The Dual Ownership Structure: a Model to Connect the Cooperative Model With Financial Markets

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The Dual Ownership Structure: A Model to Connect the Cooperative Model with Financial Markets

by

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Abstract

In business literature, the conflicts among workers, shareholders and the management have been studied mostly in the frame of stakeholder theory. The stakeholder theory recognizes this issue as an agency problem, and tries to solve the problem by establishing a contractual relationship between the agent and principals. However, as Marcoux pointed out, the appropriateness of the contract as a medium to reduce the agency problem should be questioned. As an alternative, the cooperative model minimizes the agency costs by integrating the concept of workers, owners and management. Mondragon Corporation is a successful example of the cooperative model which grew into the sixth largest corporation in Spain. However, the cooperative model has long been ignored in discussions of corporate governance, mainly because the success of the cooperative model is extremely difficult to duplicate in reality. This thesis hopes to revitalize the scholarly examination of cooperatives by developing a new model that overcomes the fundamental problem in the cooperative model: the limited access to capital markets. By dividing the ownership interest into financial and control interest, the dual ownership structure allows cooperatives to issue stock in the capital market by making a financial product out of financial interest.
Introduction

In a traditional corporation, shareholders hold the ownership interest and contribute the capital by acquiring stocks. Their financial successes are determined by the price of stock and dividends which reflect the expectation for the future performance and past performance, respectively. As the size of a corporation increases and its structure becomes complex, the modern corporation appoints a management team who manages assets and resources on shareholder’s behalf. Lastly, management hires workers to contribute the labor used in the production of goods and services. These three entities - shareholders, management, and workers-can be grouped together as stakeholders who hold the primary interest in the corporation. Their interests seem to be aligned together as the success of the corporation can bring positive results for all parties. As the corporation records more profit, it may pay more dividends for shareholders, salaries for workers, and bonus for management.

Ideally, the stakeholders should be compensated based on the performance of the corporation. However, this harmony is difficult to achieve in reality because there is a discrepancy between the performance of the corporation and the compensation each stakeholder receives. In reality, the compensation can be determined by the power structure within. For example, in the last recession which took place in 2008, CEOs in the 50 firms that laid off the most workers in 2008 received an average salary of $12 million, which was a 7% increase over their salaries in the previous year (Jones, 2010). This raise is absurd. If corporations were
truly laying off workers because of the bad performance during the recession, why did the managements responsible for the performance receive a raise? The management in general receives higher salary than workers would receive because the management has more responsibility for achieving the performance. Even if the management were to deny it is more responsible for the performance, the salary raise cannot be justified considering the massive layoffs they executed. In fact, even compared with peers, $12 million is much higher than $8.5 million, which is the average CEO salary for S&P 500 companies (which declined by 11% from the previous year). Hewlett-Packard, in particular, raised the salary for CEO Mark Hurd by 73% from 2007 salary in 2008, reaching $43 million. In the same year, HP laid off 25,000 employees while the stock price fell by 29% (Jones, 2010). This phenomenon in which managements received more compensation when other stakeholders were suffering can be feasible only when the managements had better control over the other stakeholders. They were not only powerful enough to attribute the cost of recession to workers through massive layoff, but also to influence the board of directors to increase their salary. This power differential created the discrepancy between the corporation’s performance and compensation.

There are other examples in which the compensation doesn’t seem to be determined by performance but rather determined by who has more power. For example, for Cisco, 2012 was a profitable year, as it recorded $10 billion in profit. To please shareholders, Cisco bought back nearly $3 billion worth of stock, and paid out even more in dividends. Workers who actually put their efforts into this success, however, were excluded from sharing the fruit of their efforts unless they privately
owned Cisco stock. Even before the excitement for success disappeared, the company announced the layoff of 4000 workers in the same year (Rogowsky, 2013). By the same token, the labor union in Hyundai Motor Korea organized another strike which caused $1.5 billion in losses to the company in 2012 (Hancocks, 2012). This union has been notorious for repeating the strike every year except for three in the past 26 years, although their average salary is as high as $100,000, which is five times Korea’s GNP per capita. Why were Cisco’s workers, who had a profitable year, laid off? How did the labor union in Hyundai Motor manage to increase their salary to $100,000 through a series of strikes?

These questions reveal the uncomfortable reality of corporate governance. For stakeholders, the distribution of outcome is a far more important matter than optimizing the results; even if the corporation records a large profit, it is not mine as a stakeholder unless I receive a bonus or a dividend. For this reason, the corporate governance has been the battleground in which stakeholders struggled to increase their share over the performance of corporation. The result of these conflicts of interests is often devastating for corporations. At a glance, the Hyundai example reveals direct costs from the strikes. More problematic, however, are the indirect costs which could have been used otherwise to increase comparative advantage for the corporation. The classic example is Enron’s management, which deliberately inflated the price of stock by 56% in 1999 and 87% further in 2000, mostly by manipulating operating income by 8% and engaging in high risk speculation. In return, they exercised $155 million worth of stock options, while the cash flow of the corporation was gradually depleted. This excessive pursuit of self-interest of
management created a corporate disaster in which $74 billion worth of stocks and 20,000 jobs disappeared as a result of Enron’s bankruptcy (HealyPaul & PalepuKrishna, 2013)

In United States, regulatory efforts were made to prevent corporate disaster that results from the tyranny of management. In response to the Enron crisis, the Sarbanes-Oxley Act (SOX) was enacted in 2002 to force the management to provide more transparency and accountability. The Public Company Accounting Oversight Board (PCAOB) was created to regulate ‘off-balance-sheet’ transactions and require financial reports to be filed in tight scrutiny. In addition, the Dodd-Frank Act was created in 2010, primarily to prevent large, complex financial institutions from collapse. It required Federal Reserve to adopt enhanced standards to regulate high risk taking of financial institutions. However, these regulations are limited by their intentions: to reduce the social costs rising from the failure of the corporation. As long as management is not committing fraud or taking excessive risks, these regulations will not intervene into any problems occurring within a corporation. In fact, any restrictions imposed from outside the corporation cannot resolve the problem itself. They can only prohibit certain actions that would raise the social costs. In order to effectively mitigate conflicts among stakeholders, the sometimes antagonistic relationships among stakeholders must be changed from inside the corporation.

How can the opposing nature of the relationship among stakeholders be improved at corporate level? Solving this fundamental question can significantly
increase the productivity of a corporation by converting conflicts into cooperation. If workers are assured that they will receive their fair share of return in the future, they will be motivated to work harder. The management would manage resources more efficiently. Finally, shareholders will require less risk premium for holding stock, thus lowering the cost of equity for the corporation. In addition, the trust among stakeholders will make the corporation more flexible and adaptable to changing business environments. For example, the corporation may survive a recession if workers trust the management and accept a reduced salary. By the same token, the corporation can fully take advantage of a good economic condition, if shareholders can trust the corporation and inject more capital. Despite these benefits, the question has not been fully answered primarily because not enough attempts were made to reform the corporate governance structure itself. Stakeholder theory, for example, tries to address the conflicts among stakeholders by building a contractual relationship between management and other stakeholders. As we will show more in depth later, this approach is limited by the inappropriateness of the contract as a medium to align the interests of management with that of others.

