Property Rights Constraints in Producer-Owned Firms: Solutions as Prerequisites for Successful Collective Entrepreneurship

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1. Introduction

The importance of cooperatives as a mode of organization in the agrofood supply chains of Europe, the U.S.A., and Oceania cannot be overemphasized (Valentinov, 2007). High levels of asset ownership, number of members and market shares in both upstream and downstream markets all lend support to this observation (ICA; USDA). More recently, however, agricultural cooperatives are facing major organizational and financial challenges in their attempt to respond to globalization, free trade, and the industrialization of agriculture. Cooperative failures, restructuring, and the emergence of non-traditional cooperative models during the last twenty years, have motivated organizational economics scholars to study the nature of cooperative ownership and its efficiency implications (e.g., Cook, 1995; Srinivasan and Phansalkar, 2003). Most of the aforementioned phenomena and the challenges facing agricultural cooperatives have been attributed to their unique property rights structure (Cook, 1995; Holmström, 1999).

Managing, governing and lending an organizational that is considered non-traditional in the business school lexicon requires understanding this more complex enterprise. Ill-defined and misaligned ownership rights in traditional cooperatives give rise to a set of five investment, control, and collective decision making constraints. During most of the twentieth century, successful cooperatives employed various selective incentive mechanisms to foster homogeneity of their members’ utility functions and overcome these constraints. However, these constraints to organizational efficiency became increasingly binding during the last part of the 20th century as producers began to shift their preferences toward more multiple rent-generation and risk-bearing strategies (Cook et al, 2008). Subsequently, cooperative managers and directors adopted a number of innovative solutions designed to ameliorate these constraints.

The number of theoretical contributions to the analysis of the cooperative property rights problems has expanded during the last twenty-five years (e.g., Vitaliano, 1983; Cook, 1995; Chaddad and Cook, 2004). Yet, the identification, categorization, and analysis of solutions to these problems have received comparatively less scholarly attention (e.g., Cook and Iliopoulos, 1998). This paper fills this knowledge gap by updating and enriching the list of innovative strategies and mechanisms implemented in order to address the property rights problems of traditional cooperatives.

The objective of this paper is to advance the discussion of emerging solutions to the free rider, investment horizon, portfolio, control, and influence costs constraints facing traditional agricultural cooperatives. Building upon previous analyses of these constraints and recent empirical research the article adopts an organizational economics perspective. The paper focuses on agricultural marketing cooperatives but the analysis is also applicable to other types of collective action. We argue that a clear definition and alignment of residual claimant and control rights both are prerequisites for organizational efficiency.

The paper informs and extends prior research in several ways. First, it proposes a new taxonomy of strategic responses adopted by cooperatives (i.e., exit, moderate and radical remodeling). Second, the paper reports recently identified types of the horizon and portfolio constraints and discuss solutions to each of these variants. Third, we propose a new taxonomy of radical remodeling solutions, identify recently adopted solution instruments and proffer examples of cooperatives that have implemented each of these solutions. Fourth, the paper proposes a set of cooperative policies hypothesized to enhance cooperatives’ ability to maximize organizational efficiency.

Our results are useful to, at least, three audiences; researchers and scholars interested in collective entrepreneurship and, more particularly, mechanism design for ameliorating organizational
inefficiencies; cooperative enterprise decision makers who struggle with one or more of the property rights problems of traditional cooperatives; and policy makers involved in designing efficient rural development policies.

The following section describes the characteristics of ownership in traditional cooperatives and briefly defines each of the property rights constraints. Next, we analyze past and emerging solutions to the property rights problems, introduce a new taxonomy of generic solutions, and report recently adopted solution instruments accompanied by examples from various countries. The final section discusses the results, introduces a set of observations, and proposes a set of efficiency-maximizing organizational policies.

2. Property rights constraints in traditional agricultural cooperatives

The ownership of a firm is assigned to a subgroup of its patrons so as to minimize the total costs of transactions between the firm and all of its patrons (Hansmann, 1996). These transaction costs fall into two generic categories: (a) the costs of contracting, and (b) the costs of ownership. The first category entails costs arising from various market imperfections, which can be reduced by assigning ownership to the affected patrons. The latter type refers to costs inherent in the two essential attributes of ownership, namely, the exercise of control and the receipt of residual earnings. This article focuses on the costs of ownership incurred by traditional agricultural marketing cooperatives.

