

Incentive Pay for CEOs in Cooperative Firms

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Abstract

Cooperative owners have a transactional relationship—as customers or input suppliers—with their firm in addition to their investment relationship. This changes both the incentives and the information that owners have to monitor managerial performance. We argue that this difference reduces the need for cooperative CEOs to receive performance-based pay, relative to CEOs in other kinds of organizations. We conduct 9 interviews of cooperative CEOs to informally test our hypothesis. Although our sample is small, results strongly support our hypothesis: in every case but one, the CEOs we spoke with face a mostly subjective and discretionary pay system. Our results also reveal that, while cooperative CEOs are subject to intense supervision by the board, they enjoy a relative independence in devising firm strategy. This finding is consistent with the notion that cooperative owners may be informationally advantaged on some dimensions (e.g., monitoring diligence), but informationally disadvantaged on others.

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1 Introduction

Relative to public-stock or private firms, cooperative ownership fundamentally changes the agency relationship between a firm's owners and its manager. By construction, cooperative owners have a transactional relationship—as a customer or input supplier—with their firm in addition to their investment relationship. This changes both the information and incentives that owners have to monitor managerial performance. In some cases (e.g., labor-managed and retail-sales firms), the relevant transactional relationship involves weekly, or even daily, observations of the firm's activities. Moreover, the bundling of the investor and patron roles that occurs with cooperative ownership concentrates two separate economic interests in a single stakeholder group. Doing so arguably enhances owners' individual incentives to monitor managerial performance.

The Board of a cooperative firm arguably also has a distinctive mission, and intrinsic advisory capacity, relative to the Board of a public-stock company. In the United States, for example, a firm that formally incorporates as a cooperative, or that wants to be taxed as a cooperative, faces limits on the extent to which the firm's earnings can be distributed to owners on the basis of their investment stake. Earnings, to the extent that there are any, instead must be distributed based on the quantity of transaction units, or patronage stake. It is therefore reasonable to assume that each owner, in conducting business with a cooperative, seeks to maximize "return on patronage," including both the value from the owner's transactional relationship with the firm, and any earnings distributions that derive from patronage. The advisory capacity of owners in a cooperative firm is distinctive because the owners have very good information about one particular dimension of the firm, but are often ill informed about many other important dimensions (e.g., marketing, finance, human resources). Because only a single class of stakeholders can be owners, management cannot

seek board participation from a broad range of skills.

There are a variety of reasons why we should expect these differences to alter the structure of CEO compensation in cooperative firms, relative to what is observed under other ownership models. On the one hand, access to better information and heightened incentives for monitoring might lead to more detailed contracts and reliance on a richer set of performance indicators. On the other hand, the close proximity of board members to management, and a relative lack of expertise on key management decisions, might lead to greater reliance on subjective performance evaluation and more managerial autonomy. Similarly, because there typically is heterogeneity across owners in how they value their transactional relationship with the firm, it may be difficult to achieve consensus on the Board regarding specific performance targets. This too may lead to "looser" contracts that allow the manager to accommodate a diverse set of interests.

The purpose of this paper is to flesh these (and other) hypotheses out more fully, and then to provide tentative evidence on the actual structure of CEO compensation in cooperatives with a series of case interviews. On a variety of dimensions, cooperative governance provides a contrast that can be used as an experimental "treatment" to test theory and inform debate about the fundamental forces affecting CEO compensation. Toward this end, we aim to place our work in the broader context of research on CEO compensation across all organizational forms. The relevant literature is vast, so we will focus on the narrower question of how executive performance is (or is not) measured and rewarded.

2 Alternative hypotheses

To further contrast the cooperative ownership model with other forms of ownership, consider the four different corporate forms: public-stock, private, non-profit, and cooperative. In all cases, it is the board that sets CEO pay, but the composition and nature of the board differs in important ways across each organization type. Public stock directors are motivated through stock-based pay and an obligation of fiduciary duty. They receive information from management about firm performance typically on a monthly basis and often have considerable business expertise as former CEOs, and as directors in other companies. The total equity stake of any one director is, however, typically a small fraction of total firm equity. In contrast, directors (and management) of a privately held firm often have substantial equity stakes. Directors at non-profit firms typically receive no pay, but participate as advisers for the utility benefit that it confers from contributing to a noble cause, and possibly also from the networking benefits that result from interacting with other business and civic leaders. As with directors at public and private companies, non-profit directors typically have significant professional human capital and interact with management on a monthly basis.

