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Co-Determination: Shareholders‘ Perspective

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Abstract:

The aim of this paper is to examine the consequences of employees‘ participation in boards of public companies. As the topic has been discussed thoroughly from the point of view of board performance and stake-holder problem, this work is focused on shareholders’ perspective. In the first I analyze the anatomy of a co-determined board. The second part is aims at employees’ interests and their incentives for board participation. Subsequently, I discuss possibilities of legal arbitrage and implications of co-determination on capital markets. Even though the emphasis is given on German co-determination system, the results of the research are applicable for any other co-determined system of corporate governance.

Anotace:

Účelem této práce je zmapovat důsledky účasti zaměstnanců v orgánech veřejně obchodovatelných společností. Toto téma již bylo mnohokrát diskutováno z pozice výkonnosti statutárních orgánů a z pozic ostatních stran zainteresovaných na korporaci, nicméně, tato práce se zaměřuje na důsledky, které plynou pro akcionáře. V první části analyzuji anatomii co-determinovaných orgánů společnosti. V druhé části se zaměřuji na zájmy zaměstnanců a jejich motivaci pro účast v orgánech. Dále se zabývám možnostmi regulativní arbitráže a důsledky, jaké má co-determinace pro kapitálové trhy. Přestože se věnuji především německému systému účasti zaměstnanců, výsledky tohoto výzkumu jsou aplikovatelné i na ostatní systémy corporate governance s účastí zaměstnanců.

1. Introduction

Shareholders are generally essential constituencies of corporations as they make *ultima ratio* the choice where to allocate their investments. Their position has been strengthened by increasing capital mobility on global capital markets. To maximize their wealth, they can flexibly move the capital from one jurisdiction to another. Moreover, legislators now days cannot rely on coercive sovereignty of states to keep capital in their jurisdiction, but have to promote their own company law to make their jurisdiction as convenient for shareholders as possible. In this paper, we will examine how the corporate law framework is marked by obligatory co-determination and what kind of incentives it gives to shareholders.

a. Aims and Methodology

The aim of this paper is to examine how co-determination influences the shareholders perception of corporation. Main ideas of shareholders perspective of co-determination will therefore be discussed as well as shareholders' measures to avoid co-determination effect to maximize their wealth. Many observers have noted that corporate law systems with employee participation are now struggling under the needs of global capital markets.[1] We will therefore intend to determine what the origin of this phenomenon is.

The methodology used in this paper is multiple. Classics of corporate law theories are mainly cited in the first Parts of the discussion to determine some theories regarding corporation and its interestholders. Space is given both to the *law and economics* movement as well as to scholars that react to it. The second third of the paper describes the current legal frameworks using comparative means and opinions of contemporary scholars on corporate law developments in Europe. Furthermore, empirical survey conducted by renowned

[1] E.g. Michel Goyer: *Corporate Governance, Employees, and the Focus on Core Competencies in France and Germany*, in: Curtis J. Milhaupt: *Global Markets, Domestic Institutions*: *Corporate Law and Governance in a New Era of Cross-Border Deals* (New York: Columbia University Press, 2003) or Ronald Dore: *Stock Market Capitalism: Welfare Capitalism* (Oxford: Oxford University Press, 2000)

economists is subject to discussion in the Part 6. The last Part of this paper describes the current corporate ownership situation in Germany and its possibilities for future developments.

b. Overlook of the Contents

Regarding the content of this paper, we will firstly examine why the employees are the unique group of stakeholders that in history of corporate law was given right of representation in board beside shareholders. It can seem that generally people tend to sympathize with them,[2] but we will discuss if there is some further rational behind this policy.

Subsequently, we will discuss what the interests of shareholders and employees are. We will reveal that it is mostly approach to risk what their interests diverges as employees are more “fixed” claimants than shareholders and therefore more conservative towards risk. Our subsequent concern in this Part will be managers as moderation measure of this clash of interests.

Further, co-determiantion implications on corporate body architecture will be analyzed. We will effectively see that the most typical and developed system of co-determination is present in German legal framework. Despite the fact that also other jurisdiction will be mentioned, the German economy is the only one that is big enough to be examined thoroughly. The conclusions of this paper are, nevertheless, *mutatis mutandis* applicable for other systems if not stated otherwise.

Presence of employees’ representatives and interests in boardrooms and the way how it influences the performance of board will be discussed in the Part 4. It will be also examined how a co-determined board differs from usual boards as we know them from Anglo-Saxon jurisdictions and why shareholders may prefer the Anglo-Saxon model. In relation to this, we will also discuss the implications on monitoring possibilities.