Instead of relying on contract, this thesis will take a more direct and fundamental approach. It will try to reform the governance structure itself in which opposing relationships among stakeholders can be mitigated. To do so, this thesis will first investigate stakeholder theory in order to form a conceptual background for the study. Then, it will focus on Mondragon Corporation as a successful case of the cooperative model. In a cooperative, the conflicts among stakeholders are
mitigated by the integrated concept of “member.” However, this cooperative model has limited applications primarily because it has limited access to capital market. In the last portion of the thesis, it will try to develop a new model that resolves the conflicts among stakeholders by changing governance structure while overcoming the shortcomings previously observed.
Conceptual Background

The problem arising from the opposing relationship between the management and other stakeholders was first noted in agency theory. According to Jensen and Meckling (1976), the agency relationship is defined as a contract under which principals engage the agent to perform services on their behalf. In most agency relationships, divergence between the decision made by an agent and decisions that would maximize the welfare of principals can occur. This divergence is defined as the agency problem (Jensen & Meckling, 1976). In order to mitigate the agency problem, the principals would offer either incentive for agent to act in certain ways or limit the activities of agent through monitoring. Both incentive and cost of monitoring spent by principal are defined as monitoring expenditure. In some cases, the agent is forced to spend some resources just to ensure principals that his or her action will benefit them. The resources spent by the agent are defined as the bonding expenditure. Lastly, any remaining divergence is defined as residual loss. The sum of monitoring expenditure, bonding expenditure, and residual loss is defined as agency costs. Using equations derived from these definitions, the agency theory calculates the agency costs (Jensen & Meckling, 1976). It is often called the positive agency theory because it is believed that agency costs could be minimized at efficient equilibrium. Therefore, the focus of agency theory is to identify conditions in which this efficient equilibrium can be attained with contracts between agents and principals (Eisenhardt, 1989).
Agency theory assumes that the corporation is surrounded with efficient markets in which efficient and stable equilibrium can be found (JensenMicahel & MecklingWilliam, 1976). In other words, the principals and agents always have freedom to enter into and exit from contractual relationship. In reality, however, the market inefficiencies can appear once there is excess supply or demand of agents. If there is an excess supply of agents, agents would not have freedom to exit the contract. Similarly, if there is excess demand for agents, principals would not have the freedom to dismiss the agent (HillCharles & JonesThomas, 1992). In an attempt to modify these unrealistic assumptions, stakeholder theory was developed. In stakeholder theory, the market efficiency assumption is eased by noting the possibility of disequilibrium in the short run. Because of the disequilibrium, the market needs some time to adjust to a new equilibrium through the process characterized as frictions. Accordingly, the stable equilibrium assumption has been changed to dynamic equilibrium in which the equilibrium will constantly adjust to any changes occurring in the market. Based on these assumptions, stakeholder theory focuses on improving the market process rather than on finding efficient market conditions. It tries to find an incentive structure and monitoring mechanism to reduce agency costs.

In addition to modification in assumptions, stakeholder theory elaborates the concept of agent and principals. In stakeholder theory, the stakeholder is defined as a group of constituents who have a legitimate claim on the firm (HillCharles & JonesThomas, 1992). The legitimacy of claim is created through exchange of relationship. For examples, shareholders contribute the capital to a corporation and
expect to receive the return on their investment in the future. Likewise, managers and workers contribute human capital in expectation of receiving income from the corporation. However, stakeholder theory recognizes that management has unique roles that set the management apart from other stakeholders. In contractual relationships within corporations, the management positions itself in the center, and enters into contract with every other stakeholder. In addition, the management is the only group of stakeholders that has the direct decision making control over resources of the corporation. On this ground, stakeholder theory considers the management as the agent, with other stakeholders being the principals (Hill & Jones, 1992). Therefore, the goal of stakeholder theory is to find means to minimize the divergences between decisions made by the management and decisions that actually would maximize the welfare of stakeholders.

In order to reflect the interest of stakeholders in decisions made by the management, Hill and Jones proposed two strategies. One is the ex-ante interest alignment mechanism in which the management would be compensated if goals set by stakeholders are met. For example, the stock option can provide an incentive for the management to increase the price of stock, which would increase the value of investment of shareholders. This interest alignment mechanism can be applied in various levels to reflect different interests of stakeholders. For example, offering a tax break for decreasing carbon dioxide emissions and therefore serve the interest of the general public and local community. The other strategy aims at establishing a monitoring structure. The stakeholder theory recognizes that information asymmetry exists between management who directly make decisions over
resources and other stakeholders. Other stakeholders can pressure the management to act on their behalf by monitoring the management and reducing this asymmetry. Because it is costly for each and every stakeholder to gather information and analyze the performance of the management individually, monitoring structure that employs specialists should be established to monitor the management at the economy of scale (JensenMichael & MecklingWilliam, 1976). This line of stakeholder theory is termed instrumental stakeholder theory because it uses carrots (incentives) and sticks (monitoring) to minimize the divergence of management.

Although the instrumental stakeholder theory provides prescriptions to the agency problem, it has been questioned for lacking moral legitimacy of goals; what really is the welfare of stakeholders? Is it justifiable? In order to supplement the normative basis of stakeholder theory, Robert Phillips provides an ethical framework in which the norms in contracts should be defined. He adopts the principle of fairness. There are three conditions under which the principle of fairness can be established: 1) there is a cooperative scheme that is mutually beneficial; 2) the cooperation requires a certain sacrifice; 3) benefits produced from the scheme are freely shared. Once these conditions are met, the principle of fairness states, “a person who has accepted the benefit is bound by a duty of fair play to do his part and not to take advantage of the free benefit by not cooperating” (Phillips, 2003). Applying the principle of fairness into stakeholder theory, an obligation is created among stakeholders.
Phillips characterizes the obligation by the following four conditions (Phillips, 2003).

1. An obligation is a moral requirement generated by the performance of some voluntary act (or omission)
2. An obligation is owed by a specific person (the “obligor”)
3. For every obligation generated, a correlative right is simultaneously generated
4. It is the nature of the transaction or relationships into which the obligor and oblige enter, not the nature of the required act, which renders the act obligatory.

The first condition indicates that additional moral considerations arise from the voluntary and obligation-generating act of becoming a stakeholder who accepts benefits from the cooperative scheme. The second condition indicates the specificity of obligation. The obligation is created for a person or persons, in contrast to all people. The third condition indicates the reciprocal nature of obligation. As a corporation receives certain contributions from workers, for example, in the form of labor, the corporation is obligated to reward workers with salaries. By the same token, as workers receive salaries from the corporation, they are obligated to contribute their time and efforts in the form of labor. The last condition indicates that the existence of obligation is not determined by the content of obligation but rather by the obligating act itself. Using this technical concept of obligation, Phillips tries to provide moral justifications to stakeholder theory. The first two conditions
provide the identity of stakeholder, while the later two conditions explain how obligation is created by entering into contract.

Throughout the discussions from agency theory to the principle of fairness, the theme remains unchanged: to reduce agency cost through the contract. Agency theory tried to define conditions of contract in which the efficient equilibrium of agency cost can be found in the contract. Stakeholder theory tried to find the mechanism in which the contract can minimize the agency cost. Lastly, the study of principle of fairness reinforced the normative substance of the contract. However, questions were raised against the appropriateness of the contract as a medium to reduce the agency costs. Alexei Marcoux required stakeholder theory to answer following two questions (Marcoux, 1998):

Q1. Who are the stakeholders? (The stakeholdership question)

Q2. What are the legitimate moral claims of the stakeholders upon the firm? (The normative substance questions)

Using these two questions, Marcoux effectively challenges the stakeholder-as-contractor view.

