new sources of equity capital, and to professionalize the supervisory bodies. In sum, strategic re-orientation towards more customer focus, diversification and innovation, has been accompanied by changes in the internal governance structure.

### **3.3. Trends in internal governance**

#### *Internationalization of cooperatives*

The question was raised whether a cooperative that uses subsidiaries is still a cooperative. From a business organizational point of view this should be irrelevant, as long as the cooperative is in control over the subsidiary. Most member states – if not all – allow the use of subsidiaries. However, from a tax law of view this governance structure might have an important impact because it triggers a loss of tax facilities.<sup>38</sup> The question about the cooperative character and identity is particularly relevant for international cooperatives as defined in the research project, because international cooperatives do not adhere to the principle of open membership, excluding foreign suppliers from entering the cooperative. From the Case Study on Ownership structures and hybrid structures,<sup>39</sup> we learned that cooperatives going international have diverse ownership structures and the internationalization induces new financing techniques and new governance structures.<sup>40</sup> Foreign units are more seen as profit centers that support growth and benefit current members. According to the Synthesis report on legal aspects, cooperatives that internationalize their activities did not encounter substantial legal barriers in their national laws. This is supported by the fact that these cooperatives do not use the SCE Statute to organize their cross-border activities.

Another aspect that has been addressed in the Case Study on Ownership structures and hybrid structures was the question whether mergers would lead to hybridization of the cooperative. This was not the case: mergers between cooperatives were possible without hybridization. However, cooperatives that actively entered into the market for mergers and acquisitions of IOFs – in doing so creating a foreign subsidiary – or made investments in IOFs showed an increase of financial needs. From an internal governance point of view, an interesting result was that in some of these cases the strategy had not been discussed with the members of the cooperative. These cases presented in the Case Study on Ownership structures and hybrid structures are examples of last stage cooperatives, causing heterogeneity between and possibly

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<sup>38</sup> We refer to the EU wide comparative analysis of legal aspects, hypothesis 4.2.

<sup>39</sup> Case Study Ownership Structure and Hybrid Structure, Hypothesis 12, 13 and 14. These finding were consistent with the Case Study on Internationalization, Hypothesis 3, 6, 11, 12, 13 and 14.

<sup>40</sup> This finding may be contrary to Bijman et al. (2012).

intra-cooperative producer groups, leading to the denaturizing or demutualization of the cooperative.<sup>41</sup> Also, it effects the internal governance of the cooperative. The complexity of the internal governance is primarily a result of a continuous process of subsequent mergers, not because of the fact that the cooperative is seeking additional equity capital.

Some cases in which cooperatives use an IOF to control inflow of agricultural input are DOCKaas,- and Cosun, owning the potato processor Aviko without having potato suppliers as members. Cooperative controlled IOFs are also used to cooperate via joint-ventures and enter into M&A transactions and mergers, leaving the internal governance of the cooperative intact.<sup>42</sup> The legal form of the collaboration between ZON and Unica is a contract and not incorporated in a ownership structure. From an internal governance point of view, it was an important finding that all these cases left the internal governance structure of the cooperative itself untouched. The members of the cooperatives were reluctant to allow agricultural producers that delivered to the subsidiary to become members because they are not willing to accept changes in the ownership structure of the cooperative. Yet, as was shown above, using subsidiaries at a large scale combined with internationalization and/or diversification leads to a loss of effective member control in a double multilayered internal governance structure. From the Case Study Report on Bargaining associations, we found that larger cooperatives, but not necessarily international cooperatives, are more likely to see their members set up new associations, with the heterogeneity and not size as the decisive factor. The perception of lack of control is also reported as one of the reasons for setting up bargaining associations. Also the degree of diversification is a relevant factor that is strongly correlated with the emerge of bargaining cooperatives. Typically, these are double multilayer cooperatives, where the alignment of formal control and effective control has shifted initially towards the board of directors and subsequently to the management of the sub holding subsidiary. This raises an additional question whether the annual consolidated accounts fulfill their objective as an instrument to inform the members about the performance and implementation of the strategy of the cooperative. As one commentator brought forward: 'Members should be able to read them'.