Little is known about how cooperative directors are compensated, but anecdotal evidence suggests that they are paid very little (U.S. credit union directors are forbidden by statute from receiving pay). Much of their incentive for monitoring presumably comes from their economic stake as firm patrons. Their capacity for monitoring depends very much on characteristics of the relevant patron population, and on the specific mechanism used to elicit board participation. Cooperative owners and directors tend to have long-term relationships with their firm because ownership shares are relatively illiquid. The geographic proximity of patrons to their firm may also create stronger social ties between

management and owners.

These contrasts across corporate forms, together with those cited in our introduction, highlight differences in the information, incentives, and objectives of those who set CEO pay. How might these differences influence the use of performance-based pay in CEO compensation? We describe three alternative hypotheses, each that lead to the same outcome: less performance based pay. There are, however, measurable differences in the underlying structure that lead to this outcome and, to the extent possible, we try to interpret our empirical findings with these differences in mind.

2.1 Implicit Contracting

To the extent that there tends to be stable long-run relationships between owners and managers in cooperatives, we should observe greater reliance on implicit contracts. In this case, the manager behaves diligently in return for a reward provided that some given level of performance is observed. When discount rates are sufficiently low, first-best actions can be sustained even when performance is "subjective," or not externally verifiable (e.g., Bull, 1987; Baker, Gibbons, and Murphy, 1994). The contract is sustained through the continuation value of the relevant relationship. Strong social ties between management and directors can enhance the scope for this kind of implicit contracting. This effect should lead to less use of explicit ex ante incentives and greater reliance on subjective performance evaluation.

2.2 Action Observability

Because cooperative board members interact with management both in the boardroom, and as patrons, they potentially have more information about the production environment in which managers operate. From an agency perspec-

tive, where performance-based pay is a contractual response to unobserved managerial actions, we can think of this information as improving observability of actions. There are at least two ways that this observability might lead to less performance based pay. First, it might allow for contracts based explicitly on how the manager behaves. When actions are well observed, rewarding noisy performance only adds risk to executive compensation (Holmström, 1979). In this sense, we should perhaps expect to see relatively detailed contracts that indicate ex ante how the manager is to behave, and less reliance on ex post performance incentives (Prendergast, 2002).

Second, to the extent that there is ex ante uncertainty about a manager's ability, close observability of actions in a multi-period context can limit the extent to which ex post performance incentives are time consistent. Suppose, for example, that there are two types of managers, high and low ability, and that it is only efficient for a firm to hire and keep high-ability managers. In a two-period model where there is potentially learning that occurs about the manager's ability level as a result of first-period outcomes, learning for sure that the manager is high ability after the first period will mean that the manager should be hired in the second period, regardless of firm performance. Observing actions well facilitates this learning. Crémer (1995) shows how this effect results in equilibrium lower powered ex ante incentive schemes.

2.3 Multiple missions

A cooperative firm maximizes patron welfare in a setting where patrons are not homogeneous in their preferences. Illiquidity in the market for ownership stake makes "exit" a costly option and results in strong influence pressures on the cooperative agenda. A natural consequence of this (forced) consensual governance mode possibly is that cooperative managers are requested to pursue

several missions to please all “voices.” While some accounting measures say cost of production, can be contracted upon easily, it may be difficult to reconcile explicit performance incentives for these measures with the interests of particular patron groups. For example, a dairy cooperative with small and large producer groups might achieve greater operational efficiency by attracting more large producers and terminating relationships with some or all of its small producers. In this case, incentives for operational efficiency are in direct conflict with (some) patron interests. In this context, an equilibrium outcome might be not to use explicit incentives at all.

3 Preliminary Evidence

Each hypothesis above suggests that the cooperative governance structure is likely to result in less reliance on explicit performance incentives. Under the action observability hypothesis, we expect this difference to be paired with greater reliance on explicit ex ante contracts over behavior (rather than performance). Under the implicit contracting hypothesis we expect to see greater reliance on subjective performance review, while under the multiple-mission hypothesis we expect to hear stories about multiple conflicting objectives of directors.

In this section, we briefly summarize how the structure of performance incentives varies across public-stock, privately-held, and non-profit organizations. We then contrast these observations with the results of 9 interviews focusing on CEO compensation and board practices in cooperative firms. While admittedly a small sample, our interviews reveal, with remarkable consistency across interviewees, that this group of cooperatives relies heavily on board discretion in rewarding CEO performance. Only in one instance was there any form of explicit ex ante performance incentives. The interviews also are generally consistent with the implicit contracting explanation for this outcome. We make the

case for this conclusion in this section, but, to serve as contrast, first we briefly describe the general structure of CEO pay in other types of organizations.