In regards to the first question, Marcoux points out the dilemma that stakeholder theory inevitably faces in defining stakeholders who enter into a contract (Marcoux, 1998). He first attacks the wide account of stakeholder, which defines a stakeholder as anyone who affects or is affected by corporation. Two problems arise from this wide account. One is the difficulty of identifying those who
have legitimate claims on corporations from those who don’t. According to this wide account, virtually anyone could become stakeholder. For example, suppose a pedestrian walks by a store. Even if he does not have any intention to buy anything from the store, he could become a stakeholder by affecting the store by not purchasing the products. Does he have a legitimate claim on the corporation? If so, how can management recognize every pedestrian? The other is the impracticality of the account. Even if management recognizes all and only stakeholders who have legitimate claims on corporation, recognizing stakeholders would not be beneficial if it include virtually everyone (Marcoux, 1998).

In response to Marcoux, Phillips applies the principle of fairness, and defines stakeholder as "voluntary members of co-operative scheme for mutual benefit (CSMB)." Under this definition, any outsiders including pedestrians are excluded from stakeholders because they did not agree to CSMB (Phillips, 2003). Marcoux would term Philips’ approach as the narrow account of stakeholder, which tries to limit the account of stakeholder using more technical definition of stakeholder. Marcoux criticizes this narrow account primarily for lacking a coherent principle to include all and only stakeholders who have legitimate claims on a corporation (Marcoux, 1998). Marcoux points out that the narrow account of stakeholder necessarily contains the dilemma of including the competitors as stakeholders using the following syllogism: (a) once the principle of fairness includes all the community as a stakeholder, (b) because some competitors are members of the community, (c) some competitors should be included as stakeholders. Including competitors as stakeholders would be absurd given that serving the competitors’ interest would
incur a direct loss for the corporation, yet the narrow account of stakeholder cannot avoid this dilemma unless it excludes the community. Excluding the community from the class of stakeholder is also problematic because there is no ethical justification to exclude the particular class. This dilemma which the narrow account necessarily faces reveals the complexity in defining the stakeholder in contractual relationships.

For the second question, Marcoux attacked the normative substance of the contract by observing two possible interpretations of the contract (Marcoux, 1998). One is the legal contract interpretation which includes all and only stakeholders who have legal contracts. This interpretation seems to answer the Q1 by defining who the stakeholders are in the contract with legal terms. However, this interpretation is problematic because there is a discrepancy between the act and terms of contract. Although the act of contracting is legally binding, the content of a contract may not be settled in the contract. In fact, Marcoux observed that stakeholder theory is characterized by the management having extra-contractual obligation to stakeholders. For example, instrumental stakeholder theory proposes an ex-ante interest alignment mechanism to align the interest of management with that of stakeholders. This mechanism, however, implies the contract cannot directly govern the activity of management. Rather, it only provides an incentive for the management to act on the interest of stakeholders. Therefore, there is a discrepancy between the act of contracting which is defined legally, and the content of contract which is not fully covered by the laws.
In attempts to resolve this discrepancy, Marcoux addresses two feasible accounts of legal contract. On the one hand, the interstitial account states that a legal contract defines the boundaries of relationship between stakeholder and the firm. However, he points out that it is impossible to draft a contract that could apply to every situation. Even if the contract manages to address most of the boundaries, the success of the contract then becomes contingent upon how skillfully and carefully the relationship is drafted, not on stakeholder-theoretical norms (Marcoux, 1998).

On the other hand, the extra-contractual account of contract claims that the obligation of contract exists beyond the legal contract. This account sends the problem back to Q1 and questions why anyone would enter into a legal contract that does not settle the stake. Marcaux concludes that legal interpretation cannot provide the plausible normative substance of the contract in either account (Marcoux, 1998).

The other is the social contract interpretation. Freeman and Evan state: "Throughout this essay, ‘contract’ should be interpreted broadly to cover cases of ‘implicit contract.’ We distinguish ‘contract’ from one-shot exchanges and intend it to stand for ‘multiple transactions’ that require some governance mechanisms" (Freeman & Evan, 1990). Here, Freeman and Evan reject the legal interpretation of contract and interpret contract as a social contract that exists among various stakeholders. This interpretation avoids the problems observed in legal interpretation by letting both act and contents of contract be determined by stakeholder theory through social contract. However, Marcoux points out that this interpretation sends stakeholder theory again to Q1, who are the stakeholders.
Under social contract interpretation, the competitors once again should be included as stakeholders because they are part of the community.

To conclude the study of conceptual background, agency theory first recognized the agency problem occurring from the relationship between the agent and principals. Stakeholder theory was then developed to provide instruments through which the contract can minimize the agency cost. The principle of fairness was adopted later to provide a normative substance. However, this framework was challenged by Marcoux in regards to the appropriateness of the contract as a medium to reduce agents cost. If this criticism is to be taken, then the question becomes what mechanism can reduce the agency costs? Rather than finding another medium that tries to mitigate the conflicts of interest, this thesis proposes to think outside of the box, and consider taking a different approach to minimize the agency costs: what if stakeholders are integrated? In other words, how would agency costs change if the very same people who work for a company are the people who own the company and elect the management among themselves? In fact, this approach was proposed by Marcoux as equalitarianism which requires equal shares for all stakeholders. A stakeholder theorist, Phillips rejected this idea by criticizing Marcoux who he says “misses one of the more obvious-and indeed strongest-interpretation of balance among organization stakeholders: meritocracy” (Phillips, 2003). As a counter example to Phillips, a successful organization in which equal amounts of shares are owned by all stakeholders exists: Mondragon Corporation. The next portion of this thesis will study Mondragon, observing how this model can be used to reduce the agency cost.
The Mondragon Corporation is a Spanish corporation founded in the Basque region. It started from one cooperative consisting of 23 members in 1956 and rapidly grew to a giant corporation which employed an average of 80,321 workers in 2012 (Mondragon Corporation, 2013). It has 110 cooperatives and 147 subsidiaries. Mondragon Corporation can be divided into retail, industry and distribution. In retail, it competes on a national scale and recorded €8 million in sales in 2012. In industries, it manufactures various products ranging from home appliances to high tech materials which are used by NASA, recording almost €6 billion in industrial sales, €4 billion of which came from international sales. Lastly, in distribution, Caja Laboral controls more than €13 billion as a development bank while Lagun-Aro funds hold another €4.5 million for welfare of employees (Mondragon Corporation, 2013).

Although each business consists of different cooperatives, they are all grouped together Mondragon Corporation. It is important primarily in two ways. First, Mondragon maintains a unique governance structure which democratizes the process of production. As of 2012, 85% of workers (Mondragon Corporation, 2013) participate in the cooperative, which is co-owned by workers and entails a democratic decision making process. In the cooperative, each member owns an equal amount of share and contributes the same amount of capital, casts a vote in important decisions or electing management, and participates in production as a worker. This unique structure relieves the agency problems by integrating the
Secondly, Mondragon is the most successful example of a cooperative model. It is a major corporation that has expanded rapidly and competed with other firms successfully using the cooperative model for over half a century. In the period between 1956 and 1986, only three cooperatives out of its 103 cooperatives were shut down. In the same period, only 20% percent of firms founded in US survived more than five years (Whyte, 1991). Also, even during the severe recession in the early 1980s when the unemployment rate was over 25% in Spain, Mondragon survived without massive layoffs. Not only did Mondragon cooperative survive better, it also grew more rapidly than other firms in Spain. It became the seventh-largest Spanish company in terms of asset turnover in 2012 (Mondragon Corporation, 2013). The purpose of this part of the thesis is to observe the formation and development of Mondragon Corporation. Studying its success will allow us to understand the role of its unique structure in the early development of Mondragon.