### *Transnational cooperatives*

In this project, we made a clear distinction between transnational cooperatives and international cooperatives, transnational cooperatives being cooperatives having members from one or more member state, international cooperatives being cooperatives that have agricultural producers in other members states delivering or purchasing from the cooperative without being a member. From the Case Study Report 'Can transnational cooperatives export the cooperative model', we found similar conclusions for transnational cooperatives as for international cooperatives: managers of transnational cooperatives prefer to run foreign operations like an IOF. Transnational cooperatives are more likely to have diverse ownership structures. Foreign subsidiaries<sup>43</sup> are more likely to be treated as profit centers not geared towards supplier income,

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<sup>41</sup> See Van Diepenbeek (1990) and (Chaddad & Cook 2004), discussing demutualization of cooperatives.

<sup>42</sup> This explains why cross-border mergers between cooperatives are not common. Rather they merge on a sub holding level. See Van der Sangen, G.J.H. van der (2007), 'Grensoverschrijdende reorganisaties van coöperaties' in: G.J.H. van der Sangen e.a. (eds.), *De coöperatie, een eigentijdse rechtsvorm*, Boom Legal Publishers, The Hague 2007, p. 63-84.

<sup>43</sup> It should be pointed out that a cooperative can be labelled a transnational as well as a international cooperative at the same time. E.g., Friesland Campina.

because domestic members fear a dilution of income rights. As was the case for international cooperatives, foreign suppliers are not invited to become member in order not to disrupt the internal governance of the cooperative and the ownership structure. The reason why transnational cooperative emerge is amongst others to have members abroad as a prior stage to a merger. If a future merger is not the objective, transnational cooperatives tend to do business in other member states through IOFs. However, this does not imply that the foreign suppliers are worse off than the members, because transnational cooperatives generally pay market prices to the foreign supplier. We cannot say that the use of IOFs is a bad thing. For example, FrieslandCampina is paying in Greece to local suppliers the market price.

### *Outside investors*

Another aspects with regard to the question whether international cooperatives are still considered a cooperative relates to their financing, especially in those cases that equity capital has been raised from outside investors at the level of the sub holding subsidiary through the issuance of tradable shares, e.g. in the case Südzucker and BayWay. As long as there is a cap on the number of shares available for trading and the free float does not exceed 49%, from a legal point of view the cooperative is still in control, although having to take into account the interests of the outside investors. In these cases, there is also a strong perception that members loose effective control, especially with regard to the issue whether members have decision rights on major transactions taken at the level of the sub holding. The comparative analysis on legal aspects (Van der Sangen 2012) indicates ill-defined control rights of members in this respect. However, the cooperative statutes of the member states seem to provide sufficient facilities to incorporate these items in the bylaws of the cooperative. So, members should be aware of this associational freedom to reorganize the internal governance through the adjustments of the cooperatives' bylaws.

This is not a theoretical issue, because research strongly indicates that traditional cooperatives show lower performance while cooperatives with a diversification strategy show higher returns.<sup>44</sup> In the case of Greece, there was a direct negative linkage between the complexity of the law and member participation as well as the fact that members are not allowed to trade outside their region. The latter was also the case to some extent in France, where territory plays a role in governance of niche cooperatives due the proximity of the members, reinforcing commitment. French territorial legal constraints mandate to do business in a specific region.<sup>45</sup> In case they use IOFs, they are located near the head office.

### *Federated or second-tier cooperatives*

From the Case Study on Strategy and Structure of Second-tier Cooperatives, we learned that federated or second-tier cooperatives are not necessarily less efficient. The trend however is that the federated cooperative model is disappearing. The case study on Strategy and Structure of Second Tier Cooperatives assessed the down-fall of the Dutch federated cooperative the Cebeco Group. In this case, there was a mismatch and divergence between large members of primary cooperatives and federated cooperative. Initially, the Cebeco Group had a positive track

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<sup>44</sup> Hendrikse and Van Ooijen (2004) and M. Hanisch (2012), Case Study Report on Internal Governance

<sup>45</sup> A future research question could be whether this is an infringement of the freedom of movement.

record on international investments, created trust of members, but the board of directors became overconfident in their diversification strategy. In order to survive, the cooperative group had to disinvest on a large scale and finally was dissolved. Although this is a highly specific case where several things went wrong at the same time, the mismatch of the internal governance was surely one aspect, but not the driving factor. What we learn from this case and has been described in the literature<sup>46</sup> is that secondary cooperatives have a lifecycle. The function of the federated cooperative was gradually taken over by the primary member cooperatives, while acquisitions were too diversified. Multiple problems with regard to heterogeneity were reported.