Legal arbitrage as a mean to partly avoid co-determination will be discussed separately as there is serious empirical evidence that support the theory of effective legal arbitrage. We will

[2] Jonathan R. Macey and Geoffrey P. Miller: *Corporate Stakeholders: A Contractual Perspective*, University of Toronto Law Journal, issue 4 (1993), p. 417

see if the investors are willing to undergo reincorporation process in order to mitigate the level of employee participation in board.

Finally, the relation of the fact of co-determined board and ownership structure of corporations will be analyzed in Part 7. We will focus mainly on the traditional ownership structure of Germany, i.e. on blockholder ownership, and further on the possibilities of capital market development. The main concern is to determine if co-determination burdens development of capital markets.

In the end, we will conclude to see the overall consequences of co-determined boards and its implications for the shareholder perspective.

2. Why Should the Employees Be the Privileged Class of Interest Holders?

Before committing wholly to the discussion how shareholders deal with employee participation on corporate governance in the following Parts of this paper, we will briefly overlook some theories that explain who should be given the right to decide upon the matters of the corporation. Further, we will look examine why employees are the only interest-holders that were given the right of codetermination.

Traditionally, the shareholders are seen as the most suitable group of stakeholders to dominate the decision making process in corporations.[3] This theory was widely promoted by the *law and economics* movement as the shareholders were seen as the ultimate residual claimants of corporation and therefore mostly affected by corporate decisions.[4] As residual claimants they have most incentives to avoid insolvency and motivate corporation's profits. For this reason, as stipulated also by Kelly and Parkinson, they are usually entitled to monitor the management.[5]

[3] Frank H. Easterbrook and Daniel R. Fischel: *Voting in Corporate Law*, *Journal of Law and Economics*, Issue 26 (1983), p. 403
[4] *Ibid*.
[5] Gavin Kelly and John Parkinson.: *The Political Economy of the Company*, (Oxford: Hart Publishing, 2000), p. 117

However, later the portfolio theory evolved and scholars began to underline the fact that shareholders are not the ultimate risk-bearers as they can effectively hedge against the risk of mal-functioning of the firm by diversifying their investments.[6]

Non-residual and in terms of insolvency law unsecured claimants usually have two options how to protect against the default of the corporation (i) contractually (as for example providers of unsecured loan or big suppliers do by including bonding covenants to their contracts with the corporation),[7] or (ii) by diversifying in the same way the shareholders do (this is, for example, case of consumers).

Nevertheless, neither of the both hedging options is available to employees. Bonding covenants in employment contracts are economically almost unimaginable[8] and diversifying is in their case also impossible as they develop firm-specific skills.[9] In the end of the day, they are the class of risk bearers that is most improbable to effectively hedge their risk and therefore it seems logical to provide them with a special protection also in corporate law.[10] Still it is not without interest that these theories emerged in papers of North American scholars much later than the actual employee participation was established in other parts of the world as in Europe (see below) or in Japan.[11]

We can conclude that shareholders are the group that traditionally has the right to determine upon the fate of the corporation. However, as they can diversify their portfolios, they are not necessarily the group with major interest in the corporation. The economic theory says that the employees should have most incentives to effectively monitor the corporation as they have, apart from labor and insolvency law, no efficient measures how to hedge their risk. The clash of their interests will however be subject to discussion in the following parts as the divergence of employees’ interests and shareholders’ interests seems to be essential problem of co-determined boards.

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[6] Eugene R. Fama: *Agency Problems and the Theory of the Firm: The Journal of Political Economy*, vol. 88, no. 2. (April, 1980), p. 291
[7] Clifford W. Smith, Jr. and Jerold B. Warner: *On Financial Contracting: An Analysis of Bond Covenants*, Journal of Financial Economics, issue 7 (1979), p. 117
[8] Jonathan R. Macey and Geoffrey P. Miller, *supra* note 2, p. 417
[9] Kelly and Parkinson, *supra* note 5, p. 124
[10] Apart from labor and insolvency law protection.
[11] Concept of life-time employment. Please refer for example to Richard R. Ellsworth: *Leading with Purpose* (Stanford: Stanford University Press, 2000), p. 281

3. What Are the Interests of Shareholders and Employees?

Divergence of interests of shareholders and employees will be further discussed. As we noted in the previous Part, interests of these constituencies are different. Otherwise there would be no problem for shareholders to let the employees govern the corporation as their stakes are bigger. Still, for various reasons employees do not reign over corporations in any democratic jurisdiction.

Supposing that the corporation is a nexus of contracts,[12] it is inevitable that several interests will be clashing over the optimal governance of the firm.[13] The approach towards risk bearing will differ regarding the constituencies.