**History**

The history of Mondragon Corporation started from the vision of Catholic father, Don Jose Maria. Born in the Basque region, Father Maria joined the liberal Republican army and participated in the Spanish Civil War against the Fascist regime. From the war experience, he formed a particular interest in cooperation and collective solidarity among Basque people. He organized the vocational school, Escuela Politecnica Professional, to improve the education of young men after the
war in 1943. Impressed with his social visions, the first graduates of the school realized that they would not be able to rise above minor managerial positions in local firms which were controlled by a few rich families. Rather than conforming to reality, they wanted to start something that did not exist in the past. With the guidance of Father Maria, they decided to form a worker cooperative in their town. With the help of the local community, pioneers and the father were able to raise 11 million pesetas (about $361,604 in 1955 dollars). They used this capital to acquire a bankrupt private firm that had license to produce electrical and mechanical products for home use in Victoria. With 18 other associates, five pioneers founded Ulgor which became the first worker cooperative at Mondragon region in 1955 (Whyte, 1991).

Ulgor started with technical difficulty in the beginning. Their first product, an oil-burning heater, was of poor quality and its metal pieces would often break off. Even with the risk of fatal burns during product testing, the pioneers worked twelve hours a day, six days a week, without any thought of overtime pay (Whyte, 1991). While the pioneers struggled to improve the quality of the product, Father Maria, who helped the formation of cooperative as an adviser, persuaded pioneers to start cooperative bank. He foresaw that more cooperatives would emerge in Mondragon region if there was an institution that can provide financial assistance to these cooperatives. Because issuing stock to the public was not an option for a cooperative, Mondragon cooperatives would rely heavily on loans from banks in the future. However, he was very well aware that it would be difficult for a cooperative to borrow from private banks which did not trust in the idea of worker-owned
business. On this ground, he saw the necessity of the cooperative bank which holds the capital from all cooperatives and workers, and provides the capital to a cooperative that is in need. After intensive research, he found an opportunity in a regulation that specified special savings program for blue-collar workers which allowed worker-owned banks to pay .5 percent above the normal interest rate. This regulation allowed the formation of the cooperative bank, Caja Laboral, which soon attracted a large amount of capital from local workers who were enthusiastic about the cooperative (Whyte, 1991).

By the early 1960s, Ulgor overcame its initial difficulties with technological breakthroughs and local supports. Its success and Father Maria’s constant efforts to spread his social vision inspired other groups of entrepreneurs to establish new cooperatives in the region. Three other cooperatives, Arrasate, Coperci and Ederlan were created in this formative period between 1958 and 1963. Ulgor and other cooperatives shared their visions in improving Basque region and adopted the advancement of society, economy, and technology as their common goal. They collaborated on projects to improve public health, education and sports. This created the linkage among early cooperatives in Mondragon and contributed to formation of Ularco, a cooperative group that was named after first two letters of Ulgor, Arrasate and Copreci. Each firm maintained its independence, yet they now had a general management to make collective actions. A group of Americans who visited Mondragon in 1980s focused on this integration: “perhaps the most profound innovation, however, has been the creation of the Cooperative Groups. During recession of 70’s, now called ‘The Crisis,’ the co-ops found that they remain
far more flexible by organizing themselves into groups that could shift resources, profits, losses and employees among themselves” (Springfield Union, 1988). After extensive study and interviews on Mondragon, this delegation concluded that flexibility was the goal of creation of the groups. By creating Ularco, cooperatives could react collectively against any market uncertainty with from adjustments among themselves. In fact, during the recession Mondragon suffered in the early 1980s, this collective sacrifice and response played very important role.

The creation of Ularco was also important for its expansion. Creating the larger group of cooperatives meant their resources could be concentrated for the expansion. One consequence was expediting the formation of fifth and later cooperatives. The other consequence was collective effort to foster the education and technology. Escuela Politecnica expanded its educational program through the collaboration with Ularco. In order to help students to help pay the tuition, Alecep, which mostly included students of Escuela Politecnica, was created in 1966 to allow students to work part time in Ularco and to help pay their tuition and living expenses. In this way, more students could receive a higher education through this program and later would join Ularco as members. Instructors in Escuela Politecnica also created Ikerlan, the research department, in 1966. Ikerlan specialized in conducting research projects on demand of cooperative or outside customers. Unlike the research department in other private companies, Ikerlan soon became a competitive research complex that accumulated expertise in making improvement in a wide range of products and service, and created a synergy among technologies; Ikerlan is now the only high tech company in Spain to meet technological standard
of NASA. Instead of having R&D departments in each cooperative, Mondragon cooperatives collectively supported Ikerlan to acquire technology at low cost (Whyte, 1991).

With the formation of a cooperative group, higher education and technological advances, Ulgor and other cooperatives entered into a stage of rapid growth from the 1960s to early 1970s. Total membership surpassed 3,500 in 1974, and led to the creation of a number of new cooperatives. This success was further strengthened by the central role played by Caja Laboral. As a development bank, it provided the necessary funding for both startup cooperatives and expansion of existing cooperatives. It collected savings and profits from all cooperatives and distributed this capital to cooperatives in need. It facilitated the formation of new cooperatives by reaching out to them and offering consulting and emergency assistance. It also connected cooperatives within Mondragon more tightly through contracts. Cooperatives were required to act in norms and structures specified by General Assembly of Caja Laboral, in which representatives from each cooperative discussed important issues. For example, Caja Laboral would intervene in an underperforming cooperative to protect the investment and improve the operation through structural adjustments. Through this governance structure, the Mondragon cooperative complex was further integrated and expanded rapidly. More entrepreneurs from outside as well as entrepreneurs from existing cooperatives who had business ideas and shared social vision of Mondragon would now receive total care from Caja Laboral. Once they were selected by Caja Laboral based on the profitability and feasibility of their plan, they would borrow money from Caja
Laboral, receive managerial and educational assistance from Caja Laboral, and contribute their capital back to Caja Laboral once they begin to make profit.

From the 1950s to early 1970s, Mondragon outperformed most Spanish corporations. According to Henk Thomas and Chris Logan, “cooperative efficiency exceeded that of the largest [Spanish] enterprise by 7.5 percent and of medium and small-sized enterprises by 40 percent” (Thomas & Logan, 1982). At this point, the Mondragon cooperative began to draw attentions internationally. In Times, Economics editor Peter Jay observed the success of Mondragon in depth in 1977: “the Mondragon community is growing at the rate of about four new cooperatives a year...It [Caja Laboral]...deposits of nearly £100m and capital and reserve of £15m, having increased its number of savers 22 times between 1966 and 1974. It also deploys a high degree of control and monitor through its Empresarial division with a staff of 90, which insists on and provides highly qualified modern management for the cooperatives” (Jay, 1977). Jay not only points out the success of Mondragon in terms of size, but also goes further and casts light on the structure. Fascinated with the ownership of workers and a structure that fosters growth, he concludes his article by arguing that this model should be copied in England: “there can be little doubt... that Mondragon has been outstandingly successful so far. The questions whether and how this approach should be imported into Britain to work alongside the conventional private and public enterprise sector” (Jay, 1977).