### *New Member States*

In general, internal governance is about the institutionalization of fiduciary duties of management in order to be accountable towards members to overcome agency problems. In regions with emerging new cooperatives as well as in the New Member States, internal governance issues are developing quite differently. From the Case Study Report on Cases in the New Member States, we learned that these member states did not have a similar development. There are quite some differences. We would like to refer to the Case Studies on Emerging new cooperatives and Cases in the New Member States. We found support for the argument that policy measures and internal governance should reflect or be able to take into account the different stages of development of cooperatives. The question is whether it is a feasible option to work with transplants. Given the path dependency of member states' cooperative statutes and the different cultural and societal backgrounds, it is highly questionable whether such an approach would work. The case studies on emerging new cooperatives and the cases in the New Member States show rather diverse developments, although the element of trust and leadership was common for all cases. Education is essential as well as advisory services and financial support, e.g. through state aid exemptions. Also, there was a strong demand for professionalism of the management organ as well as the supervisory organ, which in some member states has not been facilitated in national cooperative statutes.

From the Case Study Report on Human capital development in cooperatives, we learned that board compensation is very diverse according to the size of the cooperative. **Small cooperatives seem to have trouble attracting professional management.** Training of professional management is an important aspect. However, this situation is not comparable with the situation of large transnational and international cooperatives, where members of the management are selected from the market for managerial labour, where e.g. CampinaFriesland competes with IOFs like Nestlé, Danone and Unilever for professional managers in the food sector.

In some of the Eastern European Countries, the cooperative actually functioned as a hybrid between member organization of agricultural producers and a worker organization. From a policy point of view, this is an important finding, since the incentives within a worker cooperative are different from those of an agricultural producer cooperative.<sup>47</sup> The communist legacy persists as the lack of trust and leadership are common social issues and obstacles to

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<sup>46</sup> Søgård, V. (1994), 'Power-dependence relations in federative organizations', *Annals of Public and Cooperative Economics*, Vol. 65, Nr. 1, January 1994, p. 103-126.

<sup>47</sup> Hansmann (1996) and Dow, G.K. (2003), *Governing the Firm: Workers' Control in Theory and Practice*, Cambridge University Press (2003).

cooperative development. From a legal perspective, this implies that national codes have to take into the peculiarities of a member state and therefore, a 'one size fits all' approach might not work. Further research has to be done on the development of model codes/statutes that are flexible enough and are able to take into the different stages of a cooperative in its development. The top-down SCE approach might be too ambitious. Access to credit, human capital and the market are main issues in developing areas. For developing areas, the question is justified why the European Union does not have a Capper-Volstead Act-like exemption in competition law, because cooperatives thrive on communication and trust between members.

### *Conflicts of interests*

Internal governance should also address the issue of conflicts of interests. Especially, in small cooperatives the risks of self-dealing and moral hazard has to be solved to protect (minority) members. There is some evidence that larger members with more knowledge, experience and financial capacity are the ones to be active in the board of the cooperatives. From the report on legal aspects followed that rules to solve conflicts of interests in general are ex post remedies and sometimes not or ill-defined. Cases of self-dealing may also arise from the weak monitoring function of the board of directors, composed by members, that have delegated the management of day-to-day business to a managing director that has no formal authority as a board member, but as an employee.<sup>48</sup> So the traditional model is far without risk, supporting the case that trust and reputation combined with professionalism on the board is pivotal for effective internal governance. Too much confidence and trust could easily result in a lack of effective monitoring of the board. We also found that proper remuneration giving the right incentives to board members is important in this respect (case study Gijselinckx).

## **3.4 Comparing countries, regions and sectors**

Particularly in those sectors where agricultural products needs to be processed before reaching the consumer, and such processing involved substantial economies of scale, cooperatives have become not only large companies but often also developed a hybrid ownership structure. This applies to sugar and pork. The dairy industry, which is also characterized by large economies of scale and scope is slightly different as the need for high coordination in the farmer-processor transaction favors cooperative ownership structures. Once a hybrid ownership structure appears, issues of member control also arise. Interestingly, differences in legal situation have not preclude the similar development into larger cooperatives in dairy, sugar and pork.

Also internationalization of cooperatives does not seem to be hindered by differences in cooperative legislation, as most internationalizing cooperatives use a IOF structure for their foreign subsidiaries anyway. This choice for IOF-type of foreign subsidiaries is mainly due to the wish of the cooperative managers to have full control over foreign activities and to domestic cooperative owners to prevent dilution of control and income rights.