The efficient assignment of ownership to an asset dictates that residual rights of control and residual claimant rights are well defined and aligned so that the same person incurs the costs and enjoys the benefits arising from the use of the asset (Jensen and Meckling, 1979). In order to reach such an assignment, the residual ownership rights should be unrestricted (Fama and Jensen, 1983). In IOFs the fulfillment of this condition is guaranteed because (i) stockholders are not required to have any other role in the organization, (ii) residual claims are freely alienable, and (iii) residual claims are rights in the net cash flow for the life of the organization (Fama and Jensen, 1983).

In contrast to IOFs, cooperatives’ residual claims are restricted. Ownership in traditional cooperatives is assigned only to member-patrons who supply the firm with its major inputs and at the same time own the residual rights to control the firm. Furthermore, no secondary market exists to value residual returns in the cooperative firm while such returns are only partially redeemable. The ownership horizon of cooperative residual claims is also restricted since member-patrons’ ownership is valid only as long as they patronize the cooperative (Vitaliano, 1983).

This structuring of cooperative property rights so as to combine the roles of residual claimant, patron, and residual controller into a single agent, eliminates many of the conflicts of interest between these agent roles and thus provides incentives for participating in cooperatives (Vitaliano, 1983). Also, it has provided traditional agricultural cooperatives around the world with some unique strategic advantages (Cook and Iliopoulos, 1998). At the same time, however, it is responsible for the following investment, control, and collective decision making constraints to efficiency.

2.1 Investment constraints

Investment constraints refer to the first element of ownership: the right to receive an organization’s residual earnings. Due to their ownership structure, traditional agricultural marketing cooperatives provide their member-patrons with disincentives to supply the cooperative with risk capital.

Constraint 1: The Free Rider Problem. This problem can be of two types; external and internal. The external free rider problem refers to the situation where a non-member receives benefits associated with the provision of public goods by the cooperative (e.g., higher commodity prices), but

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1 Traditional agricultural marketing cooperatives (TAMCs) possess the following characteristics: open membership to eligible patrons, risk capital generated mainly by means of retained earnings from member patronage, illiquid ownership rights, and their main objective is to safeguard the on-farm rent generation capacity of their member-patrons.
avoids becoming a member—and thus eschews contributing to the costs associated with this provision, which are incurred by members alone. A similar problem occurs when a member stops patronizing the association temporarily when s/he finds it to her/his best interest.

The internal free rider constraint hints at a common-property problem that occurs in cooperatives when newly entering members are entitled to the same payment per unit of patronage as existing members and thus receive, in part, a return on an investment for which they did not contribute equity. In the absence of active compensation by new to existing members, a clear disincentive is created for the existing members to invest equity capital in the cooperative (Cook, 1995).

Constraint 2: The Investment Horizon Problem. This problem refers to the creation of a business environment in which there is a disincentive for members to contribute to growth opportunities because a member’s residual claim on the net income generated by an asset is shorter than the productive life of that asset (Porter and Scully, 1987). Four variants of the problem are identified in recent empirical work (Krumpelman-Farmer, 2005):

- ‘Wait-to-receive’ horizon problem: members might prefer the cooperative to accelerate the redemption of allocated equities.
- ‘Current obligation’ horizon problem: members might prefer a higher cash payment in year earned, or less of the equity retained as allocated, if the cost to pay taxes on the residual claims in combination with current working capital obligations is greater than the benefit of further cooperative investment.
- ‘Short-term’ horizon problem: members might prefer the cooperative to invest in assets from which they cannot extract complete benefit during their membership horizon.
- ‘Hassle’ horizon problem: members might prefer limiting investment in the organization because understanding the capital formation and redemption procedures is too complex.

Constraint 3: The Portfolio Problem. The lack of transferability, liquidity, and appreciation mechanisms for exchange of residual claims prevents members from adjusting their cooperative asset portfolios to match their personal risk preferences. Those members who are forced to accept more risk than they prefer will pressure cooperative decision makers to rearrange the cooperative’s investment portfolio, even if the reduced risk portfolio means lower expected returns (Cook and Iliopoulos, 2000). Recent empirical research identifies two variants of the portfolio problem (Plunkett, 2005):

- Lateral portfolio problem: Refers to the conflict arising between increasingly specialized members of a diversified cooperative. Highly specialized member-patrons will tend to prefer cooperative investments that reflect their on-farm specialization while more diversified members will prefer cooperative investments that reflect their on-farm diversification.
- Vertical portfolio problem: Refers to the conflict arising among members with different growth strategies within a single commodity cooperative. Members with high growth strategies will tend to prefer cooperative investments that will underpin their on-farm investment, while relatively low growth member-patrons will tend to prefer investment that increases commodity prices or returns from upstream cooperative investments.