In article published few months later, Geraldine Norman attributes its great success to the intelligent structure of Mondragon. She points out that the success of
management in Mondragon relies on the system, not on the skills of individual: "The fact that financial success or failure depends fundamentally and almost exclusively on management is a basic assumption of all those within the group. At the same time the 3 to 1 ruling on earnings make it difficult to attract suitable management talent" (Norman, 1977). Although she admits that there are a few talented individuals in management, she notes that most of them are relatively young (in their 30s) and vary significantly in their skill. However, the management in cooperatives manages each cooperative successfully based on guidance provided by Caja Laboral. They are not dictates, but rather advice which both management and other members can discuss, and thus address the need of cooperative. If the management is not qualified to make right decisions for the cooperative, they could be replaced by election. From this perspective, the democratic management system was in fact the strength of the cooperative.

In the late 1970s, Spanish economy suffered from stagflation which persisted until the 1980s. The inflation averaged 16.2%, the highest in Europe, and unemployment rate increased by 20% in Spain and even reached 27% in the Basque region (Bradley & Gleb). Even in this difficult time, Mondragon Corporation was able to continue their earlier success primarily in two ways. On the one hand, Mondragon dramatically increased its exports to 30% of their sales by 1980. This transition helped Mondragon to recover from the recession relatively faster than other Spanish corporations by increasing its revenue from other countries whose economies recovered faster than Spain’s. On the other hand, members in Mondragon agreed on mutual sacrifice for the survival of all. They agreed to raise
capitalization by 1.8 billion pesetas (approximately $12 million) and accepted the adverse wage system in order to survive the adverse economic condition. Also, the cooperatives absorbed and minimized the impact of relocation and temporary unemployment that were necessary for the survival of cooperatives through Lagun-Aro, the cooperative that provides social security service to members of Mondragon. Lagun-Aro had the responsibility to place for unemployed workers within Mondragon and pay “80% of basic take home pay plus 100 percent of what they would be paying to the social security fund if they were still employed” (Whyte, 1991). Through this generous social plan within the cooperative, members in Mondragon shared the cost of the impact of the recession and endured the difficulty time.

This success story gained recognition not only within Spain but internationally. An article published by International Trader describes Mondragon as follows: “imagine you can cross between a Chinese commune and a capitalist enterprise. It can be found in Basque region of Spain... they survived the recent recession without reducing employment because they have developed sophisticated business strategies” (Bois, 1984). These sophisticated business strategies refer to adaptations mentioned above. On the one hand, “Exports have doubled in three years, and now generate 22% of sales. Investment has been maintained” (Bois, 1984). This observation describes the successful transformation of Mondragon’s strategies from domestic focused to export focused. On the other hand, “the cooperatives’ bank requires monthly budgets and reports, and sends in troubleshooters at the first hint of trouble” (Bois, 1984). This statement attributes the
efficiency of the management to the active role of Caja Laboral. Although this article was written in the Cold war ideology, it did capture the successful performance of Mondragon during the recession correctly.

Despite the praises from the media, the success of Mondragon did not spread to other European countries. The report published by Anglo-German Foundation for the Study of Industrial Society provides useful insight into perceptions of contemporaries (Alastair Campbell, 1977). This significant report was widely used as a source for articles mentioned above, and introduced the Mondragon model to other European countries. To begin with, the report did evaluate Mondragon positively: “the success of the Mondragon group over a 20 year period tends to disprove the argument that producer co-operatives are unworkable” (Alastair Campbell, 1977). However, this report went further and observed the limit of the study. It acknowledged that special geographical and historical factors have contributed hugely to the success of Mondragon. In special factor analysis, it points out that the post-Civil war Basque region had both special geographical and historical factors: large unemployment, industrial opportunities during the recovery, post-war isolation, and most importantly, Basque nationalism which provided “strong community backing for this strictly regional, commercial initiative” (Alastair Campbell, 1977). These numerous factors were combined to provide “perfect breeding ground” for producer cooperative (Alastair Campbell, 1977). Also, in the case against producer cooperatives, it pointed out that the success of Mondragon was limited to small or medium-sized cooperatives, in order to suggest that this producer cooperative model may not apply to other societies, particularly Britain,
where most labor conflicts took place in large corporations. Nevertheless, this report proposed to concentrate on key features of Mondragon which could be applicable to any society: democratic structure of control by workers, workers’ capital contributions and reinvestment of profits, the Management Consultancy Division of Caja Laboral, and principle that a new co-operative is only set up on the initiative of workers. (Alastair Campbell, 1977). In conclusion, this report takes a reserved positive stance toward the Mondragon model.

This reservation was turned into criticism in US during the recession. Although Mondragon did relatively well during the recession, other cooperatives in Europe went into bankruptcy. Steven Greenhouse described this change in trend as “pendulum has swung” in his article in the New York Times after the recession (Greenhouse, 1988). Although the concepts of worker cooperative and worker-owned cooperation were formed and developed in Europe, many French and British cooperatives at the time could not handle the recession as successfully as Mondragon and went to bankruptcy. Greenhouse points out that “after years of growing faster than in the United States, the [Cooperative] movement’s European rate has fallen below the American” (Greenhouse, 1988). On this ground, Greenhouse pointed out that now the trend in Europe has been changed from “worker cooperative and participation to incentive creation more along the American line” (Greenhouse, 1988). This statement reflects the understanding in US that, even in Europe, the cooperative model was failing during the recession and a more capitalistic model based on incentive system should be preferred. This critique
provides an explanation as to why the cooperative the model lost so much enthusiasm in the US.

**Analysis**

The history of Mondragon can be divided into three periods: the Formation Period (1950s~early 1960s), Development Period (early 1960s ~early1970s) and Restructuring Period (late1970s~early1980s). Using history as a basis, the analysis of Mondragon will focus on the factors 1) that were unique to Mondragon and 2) led to its success.

First, in the formation period between the 1950s and early 1960s, the sense of ownership and solidarity among workers played a key role. In Mondragon Cooperative, the governing council was elected by the members. All members had one equal vote, and therefore had equal voice. They also shared profits together and were paid at a defined pay scale; no worker would receive a salary exceeding three times the lowest paid salary. This compensation structure is counter-intuitive to our society where compensation based on merit is considered as a norm. However, pioneers in Mondragon valued creating a democratic workplace over gaining higher status in local companies. Spanish law at the time did not even recognize the cooperative as a legal entity. Even with the absence of regulation, the pioneers of Mondragon acquired a private firm under the name of one of them, and invested all of their savings and passion into this cooperative. In fact, it is this enthusiasm that overcame technical difficulty, too. Had all twenty-three of the workers not worked
cooperatively with the sense of ownership, they would not have worked overtime almost every day and risked severe fatal burns without any extra pay. This commitment to a firm is unique to Mondragon, compared with other private firms where most workers work passively under supervisions of managers. In fact, most startups, even with a great business idea, often fail too quickly because of lack of investment or technological breakthrough. Mondragon had neither in the beginning yet gained both soon with the sense of ownership.