The cases in the New Member States made clear that training and education of both members of the board of directors and managers is crucially important improving the working of internal

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<sup>48</sup> As was the case in the Heino Krause-case in the Netherlands. See High Court Netherlands 13 October 2000, *NJ* 2000, 699.

governance. While a proper governance structure may be in place to give members control over the cooperative, effective control may be absent due to insufficient experience and knowledge.

The accountability of the management to members is problematic in Greece, Portugal, Spain and the UK. The absence of a supervisory board or an equal institution hinders effective member control. The efficiency of cooperatives as well as the control of the management could be increased through professional managers on one hand and the introduction of a supervisory board on the other hand.

Several member states, like Denmark, Germany, The Netherlands and Sweden, have rules on the participation of employee representatives on the board. However, these rules on co-determination do not seem to hinder member control. In The Netherlands, employee representatives are members of the Board of Supervisors, not of the BoD.

## 4. Analysis

This case study on internal governance analyzed the linkage between internal governance and performance. There are no conclusive data that support a positive correlation between internal governance and performance. However, cooperatives that internationalize, diversify and use (foreign) subsidiaries generally perform better. These strategic developments induces changes in the internal governance as well as in the ownership structure. Two developments with regard to large international and transnational cooperatives came to the surface: 1) the internal governance of these cooperatives evolved towards a multilayered double governance structure with a clear distinction between the associational part in the cooperative and the entrepreneurial part in a sub holding subsidiary, and 2) the primary center of decision control has been transferred to the management. The consequence of this development is that decision control rights of members become dispersed and member loose effective control. Research on Dutch cooperatives show that these cooperative have tried to regain membership involvement through the introduction of member representative councils. The internal governance follows changes in strategy and the structure of the cooperative and not vice versa.

In general, the legal frameworks for internal governance in the member states do not hamper the sound development of cooperatives. Yet, the complexity of internal governance models in practice is not reflected in the law, leading to a discrepancy between formal control and effective control of members. Looking at the cases of international and transnational cooperatives – a typical Northern European phenomenon –, the member states' cooperative statutes provide sufficient legal facilities to address internal governance needs through adjustments of the bylaws. However, with regard to strategic decision-making the law should involve members more explicitly, in particular when major decisions are taken at the level of the sub holding subsidiary.

With regard to internal governance, we have no experience with the application of the SCE Statute on agricultural cooperatives. In this respect, we can say that national cooperative law provides for a business organizational framework that is able to take into account the different stages of the evolution of a cooperative. This, however, may not be true for all the New Member States. Several internal governance issues were indentified that hamper the sound development of cooperatives: the absence of professionalism on the board of directors and supervisory board, the lack of a clear mandate to introduce a supervisory body monitoring the board, as well as the lack of knowledge and experience of members with the cooperative affairs, including knowledge of accounting. Also in the southern region (Portugal, Spain and Greece), several specific issues with regard to internal governance possibly influence the performance of cooperatives negatively, in particular because internal monitoring is underdeveloped due the lack of clear legal mandates on supervisory boards. Especially, in small start-up cooperatives the traditional internal governance model of a general meeting and a board of directors needs to be complemented by transparent rules that address conflicts of interests.

Although the top-down and 'one size, fits all'-approach in the SCE Statute provides a state of the art of internal governance, the SCE Statute is not used by agricultural cooperatives for other reasons. Transnational and international cooperatives maintain their internal governance structure based on national cooperative law. The question was raised whether the SCE Statute



could be useful for the development of cooperatives in developing regions and the New Member States. However, the results of the case study on Cases in the New Member States indicate that using the transplants will not be a feasible option given the path dependent development of the cooperative law and the cooperative business culture. Furthermore, the SCE Statute in its current form is too complex to apply for small start-up cooperatives, besides the fact that there is no cross-border element. At best, the SCE Statute could function as a model act or as a best practice.

An important finding with regard to transnational cooperatives as well as international cooperatives was that these cooperatives generally are reluctant to allow foreign suppliers that deliver their agricultural commodities to a foreign subsidiary of the cooperative, to become a member. The main reason is that the members fear a dilution of their property rights. Yet, as has been pointed out above, the growth of the cooperative group creates a double multilayered internal governance structure. From a legal point of view, the cooperative parent company accounts for the performance of its subsidiaries through the annual consolidated accounts.