3.1 Public-Stock, Privately-Held and Non-Profit Corporations

Public-stock companies are of course unique in their ability to use stock-based incentives to motivate CEOs, but accounting-based measures are also used. Using data on 177 publicly traded firms covering the period 1996-1997, Murphy (1999) reports that "less than half of the companies use a single performance measure in their incentive plan; most companies use two or more measures." Moreover, median performance-based pay accounts for well over half of total median pay so that CEOs face considerable year-to-year variability in their compensation. Notably for our purpose, there is little or no discretionary pay-for-performance. According to Murphy (1999, p. 11), "One result that emerges... is that annual bonus contracts are largely explicit, with at most a limited role for discretion."

Although there is much less known about the structure of CEO pay in privately held companies, the existing evidence suggests greater reliance on equity-based compensation and higher powered incentives compared to public companies. A recent paper by Leslie and Oyer (2008) shows that base salary for CEOs at private-equity owned companies is on average 12% lower than at comparable publicly held companies, and equity stakes are much higher. Overall, a substantially larger share of total compensation is earned through variable pay. Private companies give more weight to subjectivity in determining CEOs' year-end bonuses; Murphy and Oyer (2003) find that "CEOs in private firms receive 11% more of their bonus based on subjective measures of individual performance than CEOs in public firms." However, only 8% (5% for public companies) of the privately held companies use a fully discretionary bonus to reward their CEO.

Most studies of managerial incentives in non-profit organizations are found in the hospital sector. All of the studies that we are aware of do show that not-for-profit hospitals use lower-powered incentive schemes compared with for-profit hospitals. Base salary is significantly higher in not-for-profit hospitals, while bonus eligibility and bonus amount are significantly higher in for-profit hospitals (Ballou and Weisbrod 2003; Erus and Weisbrod 2003). Although not-for-profit hospitals are constrained from distributing profit to their managers, they are free to setup incentive schemes rewarding financial performance, cost effectiveness, and (perhaps more importantly) non-financial performance such as the quality of care. Although measuring the quality of care can be problematic in some circumstances, Ballou and Weisbrod (2003) show that well-defined proxies for such measures are used to determine CEO bonuses in non-profit hospitals. Overall, subjectivity seems to be absent from these compensation schemes.

Although cooperatives and not-for-profit corporations share many common organizational traits, a key difference is that not-for profit organizations do not have owners while cooperatives do. From a control-right standpoint, these organizations seem opposite. Although not-for-profit organizations have some defined objectives, the intended users of their services (e.g. low-income populations) do not sit on their supervisory board. Board members are usually benevolent “patricians” who derive some utility from supervising these organizations. Potentially a strong informational disconnection exists between the users and the board of directors of these organizations (who are not even elected by users).

In the case of cooperatives, patrons do own the organization, elect some of their peers to the board, and are in a privileged position to observe and monitor managerial operations. In the next section we report evidence suggesting that this difference leads to far less use of explicit performance-based pay, and much

more reliance on subjective performance evaluation.

3.2 Cooperative corporations

Empirical knowledge on managerial compensation in cooperatives is sparse and mainly anecdotal. In the only formal study of cooperative CEO compensation practices that we know of, King, Trechter, and Cobia (1998) report considerable use of end-of-year subjective performance evaluation, but say nothing about why this might be so. The interviews that we conducted feature three electricity distribution cooperatives, two retail grocery cooperatives, one taxi company, one credit union, and two agricultural cooperatives. From an organizational perspective, two of these firms are “worker” cooperatives, six are “consumer” cooperatives, and one is a “producer” cooperative. These were selected randomly, but of course the sample size is too small to draw any statistical inference about the relevant population. As we will see, however, there are indications of sharp differences in CEO compensation practices between cooperative and other (private, public, and non-profit) types of firms.

3.2.1 CEO Pay

Seven respondents reported no explicit pre-defined incentive clauses in their compensation package, but 8 indicated that they did receive a bonus based on the past years’ performance. In one case, a respondent claimed that there was no performance reward at all, while in another case it was impossible for the respondent to identify the fraction of typical pay adjustments that could be attributed to performance versus cost-of-living. In all cases where there was some form of performance-based pay, the Board exercised considerable discretion in setting the bonus level.

Seven respondents also reported that their board used a compensation con-

sultant to advise on CEO pay. This simple fact arguably leads us to consider reasons other than ignorance (regarding compensation practices) to explain observed compensation patterns. In addition to the 9 firm interviews, we spoke with a compensation consultant who specializes in work with the banking sector, and credit unions in particular. This expert indicated that expected total compensation (including benefits) is lower in credit unions than in comparable size private banks, with base salary tending to be higher. This description is consistent with our interviews where several cooperative CEOs report that they earned substantially less than peer CEOs in comparable private companies.