Firstly, we can start with axiom that good business performance is a common interest of all stakeholders of corporation. It is, *inter alia*, confirmed by the European legislators that one of the objectives of European corporate law is to foster business efficiency.[14]

Secondly, employees’ main concern is to keep their jobs therefore they do not have incentives to accept bigger risk. In fact, employees care about the economic performance of the firm only to that extent as it influences their wages. As they will in general receive proportionally less with better corporation performance,[15] they do not always have enough incentives to foster on maximum the economic performance of the firm.

Thirdly, shareholders, on the other hand, tend to take more risks. Sometimes too much risk as the corporations usually have some debt in their financing structures so the shareholders are not taking all the risk, but benefiting fully from the risky project. Moreover, they are hedged by portfolio theory so they can care less about risk.[16] Generally firms with more shareholder rights achieve better business performance, because they aim more on profit

[12] Ronald H. Coase: *The Nature of the Firm*, Economica, New Series, Vol. 4, No. 16 (1937), p. 390
[13] Kelly and Parkinson, *supra* note 5, p. 122
[14] Gert-Jan Vossestien: *Modernization of European Company Law and Corporate Governance: Some Considerations on its Legal Limits* (Alphen aan den Rijen: Kluwer Law Internatonal, 2010), p. 44
[15] Frank H. Easterbrook and Daniel R. Fischel: *The Corporate Contract*, Columbia Law Review, vol. 89 (1989), p. 1425
[16] *Ibid*, p. 1440

that is to be distributed to shareholders as residual claimants[17] and generally use capital more productively.[18]

This incentive of excessive risk taking by shareholder is, on the other hand, present only in economies with diffused ownership.[19] If the corporation is owned by a blockholder, the probability that undiverisified investor would take an excessive risk is lower.[20] The interests of blockholders and employees tend to converge and wealth maximization is diminished.

In the end of the day, the risky ventures that may shareholders promote are always moderated by managers that have to conduct them as is stipulated by Blair and Stout.[21] As managers also have their stakes in corporation and their interests tend to converge with those interests of employees (stable jobs, fixed income). Managers also owe fiduciary duties towards company and are therefore exposed to civil liability.[22] For these reasons, they tend to mitigate the risks to be taken by the corporation.

As the managers are, on the other hand, appointed by the shareholders, they have incentives to reasonably maximize shareholders' wealth to keep their positions as underperforming corporations are easy targets for takeovers. This balance of risk is, however, present regardless of employee representation in board.

In this Part, we have examined that employees and shareholders have because of this generally very diverse interests. Employees focus on maintenance of their jobs employees and therefore tend to exclude risks which can mitigate the overall business efficiency of the corporation. Shareholders on the other hand prefer maximization of corporations' profit. This focus on profit is greater when diffused ownership and debt are present as shareholders bear less risk. Willingness to take risk then decline as these two elements are not present. As a moderating power, usually managers' incentives are used to produce optimal balance of prevailing interests regardless of employees' direct participation in the board.

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[17] Hideki Kanda et al.: *Transforming Corporate Governance in East Asia* (London: Routledge 2008), p. 17, please refer also
[18] Ronald Dore, *supra* note 1, p. 206
[19] Michel Goyer, *supra* note 1, p. 186
[20] Easterbrook and Fischel, *supra* note 15, p. 1440
[21] Margaret M. Blair and Lynn A. Stout: *Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board*, Washington University Law Quarterly, vol. 79, number 2 (2001), p. 428
[22] *Ibid*, p. 424

4. Anatomy of Co-Determined Board

For the purposes of this paper, we will handle mainly German co-determination model and some other minor European jurisdictions will be only briefly noted. Architecture of corporate bodies will be the main concern of this part. Firstly we will discuss the German model and secondly we will examine co-determination in the rest of Europe.

a. Co-Determination in Germany

The German defeat in the Second World War brought an economic and social disorder to the country. Therefore solutions of a new social balance had to be sought. In the end of the day, the compromise was found and employees factually accepted lower wages and personal commitment in exchange of representation in boardrooms.[23] This revolution came from above as co-determination was made compulsory by statute. [24] By that time it was for Germany technically impossible to develop strong capital markets as there were lack of wealthy investors that would invest in public companies.[25]

Since the first codetermination acts in the 1950s, the legislation has evolved. Through an expansion in the 1970s when all companies of the public company form[26] were subject to co-determination to the last amendments in 1994 that liberate from co-determination those companies with less than 500 employees.[27]

Employee representation is limited to the supervisory board which is advisory and controlling body of the two-tier system of German corporate structure. This two-tier system is obligatory for all AG corporations. This system enables to anchor the co-determination in the supervisory tier and no employee representation is then present in the management board.