2.2 Control and collective decision making constraint

Control constraints refer to the agency costs incurred by a cooperative in monitoring its management and deterring managerial opportunism. They are primarily related to the second element of ownership: the exercise of control.

Collective decision making constraints refer to the costs of reaching effective, cost-minimizing and mutually acceptable agreements on the crucial issues of (1) resource, cost, and revenue/loss allocation, (2) choice of products and services to be handled by the cooperative, and (3)
financing the cooperative. The cooperative may also incur high costs in case its members fail to reach an efficient agreement on the aforementioned issues. Collective decision-making costs are different from agency costs; they can be very high, even if the costs of monitoring and managerial opportunism are low (Hansmann, 1996). The following control and collective decision making constraints are examined:

**Constraint 4: The Control Problem.** It refers to the agency costs arising from the divergence of interests between the principals (membership and board of directors) and the agent (manager) in agricultural cooperatives (Cook, 1995). Two major categories of such costs exist: the costs of monitoring the manager and the costs of managerial opportunism that result from the failure to monitor the manager with perfect effectiveness (Hansmann, 1996). This failure entails that members either cannot monitor the manager effectively or they prefer to free ride. The latter case implies the existence of a control-free rider problem.

**Constraint 5: The Influence Costs Problem.** Refers to the influence activities that arise whenever the decisions of the board of directors and management create quasi-rents within the cooperative. Cooperative stakeholders, attempting to capture these quasi-rents by influencing cooperative decisions, impose costs on the cooperative and on their individual member-patron farms. Illiquid ownership rights cause this problem. Members who wish to, but cannot, exit the cooperative have an additional incentive to attempt to influence the cooperative’s decisions in order to capture as much of the generated quasi-rents as possible.

Influence costs emerge from the principle of residual claim distribution based on patronage not investment and belong to one or more of the following categories: (1) opportunity costs of cooperative stakeholders’ time; (2) costs of monitoring and enforcing decisions that create quasi-rents; (3) costs of delayed decisions, which include both coordination and measurement costs; (4) costs of discretionary authority; (5) costs of wrong or no decisions; and (6) costs of policies designed and implemented in order to avoid influence costs (Milgrom and Roberts, 1992). We turn now to remedies to the property rights problems facing traditional agricultural cooperatives.

3. **Solutions to the property rights problems of traditional cooperatives**

In attempting to solve their property rights problems traditional agricultural cooperatives have chosen among three generic strategies: (i) exit, (ii) moderate remodeling, and (iii) radical remodeling. This section focuses on each of these strategies by reporting solutions identified in the literature, introducing recently adopted solutions to each of the problems, including the variants of the horizon and portfolio problems, and providing examples of collective entrepreneurship enterprises, which have adopted each solution instrument.

3.1 **Exit**

Traditional agricultural marketing cooperatives choosing an exit strategy have preferred one of two alternatives: (i) liquidation of the cooperative, or (ii) conversion to an IOF structure (Schrader, 1989; Collins, 1991a and 1991b; Cook and Iliopoulos, 1998). A variant of the latter approach is to form a farmer-owned limited liability company (Cook et al, 2008). Several new generation cooperatives have been restructured as limited liability companies (e.g., US Premium Beef, Dakota Pasta Growers, and Golden Oval Eggs) and numerous US ethanol cooperatives. Another exit strategy, at the member-patron level, has also been observed; some of the members leave the cooperative and start a new, non-traditional one.

The liquidation of cooperative assets or the conversion of agricultural cooperatives to an IOF structure is predominantly a non-US phenomenon. Such vertical coordination strategies have been observed primarily in countries such as Canada (e.g., Saskatchewan Wheat Pool), Australia (e.g., Donegal), United Kingdom (e.g., Dairy Crest), and Ireland (Irish Agricultural Wholesale Society).
In the US, on the other hand, the most dominant forms of restructuring have been mergers among cooperatives, not conversion to an IOF (Mooney and Gray, 2002).

### 3.2 Moderate remodeling

Traditional cooperatives pursuing a moderate remodeling strategy have selected from a pool of five generic solutions. Each of these solutions has been used to solve more than one of the five property rights problems.

The “user alignment” solution is intended to align residual claimant and control rights within the cooperative; that is, to force each member-patron to contribute to the cooperative in proportion to the benefits s/he receives (Cook and Iliopoulos, 1998). Among the most commonly used mechanisms to implement this solution are base capital plans (a capital contribution mechanism that requires proportionality of capital and patronage), the design and implementation of a marketing orders system, the introduction of marketing contracts signed with members, the adoption of proportional voting schemes, the establishment of a significant up-front equity requirement, and the issuance of transferable and appreciable delivery rights.