## 5. Discussion

This case study report started with the question of the relationship between internal governance and performance. With regard to corporate governance for listed firms, an extensive body of literature has been established. The performance of listed firms is commonly related to shareholders' value. With regard to measuring the performance of cooperatives, there are several issues to be addressed in future research. In the first place, cooperatives use different techniques to benefit the economic interests of their members: the cooperative could perform its economic function towards members on a cost price-basis in proportion to the amount of member patronage or a cooperative could pay the members a price for their supplies in conformity with the market price. In the first case, a cooperative does not show a profit for all net proceeds are distributed to the members; in the second case, the cooperative generates a profit like an IOF. These differences make the annual accounts and the performance of different cooperatives hard to compare. A second aspect is that in several cooperatives, members are partially compensated for their capital invested in the cooperative separate from the patronage. Thirdly, cooperatives use a variety of instruments – even within one country –<sup>49</sup> to raise debt and equity capital from members and in several occasions from non-members. In practice, problems may arise from these differences between cooperatives to compare their performance, which become apparent in case of a merger. For example, the question may arise whether redeemable or puttable cooperative shares and other redeemable financial instruments are part of the equity of the cooperative or not. The situation becomes even more complex in case a cooperative uses a subsidiary to issue new shares to members and investors. These differences effect the internal governance, in particular where cooperatives depart from the 'one man, one vote'-principle and introduce financial schemes that compensate members for financial investments in their cooperative. Future research therefore should look into the effects of alternative techniques of equity raising on the internal governance of the cooperative. In this respect, it is worth noting that several member states strictly adhere to a mandatory 'one man, one vote'-rule, which might contravene with the development and growth of the cooperative.

In this report, we specifically focused on the legal attributes for the internal governance of cooperatives. Unlike the situation of listed firms, the use of corporate governance codes is not well developed for cooperatives in Europe. Yet, cooperative governance codes could be an important instrument to transfer best practices, models and knowledge about internal governance models. Future research should address where cooperative governance codes are used, what their effect is on internal governance and member participation, and finally how they contribute to the identity of the cooperative as described in the ICA-principles.

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<sup>49</sup> Zwanenberg, A.C.M. (2010), 'Coöperatie en risicodragend vermogen', in: R.C.J. Galle (ed.), *Handboek Coöperatie*, Convoy Publishers, Dordrecht, p. 238-258, showing that the top 10 of agricultural cooperatives in the Netherlands have 25 different techniques for raising equity capital from members.

## 6. Conclusions

Member states' statutes on cooperatives increasingly do not reflect the practice with regard to internal governance. However, there are no indications that national cooperative statutes would prevent promoters and members to adapt the internal governance to their needs. In this respect, it is worth mentioning that the legal form of the cooperative – with some exceptions – is the dominant legal business form for agricultural producers to organize their joint activities. We found no agricultural cooperatives to have the legal form of an SCE, although the SCE Statute provides a very detailed internal governance structure. Apparently, the possible benefits of the internal governance structure provided for by the SCE Statute do not outcompete the disadvantages of the SCE vis-à-vis its domestic cooperative law counterparts. From a policy perspective, questions may be raised whether the SCE Statute is able to have a harmonizing effect. Future research should also look into the role of cooperative governance codes and the use of model codes or bylaws, especially as a tool to inform members and management of best practices, especially for first stage cooperatives and developing cooperatives. Also, the education and capacity building of management, but also of members needs to be supported by policy-makers, for example with regard to the accountability towards members and the function of the annual accounts. National cooperative statutes should reflect as a default rules that members are at least to be consulted in case major strategic transactions on sub holding subsidiary level are taken.

With regard to large cooperatives, transnationals and international cooperatives, there is clearly an issue how to align formal member control and participation with effective control of the management. From a legal point of view, the attribution of decision rights in case of major corporate decisions are sometimes ill-defined in the law. For example, although the Netherlands has a 'sophisticated' and flexible cooperative law, it lacks a clear provision in the law that major corporate transactions in all cases need approval not only by the supervisory board but also consultation of the members. This is particularly needed in case the cooperative itself merely functions as a holding company and all business activities are conducted through subsidiaries. In these cases, the risk of losing effective control by members is omnipresent and needs adjustments of the internal governance structure.

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