[23] Mark J. Roe: *Strong Managers, Weak Owners, The political Roots of America Corporate Finance* (Princeton: Princeton University Press, 1994), p. 215
[24] Wolfgang Streek and Kozo Yamamura (eds.): *The Origins of Nonliberal Cpitalism: Germany and Japan in Comparison* (Cornell: Cornell University Press, 2001), p. 163
[25] Caroline Frohlin: *The History of Corporate Ownership and Control in Germany*, [available online at: http://www.nber.org/chapters/c10271.pdf], p. 224
[26] *Aktiengesellschaft* [**AG]**
[27] Charles E. Stewart: *Mergers and Acquisitions: Germany* (Oceana Publications, 2000), p. 7

The current legislative framework stipulates that employees of all AG corporations should be represented in supervisory boards according to the following pattern:[28]

Size of corporation (number of employees)	**Size of supervisory board**	**Number of employees' representatives**
0-500	at least 3 chairs	no obligatory co-determination
500-2000	12 chairs	one third
2000 and more	20 chairs	one half[29]

As we can see, the German employees enjoy a broad representation in the controlling body of public companies as they almost reach parity with shareholders representatives. The amount of chairs in boardroom enjoyed by German employees is unprecedented even in other European jurisdictions as we will see further. Moreover, the statutory requirements keep supervisory boards excessively big. What once was born as social compromise survived until today and employees keep holding their monitoring and controlling rights through their direct representatives in the supervisory board.

b. Co-Determination in Other European Countries

Before the actual discussion on the co-determination models in Europe, the issue of corporate structure is to be explored as it seems to be determining for the possibilities of co-determination. Afterwards we will review some other European systems of co-determination that exist besides the German model.

Despite of the proclaimed harmonization of European corporate law, only minor harmonization has been done so far on the field of corporate bodies. We can observe in total three models applied for public corporations across Europe: (i) obligatory two-tier system as we know it from Germany, (ii) obligatory one-tier system (e.g. Italy or Spain) and (iii) mixed system where it depends upon the shareholders which mode they prefer (e.g. France or the

[28] German Codetermination Act of 1976 as amended
[29] Quasi-parity with decisive vote of the supervisory board chairman (appointed by shareholders)

United Kingdom[30]). The one-tier model seems to be the most widespread and the best functioning as it enables better monitoring at lower cost.[31] Firms seem to prefer one-tier system as for example in France where they are free to choose, but only 2-4% of corporation opt for two-tier system.[32]

Co-determination seems to be related to two-tier systems as no strictly one-tier system in Europe currently prescribes obligatory representation of employees.[33] The reason why one-tier system does not attract co-determination relates mainly to information flow in corporation and in exclusion of employees to engage in day-to-day business of the corporation.[34] This would probably diminish the board efficiency even more.

The most widespread model of co-determination originates from the Dutch legislation as it is sometimes claimed to be the most developed.[35] It stipulates that supervisory board in which employees are represented by one third of chairs.[36]

In France employees are represented in the board, but only for advisory purposes. Direct participation is required only in some public companies of statutorily stipulated size. [37] In this case the shareholders will presumably opt for two-tier structure.

An interesting model of co-determined corporate architecture can be found in the Czech Republic that obligatorily prescribes two-tier system. Employees are represented in the supervisory board with no managerial function, but with supervisory duties only. The management board is elected directly by shareholders so employees are left with their strictly controlling position.[38]

To conclude this part, no other European corporate law framework stipulates as high level of employee participation as German model does. Employees are represented in two-tier

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[30] In the United Kingdom the two-tier system involving a supervisory board is compulsory for listed companies, as the listing rules stipulate. Stefan Grundmann: *European Company Law*, 2nd edition (Cambridge: Intersentia 2012), p. 259. More on the rise of monitoring boards in the United Kingdom: Paul L. Davies: *Board structure in UK and Germany* (2000), p. 2 [available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=262959]
[31] Stefan Grundmann, *supra* note 30
[32] *Ibid*, p. 257
[33] *Ibid*
[34] Paul L. Davies, *supra* note 30, p. 20
[35] Stefan Grundam, *supra* note 30, p. 263
[36] *Ibid*
[37] *Ibid*, p. 264
[38] Karel Drevinek and Petr Severa: *Getting the Deal Through: Czech Republic* (2005) [available online at: http://www.weil.com/news/pubdetail.aspx?pub=3648]

models of corporate bodies as it should give the possibility to shareholder to dominate at least the executive tier (management board).