Secondly, Mondragon was able to grow rapidly in the development period between the late 1960s and early 1970s by successfully crafting and executing strategy. In this period, cooperatives overcame difficulty and began to gain success. However, they did not want their success to remain in their pockets; they could have increased salary or cash dividends for themselves. Rather, all cooperatives that participated in Mondragon shared a social vision to serve the community, improve education and increase working conditions for other workers. They tried to 1) increase the number of cooperative and members, and 2) share the profit with the community. To achieve the first goal, each cooperative had a governance structure in the form of a capital account at Caja Laboral, not in the form of stock. Initial investment and returns on the investment would be held in the form of the capital account, whereas return on stock would have been distributed away to shareholders as a cash dividend. This governance structure allowed Caja Laboral to raise more capital which then could be reinvested to new or existing cooperatives. If any entrepreneurs both from inside and outside cooperative had any business plan, they would send it to Caja Laboral’s monitoring board which would review the
feasibility and necessity of the plan. Then Caja Laboral would provide all necessary resources, from seed money to consulting and technical training, to entrepreneurs. Once the cooperative successfully took off, it would contribute its capital back to the bank with interest. This process was highly successful both in terms of number of survivals (only three failures) and profitability of Caja Laboral which was the fastest growing financial institution in the period in Spain. As a result, Mondragon was able to expand exponentially. To achieve the second goal, cooperatives collectively supported a social security program (Lagun-Aro), an educational program (Alecep) and technical consulting (Ikerlan). These programs not only increased the competitiveness of cooperatives through reducing welfare, training and R&D cost for each cooperative but also aimed at increasing the social welfare with economies of scale. For example, anyone who wanted to study and make a living could join Alecept to receive professional training. More importantly, their constitution required cooperatives to set at least 10% of their profits apart for community projects such as building schools and sports complex in Basque region. The success of Mondragon Corporation transformed what were once small rural towns of the Basque region, severely destroyed by civil war, into a high-tech cluster filled with modern buildings. More people in the Basque region would become involved with Mondragon through education or social projects, buy products from Mondragon, and join Mondragon as members. This support provided a sustainable base on which Mondragon could grow throughout the development phase.

Lastly, Mondragon was able to quickly recover from the recession through adaptations. From its history, one can observe Mondragon’s painful yet appropriate
response to the recession; it raised enough capital from members to invest, restructured each cooperative to become more efficient and export-based, and demonstrated flexibility in employment both through relocation and temporary layoffs. The question becomes how Mondragon cooperatives were able make such decisions so swiftly and effectively that they successfully recovered from the recession. The key lies in its decision making process. From its very beginning, Mondragon had a democratic decision making process: every worker had one vote in the election of management. This election system provided at least two advantages. One was fairness and accountability of decisions made by management. Because the management was elected by workers, they were obligated to make decision that best served the interest of other members who elected them. The other was better qualification of the management. To be sure, most members of management, who were elected from among the workers, continued to be paid at similar level with their previous salary and had little privilege. Ironically, this lack of financial interest attracted more qualified and committed people to management positions. Only the members who really possessed leadership and the most qualifications were elected as the management by other members, served the cooperative in the management, and returned to their previous positions once the term ended; the positions were not so much about money, but about honor and service to their community. They made decisions based on their knowledge which they accumulated overtime, from the perspective of members of the cooperative. This allowed managerial decisions to best represent the interest of the Mondragon community.
However, this democratic decision making process was further improved and became even more accountable through reforms. In 1974, informal committees in Ulgor organized the first strike as a result of dissatisfaction over a new job evaluation program which rated workers and paid slightly differently. Shocked by the strike, the management conducted extensive studies and reflections on its cause. As a result, the governance structure of Mondragon was reformed to be even more democratic. The management was now required to be more transparent and provide more information to individuals. Also, committees were organized at various levels to discuss imminent issues and express their concerns to management. On this ground, when Mondragon faced adverse economic conditions, members better shared understanding of the necessity for reforms suggested by management and agreed to take actions that were painful but necessary for the survival of Mondragon. This wide consensus was rather unique to Mondragon because workers were owners and decision makers at the same time. While owners, managers and employees in other companies would fight over who should bear the cost of recession, Mondragon had a competitive advantage through efficiency in its decision making process which minimized the cost of recession.

**Conclusion**

From the study of the earlier history of Mondragon, the unique mechanisms by which cooperatives operated are well shown. As workers who contributed the labor in production also held the ownership interest of shareholders, a technological breakthrough was made. Because the management was elected among workers, the
management became more accountable for their actions. In return, other members would understand the necessity of such actions and supported the management’s decisions, even ones that required sacrifice. Overall, balancing interests of shareholders, workers and management created a great synergy for Mondragon. However, it is also true that no other cooperative models have been quite as successful as Mondragon; they have remained relatively small in size and have struggled to survive. In order to understand why, external factors must be studied first.

On the one hand, Mondragon was able to take off successfully with the help of Basque nationalism. From the very beginning, Father Maria rallied young workers with his social vision to establish cooperatives that would serve the communities in Basque region. Following Ulgor, many cooperatives were developed in nearby towns to create a cooperative movement across the Basque region. In the formation of each cooperative, the local community lent initial capital to a cooperative that was enough to take over a private company. Even when the product quality was poor, there were consumers who would buy the products from the cooperative. Heavily favored by the local community, each cooperative was able to be established. In addition, these cooperatives were soon integrated and formed a cooperative group because they all shared the vision of serving the Basque community. In the dispersion of the cooperative movement, the Basque nationalism played important roles by creating strong support within the community and forming a cooperative group with solidarity.
On the other hand, the unique economic circumstances in postwar Spain protected Mondragon from competition in the early stage. After the Spanish Civil War, Spain imposed high tariffs on imports under the dictatorship of Franco. According to Chang Ha Jun, the protectionist economist, an infant industry requires both tariff and non-tariff protection from imports until it matures enough to compete with global corporations (Chang, 2008). Mondragon was very fortunate, in this sense, to avoid foreign competition and thus be able to charge higher prices to domestic consumers. They could use this extra profit to gradually build competitive strength. United Steelworkers in US, a cooperative that produces steel, for example, has suffered significantly for precisely the same reason that led the steel companies in US to bankruptcy: the US steel market is open to global competitors such as Korea and China which accumulated their competitive strength over time through the protection of their governments. For this reason, many failures that other cooperatives elsewhere suffer from the inherent risk of adverse economic conditions were avoided in the case of Mondragon.

However, these explanations seem insufficient given that no other cooperative has gained success that is comparable to Mondragon, for over half a century. Even if these factors belong uniquely to Mondragon, they do not explain why existing corporations that are already large enough to compete with others do not adopt the cooperative model. In fact, there is a major problem that is hidden under external factors: the limited access to capital market. Because all shares are distributed equally among members, no outside investors may invest in the stock of a cooperative. This not only means that a cooperative cannot attract capital by
issuing new stocks from investors, but also it has limited access to the capital market in general. Because the control of cooperative is entirely concentrated on members, non-member investors would require a significant premium for bearing the control risk; because about allocation of assets, creditors bear an additional risk for not having any control over how their investment is used. This limited financial accessibility was avoided in the case of Mondragon, because it was able to borrow from the local community from the beginning, and opened Caja Laboral later. However, not every cooperative can have the same access to the capital market as Mondragon has had. Not only is borrowing from the local community difficult, but also forming a financial institution within each cooperative is difficult unless there is a strong regional support for cooperative. Again, Mondragon is an exceptionally successful case of cooperative model that cannot be applied generally. This limited access to the capital market is a fundamental problem in all phases of business. From the formation, the capital is necessary to acquire the means of production such as a factory. Even if a cooperative has the technology and prospect, it requires significant outside investment to expand its production capability to fully capture the growth opportunity. Even when it matures, it still needs to reinvest capital to compete with other major corporations. Throughout the business cycle, the cooperative has to pay higher cost of capital than private companies that have access to the capital market.