Another generic solution refers to “member-retaining policies” whose objective is to increase members’ loyalty to the cooperative (Fulton, 1999; Fulton and Giannakas, 2001). Examples of such policies include the introduction of member relations programs, binding grower contracts, marketing agency in common exclusivity, investments in building and promoting a cooperative’s image, training schools for members, the creation of high costs associated with member exit, and emphasis on the cooperative’s evolution and history.

A third generic solution of “control of supply” covers strategies intended to give the cooperative control over its major input and/or output supply channels. Solution instruments in this category include the attainment of large size, the adoption of a closed or defined membership policy, the creation of spatial monopoly/monopsony, mandatory marketing agreements with members, and the establishment of a delivery rights system.

“Innovative capital acquisition techniques” solutions aim at attracting risk capital from members and/or external investors. Several solution instruments have been used to achieve this goal. These include the formation of subsidiaries, joint ventures or holding companies; the issuance of preferred stock; formalization of transferable and appreciable delivery rights; and the establishment of hedging services for members (Cook and Iliopoulos, 1998). More recently, cooperatives have introduced additional solution instruments: the issuance of externally tradable subordinate bonds (e.g., Campina and Friesland Foods in the Netherlands, Südzucker in Germany, and Fonterra and the Alliance Group in New Zealand); or the acceptance of external corporate investors in cooperative-owned subsidiaries (e.g., Granarolo in Italy, Capsa in Spain, and Sodiaal in France) (Bekkum and Bijman, 2006).

The fifth generic solution to the property rights constraints, “risk/measurement transparency,” encompasses mechanisms designed to allow member-patrons to choose their preferred level of risk, measure cooperative performance, and/or enable them to monitor management more efficiently. Several solution instruments of this sort have been reported. They include the adoption of separate capital, risk, and governance pools that foster the commonality of interest within each pool; the signing of management contracts with local cooperative members in regional multipurpose cooperatives; the issuance of A and B stock; the establishment of transferable and appreciable delivery rights; and placing focus on a single commodity within a region (Cook and Iliopoulos, 1998). The issuance of externally tradable subordinate bonds and the acceptance of external corporate investors represent recently added instruments in the toolkit of cooperatives.

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2 Friesland Foods and Campina were merged in 2009.
Table 1 summarizes generic solutions, specific solutions and solution instruments associated with each property rights problem. It enriches previous research by introducing for the first time solutions to the empirically verified variants of the horizon and portfolio constraints.

3.3 Radical remodeling

Cooperative leaders choosing to remodel their organizations radically have adopted one of four generic solutions (Chaddad and Cook, 2004). The first such option is to ‘merge with another cooperative.’ Another strategy is to make the ‘transition to a non-traditional cooperative structure’ such as a ‘proportional investment cooperative,’ a ‘member-investor cooperative,’ or a ‘new generation cooperative.’ Proportional investment cooperatives have implemented solution instruments such as the adoption of separate capital pools and/or a base capital plan. Member-investor cooperatives have introduced appreciable shares and the distribution of dividends in proportion to share ownership.

New generation cooperatives have adopted several organizational innovations in order to remedy the property rights constraints of traditional cooperatives. The introduction of base capital plans, closed membership policies, transferable and appreciable delivery rights, marketing agreements with members, and the requirement that members contribute a significant amount of money up-front are some of these solution instruments.

A third radical remodeling solution is the introduction of non-member residual claimant rights. Examples of this approach include ‘cooperatives with capital-seeking entities’ and ‘investor-share cooperatives.’ The first, ‘cooperatives with capital-seeking entities’, have adopted such solution instruments as the formation of strategic alliances, trust companies, and listed subsidiaries; public listing of preferred stock; public listing of value-added portion of the business; and the adoption of what has been called the Finnish Model. This model refers to three Finnish cooperatives (i.e., Metsäliitto, the LSO Cooperative, and the Atria Group), which have listed their subsidiaries in the stock exchange but have retained a controlling stake in these companies by introducing a separate class of shares (Bekkum and Bijman, 2006). ‘Investor-share cooperatives’ have issued non-voting stock or listed preferred stock in the stock exchange (e.g., Saskatchewan Wheat Pool in Canada, Clover Dairies in South Africa, and Westfleisch in Germany).