5. Employees' Interests and Implications for Boards

Firstly, we will have a brief look at supervisory board of German public corporations that tend to be big and not very operational. In the same time we will have a look why these boards differ from ideal boards. We will handle only the German model as for other co-determined models can the same *mutantis mutandis* be applied. Secondly, we will examine if there are some advantages for shareholders to have co-determined boards. Thirdly, we will see how the shareholders find their way to bypass the structure of the corporations and mitigate the co-determined boards involvement in the decision making process. Legal arbitrage will be excluded from this part as is a subject to discussion in the separate Part 7.

a. Co-Determined Boardrooms

Roe observes four main problems regarding German supervisory boards: (i) they are too big, (ii) their meetings are not frequent, (iii) there is a weak flow of information, and (iv) conflicts of interests.[39] Now we will examine these points.

As was noted in Part 4, employees reach almost parity with shareholder representation in supervisory boards of big German public corporations. Moreover, the statutes stipulate that these boards have to be composed of 20 members and therefore are big *per se*. It brings several concerns about their operational abilities as it increases free-rider problem.[40] Members of a big board tend to rely on their co-members to be prepared and well informed for the meetings and therefore engage themselves less in the monitoring tasks.

[39] Mark J. Roe: *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (New York: Oxford University Press, 2003), p. 72
[40] *Ibid*

Also meetings of supervisory boards do not seem to be frequent – typically two or four times per year.[41] Shareholders that in many occasions prefer not to share the power with employees do not have incentives to hold board meetings with more frequency and tend to monitor instead the management directly (see below). Roe also suggest that boards with a lower frequency of meeting will be less informed.[42] The monitoring effect of supervisory board is then diminished and the actual risk management process is situated to the management board.

Presence of employees in boardrooms means a direct information channel to employees. As a survey among co-determined Swedish boardrooms showed, the threat of information leak in co-determined boards was high.[43] In effect, almost any piece of information given to employees' representatives flows practically directly among employees.

The conflict of interests in supervisory boards seems to be obvious as was discussed in the Part 3. Moreover, the supervisory boards tend to split into fractions of shareholders' and employees' participants.[44] Employees representatives may therefore wish to block corporate changes and be reluctant to austerity measures that could lead otherwise to a better performance of the corporation, but are not in the interest of employees.

As we have seen and as Roe suggested, the co-determined boards are weak in these four crucial points. Co-determination decreases the supervisory board monitoring ability. The lack of board monitoring has to be replaced by other means as direct monitoring. Furthermore, bigger boards mean higher aggregate remuneration of their members and more insurance expenses with no added shareholder value.

b. Can Shareholders Benefit from Co-Determined Boards?

As it is usually observed, shareholders do not obtain much advantage from co-determined boards. As we have seen, these boards tend to be weak and block shareholders have incentives

[41] *Ibid*, p. 73
[42] *Ibid*
[43] Anders Victorin: *Employee Participation on Company Board: The Swedish Experience* (Company Law Reform in the OECD Countries: A Comparative Outlook on Current Trends, 2000) [available online at: http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/1931982.pdf]
[44] Mark J. Roe, *supra* note 39, p. 75

to monitor the management directly and not to involve co-determined boards. Now we overlook in which area can shareholders benefit from co-determination.

Co-determined boards can have significant social effect in cases of unpopular decisions. If they approve austerity measures to rescue the corporation, employees usually tend to perceive it better than in case of unco-determined boards. The social peace and strike prevention is then a surplus for shareholders.[45]

As supervisory boardrooms tend to split into fractions as we discussed above, the employee representatives usually have incentives to monitor the other fraction of the supervisory board. In effect it means that they may be more willing to block related party transactions of the shareholders’ representatives if these are harmful for the company and these transactions are to be approved by the supervisory board.[46] They can also be more willing to denounce these transactions as their position does not depend on the shareholder.

We can conclude, that there are, nevertheless, some gains for shareholders if the supervisory board is co-determined. Firstly, there are social benefits of co-determined boards the employees may feel more protected. The second benefit is that employees may have better incentives to monitor related party transactions. But despite all of this, shareholders do not prefer it in transnational enterprises if they can opt for unco-determined boards [47] as these seem to be more efficient for them.

c. How Do Shareholders Bypass the Co-Determined Boards

As we discussed in the Part 5 a., the shareholders have incentives to diminish the role of the supervisory board. Shareholders usually find ways how to cope with co-determined board and in the same time preserve the advantages that was described in the Part 5 b. The ways

[45] *Ibid*
[46] As precribed by law in Germany. For more detail please refer to Joseph A. McCahery and Erik P. M. Vermeulen: *Corporate Governance Crisis and Related Party Transactions: Post-Parmalat Agenda*, in: Klaus J. Hopt et al. (eds.): *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan and the US* (Oxford: Oxford University Press, 2005), p. 239
[47] Klaus J. Hopt: *Common principles of CG in Europe*, in: *The Millenium Lectures* (Oxford: Hart Publishing, 2000), p. 121

how shareholders bypass co-determined supervisory boards will be discussed now with the exception of the ultimate one – legal arbitrage that will be examined separately in the Part 6.