Having identified the problems in the cooperative model, what general conclusions can be made from this study? First, the cooperative model minimizes agency costs. Because shareholders, workers and management are integrated as
“members,” the interest of agent and principals are necessarily aligned together.
This change in governance structure is far more dynamic and effective than having a
contract among different stakeholders as studied previously. Secondly, despite this
advantage, it is difficult to apply the cooperative model generally. Mondragon
Corporation is an exceptionally successful example of the cooperative model in
which favorable market conditions contributed heavily to its success. More
importantly, there is one fundamental problem, the limited access to financial
market, in adopting the cooperative model. In the next portion, the goal of this thesis
is to construct a model that adopts the positive aspects of the cooperative model
while overcoming this fundamental problem.
The Dual Ownership Structure

To summarize the earlier parts of this thesis, we first observed the agency problem from stakeholder theory. I concluded that although stakeholder theory rightfully identified the conflicting nature of the relationships among stakeholders, its approach is limited by heavy reliance on the contract. Using criticisms raised by Marcoux, I pointed out the inappropriateness of the contract as a means to reduce agency costs. Then, I presented Mondragon as a successful example of the cooperative model in which agency cost is minimized by integrating the concepts of worker, shareholder, and management into the concept of member. However, I also identified the fundamental problem associated with the cooperative model, which is limited access to the capital market. In this portion, the goal is to construct a model that still minimizes the agency costs by integrating stakeholders, while connecting to the financial market.

In order to connect the cooperative with the capital market, some form of financial product must be created from the cooperative. The difficulty in creating financial products for the cooperative has been observed previously. Because the ownership of a cooperative is limited to members, the cooperative cannot issue any stock to outsiders. Also, because the control of assets is entirely held by the members, outside banks would require significant control premium for any loan given to a cooperative. In order to solve this problem, I will analyze two categories of interests associated with the ownership interest of cooperative. One is the control interest, which arises from controlling the asset. In a cooperative, a member
controls assets as a worker or management if elected. In return, the member receives a salary for the labor. The other is financial interest, which arises from contributing a capital to the cooperative. In a cooperative, only members contribute the capital. In return, members receive all the cash flows generated by the cooperative in the form of dividend. In the following model, I will try to separate the financial interest from the control interest, and create a financial product that solely consists of financial interest. Because of this division of interest, I term the model “the dual ownership structure.” This model is summarized by the chart below.

F1 illustrates the relationship between members and cooperative. Members can form the cooperative by contributing capital. In return, they acquire the control over assets of the cooperative. They elect the management among themselves, and cast votes in making important decisions. Also, they contribute the labor as workers. In return for this control interest, they receive salaries from the cooperative. At the same time, members are also the owners of each cooperative. A cooperative is created with capital that is equally contributed by members. Upon the initial
contribution to cooperative, each member would open a capital account in lieu of stock. The capital accounts would be owned individually, but they will be used collectively by the cooperative. Any cash flows generated from the cooperative in excess of expense would be accumulated in the capital account as the return on investment. This balance in the capital account, however, cannot be withdrawn until a member decides to dissociate oneself from the cooperative. The amount of dividend each member would receive is the same within the cooperative because each member has an equal share in the cooperative. However, a dividend that a member in one cooperative would receive might differ from a dividend that member in another cooperative would receive because a dividend is determined by the performance of each cooperative.

F2 represents the proposed relationship between cooperatives and a special purpose bank. The special purpose bank is a hypothetical entity that can be formed by pooling the equity of multiple cooperatives. The special purpose bank has two functions. One is to provide the liquidity to a cooperative that requires capital. In F2, this can be done by giving unused capital in capital accounts to the cooperative that requires capital. In return for this investment, the special purpose bank would acquire a mix of bonds and preferred stocks of the cooperative receiving capital. The other function is to collect these interests and preferred dividends paid by the cooperative that borrowed money. Once the special purpose bank collects the return on the investment, it has to distribute the return back to owners of capital accounts. This distribution is made in proportion to each member’s balance in the capital accounts from which it withdraws the capital. If the profitability of
cooperative that received the investment is determined to be deteriorated, the special purpose bank must temporarily take over the control over the cooperative in trouble and intervene into the cooperative in order to protect its investment. This concept of the special purpose bank is very similar to that of Caja Laboral in Mondragon.

However, the special purpose bank is fundamentally different from Caja Laboral for the following reason. Caja Laboral provides liquidity to a cooperative by simply moving capital across the cooperatives that are in the same pool. The special purpose bank, on the other hand, raises additional capital from the financial market in F3, which represents the relationship between the special purpose bank and investors. There are three benefits for members to issue common stock of the special purpose bank. First, issuing stock solves the fundamental problem identified in the cooperative model by connecting the cooperative with the capital market. By issuing stocks, members are now no longer solely responsible for providing the capital that cooperatives require. With access to the capital market, members can attract investment from outside investors. Secondly, issuing common stock of special purpose bank does not impair the control interest of members. The members maintain the control over the cooperative as the sole owners. Lastly, this access to the capital market dramatically facilitates the conversion of a corporation into a cooperative. Previously, in order for workers to convert their workplace into a cooperative, workers had to raise a large amount of capital among themselves to acquire ownership. Even if conversion takes place, it is difficult for the cooperative to successfully operate because the new cooperative often requires further
investment. With the access to capital market, however, the members no longer have to make entire payments by themselves. Instead, they have an option to issue stock of special purpose bank from the capital market or offer seller stocks in lieu of cash to the seller of the business.

Having observed the benefits of issuing stock from the perspective of members, we now have to investigate the benefits investors will receive. In other words, the question remains why any investor would acquire the stock issued by the special purpose bank. In F3, the special purpose bank will pay out the dividend to investors based on its profits. The profit of the special purpose bank is determined by return on its investments in cooperatives. Because these investments consist of debts and preferred stocks, the special purpose bank has the priority claim over the future cash flows generated by cooperatives. This process seems complicated but the common stock of special purpose bank really is a financial product that invests in the future cash flows generated by cooperatives. It allows investors to invest in the financial interest of cooperative. The primary benefit of investing in the financial interest of cooperatives is that cash flows generated by cooperatives are free of agency costs. In cooperative, the agents who will manage the assets are also principals, because members are the owners, workers, and management. The only way in which the members in cooperative can increase the balance of their capital accounts is to generate cash flows in excess of all expenses including interest and preferred dividends. For this reason, investors can be assured that their investments will be efficiently managed by members in the cooperative who are motivated to fully utilize the assets to generate excess profit.
Having observed the benefits received by members and investors, now I will examine the structure of the special purpose bank. The ownership of the special purpose bank exists in two forms held by two different entities. One is the capital account held by members and the other is common stock held by investors. Because of the difference in the form of ownership, the financial interest and control interest associated with the ownership of the special purpose bank must be divided carefully between members and investors. To begin with the financial interest, the financial interest of the special purpose bank consists of return on investments that special purpose bank makes to each cooperative. Once the returns on investments are collected by the special purpose bank, the special purpose bank should pay out dividends based on the amount of capital each member and investor contributed to this investment. In order to calculate the individual return, we must first calculate the total equity. The following example represent the mixed ownership of the special purpose bank:

Notice here that shareholder’s equity exists in the form of number of stocks, whereas total balances exist in the form of dollar amount. In order to calculate the total equity, we must first convert the shareholder’s equity into dollar amount by
multiplying the historic price of stock at issuance with shares outstanding. In the example, it will be $35000. By combining it with total balances in capital accounts ($12000) total equity will become $47000

Using total equity following ratios can be calculated:

When total equity = total balance in capital account + shareholder’s equity,
% of ownership of all members = total balances in capital account / total equity
% of ownership of all investors = shareholder’s equity / total equity

Through these ratios, the special purpose bank can determine the share of all members and all investors for the profit it generates. Once the share of all members and all investors is determined, it can then determine the amount each member and investor would receive. This can be done by calculating the percentage of contribution. In the case of a capital account, the percentage of contribution of each member can be determined by dividing individual capital account by total balance in capital accounts. In the case of share, the percentage of contribution of each investor can be calculated by dividing the number of shares investors own by total number of shares. This calculation is expressed as follow:

% of contribution (member) = member’s balance / total balances in all capital accounts
% of contribution (investor) = number of shares owned by investor / total number of shares
Summarizing the calculations, the financial interest of each members and investors can be calculated as follows

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\text{Return on investment} = (\text{total profit}) \times (\% \text{ of ownership}) \times (\% \text{ of contribution})
\]

Having calculated the financial interest of member and investor, I turn attention now to the control interest of the special purpose bank. There are two ways in which the control interest of the special purpose bank can be divided between members and investors. One is to assign one voting right to every dollar in total equity. Using the same calculations used in the financial interest, the ownership of capital can be distributed to individual members and investors. This is a more intuitive approach in the sense that it distributes voting rights based on the share of contribution. However, this approach contains the potential problem of dominance. When the special purpose bank is heavily dominated by investors, investors may require an unrealistic amount of return from the special purpose bank. This will lower the incentive for members to manage assets efficiently. By the same token, if the special purpose bank is dominated by members, members can absorb the investments made by the special purpose bank to their pockets by raising salaries in all cooperatives and deliberately filing bankruptcy. In either way, this dual ownership structure is susceptible to the problem of dominance.

In order to overcome this problem, the other way is to split the control interest by functions. Previously two functions of the special purpose bank were observed. One is to provide the liquidity to cooperatives. Solely concentrating on this function, members can be perceived as users of capital because cooperatives
receive the capital from the special purpose bank. In return, their cooperatives pay interest and preferred dividends. On this ground, users should have the control over setting these fees and terms when they receive capital. The more fees they guarantee to pay, the more capital they will raise. By the same token, the more actions they allow the special purpose bank to take, the less premium they will pay for the credit risk. Giving control to the special purpose bank seems to violate the idea of cooperative in which only the member holds the control interest. However, this intervention is compatible with the idea of cooperative because the intervention can take place only under special conditions to which the cooperatives initially consented. Moreover, the scopes of actions the special purpose bank can take are also set by the cooperatives. These interventions are necessary tradeoffs to borrow the capital from the markets. In fact, Caja Laboral intervenes and takes over the control of cooperatives in Mondragon, too. On these grounds, setting fees and allowing interventions of the special purpose bank can be understood as stating the terms of loan; it is very similar to bond indenture when issuing a bond. The control right of members can be exercised in voting for setting these terms of loan.

The other function of special purpose bank is to collect the return on investments. As the special purpose bank gives loans to cooperatives, investors also take the position of creditors. As the creditors of cooperatives, they are exposed to a credit risk or the risk of default on the cash payments by cooperatives. Even if assets of cooperative are efficiently managed by members, cooperatives may default for various reasons, ranging from changing demand to extensive competition. In such cases, investors have the right to intervene into the cooperative and protect their
investments under the terms of loan set by members. This can be done by hiring third party to monitor the activity of the cooperative, determine if the profitability is impaired, and intervene into cooperative to protect the investment of special purpose bank. The control right of investors can be exercised through voting in appointing the service company, based on the number of stocks each investor has.

To further explain the split of the control, I will set up an example to illustrate how decisions would be made in a cooperative and the special purpose bank. In each year, all members will hold an election to set the important annual goal such as profitability and intervention standards. Once approved by members, this goal will become official and be publicized to shareholders. At the same time, shareholders of the special purpose bank will form monitoring and intervention committees. These are hypothetical committees that represent the risk control mechanism of shareholders. The monitoring committee will hire external specialists who would monitor the activities of cooperatives. If serious impairment in meeting the profitability is determined, it will authorize the intervention committee to intervene into the cooperative in trouble. The intervention committee would take necessary measures to improve the profitability of the cooperative that is in trouble. Measures would include but not be limited to additional capital injection, relocation of members, and merger with another cooperative. Again, the range and the scope of measures should be predetermined at the time of the loan.

To summarize the dual ownership structure, it is a model that is created to address the fundamental problem of cooperative model which is defined as limited
access to the capital market. In order to connect cooperatives to the capital market, the cooperatives form the special purpose bank that issues common stock to attract capital. Doing so, the control interest of the cooperative is retained by members, yet a portion of financial interest is turned into a financial product which can be traded in the market. The benefits are observed from both sides. On the side of members, they can dramatically improve the access to the capital market, and rapidly expand their business. On the side of investors, they can invest in a financial product that is free of agency cost. Lastly, I addressed the structure of the special purpose bank and observed how the control interest and financial interest of the special purpose bank can be divided among the members and investors.
Conclusion

The goal of this thesis was ambitious. It tried to reform the governance structure of corporations in order to solve the conflicts of interest among stakeholders. In the first section, it studied the development of stakeholder theory, which tried to address this issue by means of contract. However, the inappropriateness of the contract as a medium to minimize agency costs was observed. In the second section, the Mondragon Corporation was presented as a successful example of the cooperative model in which the agency costs are minimized by integrating workers, owners and management into members. However, the fundamental problem, which is limited access to the capital market, was also observed. Finally, in the third portion, the dual ownership structure was developed to solve the fundamental problem. Using only financial interest of cooperatives, it creates a financial product that can be traded in the market.

In order for this model to be successfully implemented, however, further studies must be conducted on the feasibility of the model. Because the model is purely conceptual, it left out the legal discussions. In reality, forming the special purpose bank, for example, requires many legal considerations, especially in the US. After the financial crisis in 2009, US government tightened the regulations on establishing the special purpose entity. Shaping the special purpose bank in conformity with these regulations will be a challenging task. In addition to legal considerations, empirical study must be conducted to validate that this financial product will be traded in the market. I did examine the attractiveness of cash flows
of cooperatives by stating that they are free of agency costs, but there might be other inefficiencies in cooperatives which are overlooked in the model. In order to create a product that can actually be traded in the market, the efficiency and profitability of the model must be studied further.

Despite these uncertainties, the dual ownership structure would dramatically improve the accessibility of cooperatives to financial market. I hope this model enables cooperatives, which often remain small, to better compete with large corporations. Also, I hope this improvement can revitalize the discussions of the cooperative model as an alternative business model.
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