The last radical remodeling solution, the ‘introduction of non-member control rights’ is also implemented through investment-share cooperatives that issue preferred stock, various types of participation shares, or accept external investors as a class of members. Pro-Fac in the U.S., Sodiaal in France, and Granarolo in Italy have used this solution mechanism (Bekkum and Bijman, 2006). Table 1 includes a summary of radical remodeling solutions for the free rider problem.

4. Discussion and concluding remarks

Traditional agricultural marketing cooperatives are characterized by open membership, risk capital generated mainly by means of retained earnings from member patronage, and illiquid ownership rights. Safeguarding the on-farm rent generating capacity of their member-patrons is their main objective. This unique property rights structure has equipped agricultural cooperatives with tools to combat various types of market failures. At the same time, however, it has resulted in five problems that constraint cooperatives’ ability to maximize organizational efficiency.

When considering the above constraints a puzzling question emerges: why then do so many agricultural cooperatives exist? Any answer to this question should take into account the unique advantages that such firms enjoy (e.g., Cook and Iliopoulos, 1998), and the extent to which they manage to align their goals with the organizational structure they adopt (Nilsson, 1999). Cooperatives whose membership has remained fairly homogeneous while their major objective is to safeguard the on-farm rent-generation capacity of their member-patrons may perceive the aforementioned constraints as much less binding.
On the other hand, user-investor-driven cooperatives seeking multiple-level rents through collective entrepreneurship have adopted organizational structures that seem to ameliorate the aforementioned constraints (Cook et al., 2008). The significant advantages inherent in the traditional cooperative institutional arrangement are diluted when marketing cooperatives need to invest in producing and marketing high value-added products. In response to dramatic changes in the global and local economic environments but also to perceived changes in member preferences and attitudes toward their organizations, cooperative leaders have realized that ameliorating the property rights constraints is a prerequisite for success in the value chains of the 21st century.

Several scholars identify various keys to organizing successful cooperatives (e.g., Sexton and Iskow, 1988; Cook and Iliopoulos, 1998). The analysis presented in this article suggests additional success factors related to the implementation of efficient solutions to the property rights problems of traditional cooperatives. More specifically, the adoption of the following organizational policies seems to enhance the success potential of agricultural cooperatives:

- **Definition and alignment of residual claimant and control rights**: Ill-defined and misaligned property rights result in the aforementioned investment, control, and collective decision making constraints. Collective entrepreneurship organizations that have been successful during the last decade seem to have, at least partially, corrected for the negative externalities imposed on them by these constraints.

- **Homogeneity-boosting policies**: Policies that promote the homogeneity of members’ economic interests result in the amelioration of the free rider, influence and control problems. An example of such policy is the adoption of separate product, capital and governance pools in multipurpose cooperatives.

- **Wealth-redistribution**: Policies that have the potential to redistribute wealth among cooperative stakeholders (e.g., cost allocation rules) give rise to influence activities. Designing such policies based on the principle of proportionality and communicating their positive impact to members can help cooperatives in minimizing detrimental influence attempts.

- **Equity redemption**: The timely redemption of member equity through a clearly stated and executed program is a prerequisite for attracting member investment. Efficient equity redemption programs result in a better alignment of the user and owner-financier roles of member-patrons and thus facilitate the efficient allocation of ownership rights in the cooperative.

- **Manager compensation**: Hiring a professional manager who is knowledgeable of the differences between running a POF and an IOF is a prerequisite for successful cooperatives. Equally important is that cooperative leaders design compensation packages that provide managers with incentives to achieve the cooperative’s objectives as opposed to pursuing personal goals (Iliopoulos and Hendrikse, 2009). In this way the efficiency-robbing consequences of control and influence costs constraints are minimized.

Our analysis of past and more recent solution instruments adopted by cooperative leaders suggests that ameliorating these constraints is a prerequisite for designing efficient collective entrepreneurship firms. However, three points warrant further attention. First, not all solutions are applicable to all cooperatives. Designing efficient cooperative organizations becomes more and more complex as such firms enter highly competitive, value-added product markets. The set of success criteria proposed in this paper may be used as guidelines in achieving this goal. However, further research should focus on identifying the conditions under which each solution instrument is most relevant.

Second, cooperative leaders should be aware that a solution perceived as optimal today might not be such tomorrow. The rapid and fundamental changes occurring in the global food system may render some solutions inefficient. Third, as some of the property rights constraints are ameliorated new ones may emerge. The interrelationships and dynamics of particular solution mechanisms is an area that deserves the attention of both scholars and cooperative leaders. This paper is intended to contribute to a better understanding of the property rights constraints and thus facilitate better-informed decision-making in designing or choosing among alternative solution instruments.
References


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