Primarily we have to observe that a shareholder has two options how to monitor managers. It can be done by the shareholder herself or by her agents such as supervisory board. If we suppose that the corporation is controlled by blockholders (for more details see Part 7), the direct monitoring is not impossible[48] (opposing to the state of diffused ownership structure).

By installing a direct informal meetings with management board in two tier board system, shareholder receives enough information without involving the supervisory board. In this case employee representation stays without the information and can be revoked only to give formal consent as described above while preserving all advantages of co-determined board for shareholders.

To prevent information leaks, management and shareholders may tend to diminish the role of supervisory board and keep it uniformed until closing of a transaction. The result of this will be the role of supervisory board minimized to consent with fully negotiated deals, as Hopt appoints.[49]

As we have discussed, shareholders have many ways to diminish the role of the co-determined supervisory board and avoid information flow towards employees. The co-determined supervisory board than represents an expensive vehicle in relation to the benefits that it brings to the firm’s economic performance.

6. Legal Arbitrage and Co-Determination

The main topic of analysis in this part will be legal arbitrage and shareholders’ forum shopping that they may undergo to avoid co-determination. It is examined separately, because of empirical proves that support it. Firstly, free movement of companies in order to avoid

[48] Mark J. Roe, *supra* note 23, p. 75
[49] Klaus Hopt, *supra* note 47, p. 120

codetermination will be discussed. Secondly, we will discuss the "SE effect" as the most significant device for legal arbitrage of public companies.

Due to pressure of global investors, legislators have incentives to shape local corporate law more convenient for investors and boost investments in their countries.[50] We can assume that investors are more likely to invest into companies in jurisdictions that better protect their interests.

Dutch law can serve as an example of jurisdiction that is promoting foreign investments. In relation to co-determination, it has enabled to foreign capital to avoid it.[51] Apparently, this gives a strong competitive advantage to Dutch corporate law. As we will observe further, more than opportunistic behavior it represents the only logical move towards remaining competitive on the field of corporate law.

More generally, in areas of free movement of companies,[52] investors have possibilities to effectively avoid inconvenient rules (co-determination) by incorporating under another law.[53] However, opposing to all expectations, there are no evidence of a massive re-incorporation of German public corporations under foreign law as was predicted.[54] While it happened massively on the level of small private limited liability companies, public limited corporations do not seem to be subject to this trend, I suppose it is due to legal uncertainty regarding these reincorporating transactions.[55]

Co-determined public companies in Europe have instead commenced using another device for legal arbitration in recent years. This is supranational form of public company - *Societas Europea*.[56] As Grundman appointed, there were prolonged discussion on the point of employee participation regime between the member states.[57] In the end, a compromise involving negotiation agreement between shareholders and employee was adapted instead of

[50] Lars Hornuf: *Regulatory Competition in European Corporate and Capital Market Law* (Cambridge: Intersentia 2012), p. 2
[51] Stefan Grundmann, *supra* note 30, p. 264
[52] I.e. in the area of application of *incorporation doctrine* in company private international law.
[53] Jenns C. Damman: *Future of Codetermination after* Centros: *Will German Corporate Law Move Closer to the US Model?*, [available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=811564], p. 621
[54] *Ibid*, p. 613
[55] Marco Becht et al.: *Where do Firms Incorporate? Deregulation and Cost of Entry*, Journal of Corporate Finance, vol. 14, issue 3, June 2008 [available online at: http://www.sciencedirect.com/science/article/pii/S0929119908000370#]
[56] [**SE**]
[57] Stefan Grundam, *supra* note 30, p. 846

statutory co-determiantion.[58] By this mean German public corporations can mitigate the level of employee participation and size of supervisory boards depending on negotiation results.

Empiric data proved that SE is a very popular device for legal arbitration among German public corporations.[59] Eidenmüller et al. conducted a comprehensive survey among SE users in 2008 to determine what the motivations of firms to incorporate under SE are. While this unique survey has a significant importance for our discussion, we will look at it closer.

Eidenmüller et al. confirmed their thesis that firms in countries with co-determination legislation[60] will have more incentives to incorporate under SE and mitigate the level of co-determination.[61] It was also believed that in countries with two-tier board system will have the same incentives to mitigate costs by reincorporating with one-tier system.[62] This hypothesis was also confirmed.