3.2.2 CEOs and Directors

The CEO-Board relationship is key to each of our hypotheses. Accordingly, much of our interviews focused on how the CEO and Board interact. In one question, we assigned two potential roles to the Board, monitoring and advising, and asked respondents to indicate whether the Board saw itself playing one or both of these roles, and to what degree. All but one CEO perceived the board as being a stronger monitor than advisor. Most CEOs described monitoring as the key role of the board. Three CEOs described frustration with the lack of financial expertise of directors, one going so far as to say that “devising a strategy is not for the board, our business is too complex for them.” At the same time, however, these same CEOs described their board as “acting as a liaison with the membership constantly providing feedback from members.”

Several other questions were asked to elicit interaction intensity between CEO and Board members. Professional e-mails or phone communications between CEOs and at least one board member were reported to occur weekly in 6 instances. Face-to-face meeting with one or more board members between board meetings seems extremely common; two CEOs indicated to us that they have face-to-face meeting with one or more board members every day while such

encounters occur weekly for five other interviewees.

We also asked about social interaction. In all cases CEOs have occasional social interaction with board members outside of work hours. All reported knowing the names of Board members' spouses. In several cases, CEOs note that avoiding encounters with board members is "simply impossible because people live in the same town." Not surprisingly, all the CEOs also reported that their managerial teams interact with board members outside the board meetings. One interviewee noted that he uses caution when speaking with staff because of their relationship (either as family or neighbor) to board members.

3.2.3 Missions Congruence

We asked several questions about "key indicators of performance" for the relevant firms, and the extent to which there may be disagreement within the Board and between the Board and Management on the relative weight that these indicators should be afforded in daily operations. In general, respondents had the relevant performance indicators, and their relative priority, top of mind (they were able to cite them immediately), and indicated little disagreement among all the relevant decision makers about these measures. In retrospect, however, we feel that we may have asked the wrong question if our intent was to elicit information about problems with "multiple missions." This sort of conflict is much more likely to arise in the context of decisions about firm strategy, rather than operations. It likely is not difficult to agree that, for a given strategy, the firm should minimize cost and maximize revenue, for example. Although we did not find much support for the multiple-mission hypothesis, future empirical work that probes more about strategic issues is needed before drawing firm conclusions.

4 Discussion

In summary, our interviews revealed strong indications that explicit ex ante performance-based pay for CEOs is uncommon in cooperative organizations, and that directors (and other owners) observe much of what management does. There is clearly intensive observability of managerial actions for this particular set of firms, potentially supporting the “action observability” hypothesis. However, under this hypothesis, we should expect detailed direction regarding managerial actions. All our interviews tend to indicate that this is not the case. Less than half our respondents indicated that there is a written employment contract between the firm and CEO, and cooperative managers enjoy considerable autonomy in devising the firm strategy. One possible explanation for this is that cooperative boards do not have a good grasp of the business and financial issues and thus do not know what the relevant actions are in a particular context.

Although the "directed-action" hypothesis does not appear to be an empirically sound explanation for lower powered incentives, a board's inability to commit to an arm's length relationship may play an important role as well. In this case, well-informed boards are more inclined to forgive poor results when it is known that the relevant CEO is a good fit for the organization. This perspective suggests that we should expect lower powered incentive schemes, and, arguably, less CEO turnover in cooperatives. One shortcoming of this interpretation in the cooperative setting is that it strongly relies on contractible performance measures in a context where such measures seem seldom to be used.

Our interviews clearly point to the importance of implicit contracting and subjective performance evaluation. The relevant parties are engaged in repeated interaction and explicitly describe their performance evaluation systems (when

they exist) as subjective and discretionary. From a theoretical perspective, this result provides support for the notion that implicit incentives substitute for formal performance based pay.

These findings and observations suggest a number of directions for future research. Perhaps most important is the need to corroborate our findings and to build more precise hypotheses that can be formally tested. The data we report on is suggestive, but there are too few observations, and the responses are too qualitative for formal testing. We also value in seeking better information about how managers and board members in cooperative firms determine strategic direction. Most existing research on cooperative firms takes a “black-box” approach to firm behavior, reducing cooperative governance into a summary objective function (e.g., profit per worker in the case of worker cooperatives). While useful for some purposes, this approach ignores the unique control and residual return structure that characterizes cooperatives and that likely influences behavior. To the extent that CEO pay structures are intended as “directives” from the Board, clearly the cooperative firm operates under a different directive though it is still unclear which one (or more).

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