The biggest transactions involving incorporation took place in Germany[63] and the main motives for remodelation of corporate bodies were: option for one-tier system, mitigation of co-determination and reduction of the size of supervisory board.[64] More surprisingly, one of the firms reached such an agreement with its employees that the system of co-determination was abolished completely.[65]

We can therefore conclude, that shareholders with opportunities to opt for lower levels of co-determination do so. Even with high costs of reincorporation[66] they are still willing to undergo the reincorporation process to reach more efficiency of supervisory board and lower employee participation.

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[58] *Ibid*, p. 847
[59] Horst Eidenmüller et al.: *Incorporating under European Law: the Societas Europea as a Vehicle for Legal Arbitrage*, in: Allesio M. Pacces: *The Law and Economics of Corporate Governance* (Gheltenham: Edward Elgar Publishing, 2010), p. 91
[60] I.e. Germany, Czech Republic
[61] Horst Eidenmüller et al., *supra* note 59, p. 90
[62] *Ibid*, p. 88
[63] Namely incorporations of Allianz SE, BASF SE, Porsche Automobil Holding SE, etc. *Ibid*, p. 103
[64] *Ibid*, p. 109
[65] *Ibid*, p. 108
[66] In case of Allianz SE the costs of reincorporation were estimated for EUR 90 mil. *Ibid*, p. 87

7. Co-determination and Ownership Structure

As we discussed in the previous part, shareholders may employ several devices to avoid influence of co-determined supervisory bodies. In this part, we will examine the implications on corporate ownership structure. We will contrast the current interaction between corporations and blockholder owners. Subsequently, we will examine the implications and concerns that co-determination brings to capital markets and their potential future development.

a. Blockholder Structure in Germany and its Implications

Firstly, it is necessary to accept the fact that public financing provided by capital markets does not have in Germany such a strong tradition as in the traditional capital market economies. Evolution of German capital markets was a long and slow one.[67] Until recently German corporation ownership structure was marked by "… *low levels of financially-oriented shareholders as individuals, pension funds and investment funds.*"[68] The diffused ownership in its magnitude as observed for example by Berle and Means in the USA of 1930s[69] is not present in Germany.

The voting power is usually concentrated in the hands of big blockholders (banks) as these also exercise voting rights connected with their clients' shares through a proxy system.[70] An important feature of these blockholdings is that they in fact do not care about the price of securities as these will not likely be sold and if so, the price is not a matter the banks should

[67] Klaus J. Hopt, *supra* note 49, p.122
[68] Gregory Jackson: *Comparative Corporate Governance: Sociological Perspectives*, in: Gavin Kelly et al. (eds.): *The Political Economy of the Company*, (Oxford: Hart Publishing, 2000), p. 271
[69] Adolf Berle and Gardiner Means: *The Modern Corporation and Private Property* (New York: Harcourt, Brace & World, 1968), p. 4
[70] Caroline Frohlin, *supra* note 25, p. 224

worry about.[71] Their shares are moreover usually too big to be sold on the market[72] and they are recipients of own only a small portion of dividends in comparison with voting rights they exercise.

As was noted in the previous part, for blockholders it is easy to bypass the do-determined supervisory board by direct monitoring. I therefore argue that blockholders have more incentives to find “compromises” with employees and assign them with chairs in the supervisory board. The big shareholders are more willing to allow codetermination on the price of lower transparency.[73] For blockholders it is not difficult to obtain the needed information on corporation by other means as they directly influence the composition of supervisory board majority and the composition of management board. Informal meetings of the blockholder with management board can be a substitute for monitoring by supervisory board. They do not object co-determination, because they (i) anyway cannot diversify their investments and their interests converged more with the interests of employees, (ii) they can effectively bypass co-determined boards.

b. Capital Markets and Future Development

German economy is not any more a capital poor economy as it was in the times when codetermination legislation was originally born and today is capital more frequently sought on public markets. However, it seems that the move towards diffused ownership that is usually connected with capital markets brings many challenges to the current system that might have to evolve in order to survive.

The arrival of global investors to German economy is creating and need to compete with emerging markets for the investor’s attention is bringing new concerns about corporate governance in Germany. As Hopt noted, corporate ownership structure was in past not very

[71] Peter F. Drucker: *Reckoning with the Pension Fund Revolution*, Harvard Business Review, March/April 1991
[72] *Ibid*
[73] Michel Groyer, *supra* note 1, p. 206

friendly of profit-oriented investors. New global competition of new economies develops pressures on German system of universal banking financing system.[74]

Therefore it is important aim for legislators to create capital markets friendly investor environment if public capital raising should be promoted. Furthemore, more pressure on market efficiency of German corporate governance is made by the EU effort to integrate capital markets.[75]

Capital markets generally require a different kind of compromise than that made with employees during co-determination era. Major transparency is usually required by the investors providing capital on global capital markets.[76] Therefore a major conflict with blockholding system of information flow arises.

Also monitoring by the main blockholder is diminished by share fragmentation. Diffused owners cannot install the informal system of meetings with management and have to rely on public disclosure. Co-determination no more works for these investors.

Moreover, in Germany the external monitoring by control market is not easily accessible as take-over devices are not sufficiently developed. Germany generally constitutes a "… *hostile environment for hostile takeovers.*"[77] Employees and managers in many cases oppose takeovers and major corporate changes.[78] Therefore, shareholders cannot rely on bidders to discipline the co-determined boards and give incentives to at least avoid underperformance.

It seems that Germany will have to develop some efforts to improve the financial markets if it wants to remain competitive with other economies and keep attracting foreign investors.[79] It would be an interesting issue to provide comparison with less co-determined jurisdictions, but none of them has comparable market potential as Germany. Usually it is due to the overall small size of their economy (e.g. Czech Republic) or because of the measures they enable foreign investors to avoid co-determination (the Netherlands). However, legal arbitrage in favor of SE seems to show that capital markets do not prefer rigid co-determination.

To conclude this Part, the co-determination does not seem favorable of developed capital market economy. Co-determined supervisory boards seem to prevent efficient board

[74] Klaus J. Hopt, *supra* note 48, p.124
[75] Gert-Jan Vossestien, *supra* note 14, p. 34
[76] Michel Goyer, *supra* note 1, p. 185
[77] Charles E Stewart, *supra* note 27, p. 16
[78] *Ibid*, p. 22
[79] *Ibid*, p. 13

monitoring and so the current system favorites direct monitoring by blockholders. Less possibilities in the market of external control also do not add certainty to foreign investors. Some authors argue that German system brings less revenue for investors,[80] but it is not possible to empirically prove that the German system of co-determination would burden capital market environment more than other co-determined systems.

8. Conclusion

We have examined that there are reasons why employees should be treated like a special group of corporations' stakeholders as they bear the biggest risk while taking firm specific risks without any factual possibility to diversify their risks or to be contractually secured. For this reason, they remain without any reasonable hedging option and representation in board can help to mitigate their risks.

Despite of some convergence between blockholders and employees, generally there is a big divergence between diffused shareholders' and employees' interests. The interests of employees seem to be clear: good economic performance of the firm with little risk. Unlike shareholders, they usually do not profit from risky projects as their claims (wages) tend to adjust slowly. The clash of these interests is usually moderated by managers with fiduciary duties as stipulated by Blair and Stout. Managers usually also have incentives to avoid underperformance of the corporation because this could become a target of a takeover transaction.

Co-determination protects employees' interest by giving them right to be represented in the supervisory board. Several models of co-determination have been developed in Europe, but it seems that the underlying policy is to give employees right to supervise the corporation actions, but no to enable them run day-to-day business. Co-determined boards are typically present in two-tier systems while the other board is given to be governed by the shareholders' agents (appointed directly or by the supervisory board where shareholders retain majority).

The consequence of co-determined boards is a blockholders' tendency to bypass the co-determined supervisory board and diminish its role by keeping it uninformed and little

[80] Ronald Dore, *supra* note 1, p. 206

operational during its infrequent meetings. Supervisory board’s monitoring function is highly diminished. This effect flows from the shareholders’ maximization of wealth in the decision making process.

Moreover, co-determined boards seem to attract several other problems. They are statutorily big and therefore attract free rider problem. The supervisory board’s success is also jeopardized by its fragmentation to shareholders agents and employee agents.

The advantages for shareholders of having a co-determined board does not seem to outweigh the difficulties with the co-determined board that is in consequence a “weak” agent and its monitoring function is to be supplemented by other means as direct monitoring. Generally, it is proved that for these reasons shareholders do not prefer co-determined boards.

Furthermore, it seems that German public corporations are in favor of reincorporation under SE in order to diminish employee participation. It is empirically proved that by reincorporation they mitigate the level of co-determination and generally to promote more efficient boards as this corporate form enables them to create smaller supervisory boards. This presumably could constitute a source of inspiration for German legislators.

In effect, unco-determined boards tend to be more efficient and less costly as no shareholder-employee struggle is present and boards can devote their energy to effectively manage the corporation. Developed capital markets attract investors and these prefer diffused ownership because of diversification of their investments. However, co-determined boards seem to burden their development. Legislators will probably have to choose whether to preserve employee monitoring and co-determined boards or to develop strong capital markets.

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