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Codetermination: A Sociopolitical Model with Governance Externalities

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Codetermination and corporate governance have a common purpose: to control economic power associated with large corporate enterprises. The two concepts diverge in other respects, however. Codetermination gives economic power to those who control the means of production and uses employee participation as a tool to counter the interests of capital. The prevailing corporate governance paradigm, by contrast, places major control in the hands of capital owners and uses management as their agents. Employees are treated as stakeholders in a corporation, but usually not as substantial collaborators in the control over management. In essence, the main difference between the two concepts is that codetermination offers social governance, whereas corporate governance provides firm-level governance.

Social governance and firm-level governance have different socioeconomic roots. The concept of codetermination originates

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in the social movements of late nineteenth-century Europe. Active participation of employees in the decisionmaking processes of the company was seen as a way to overcome the contradiction between the classic liberal ideals of self-determination and the rights of the individual, on the one hand, and the reality of industrialization, on the other, which was, as Marx termed it, the alienation of workers from the fruits of their labor. This assessment of the status of workers in large corporations was not limited to leftist circles. Otto v. Gierke, an acclaimed nineteenth-century scholar of German legal tradition and business organization and a social conservative, wrote in 1868 that the "property-less classes have been or are at least threatened to be deprived of their economic personality by the development of the capitalist large enterprise. The old economic organisms . . . have been dispersed into loose atoms. From these atoms have been built extreme powerful entities which are constantly gaining additional power, for which capital is the basis and the master, while labor is only an adjunct tool."¹

Corporate governance is a younger concept. It first found great acclaim in the United States in the early 1930s, with the publication of a classic work on the modern corporation by Adolf Berle and Gardiner Means.² This concept emerged not in response to social conflicts, but rather as a result of developments in the American economy, which seemed to be giving dispersed shareholders less and less control and allowing managers to become ever stronger. In the language of the social advocates of the nineteenth century, one might call this the "alienation of owners from their capital." The corporate governance debate, with its focus on the separation of ownership and control, did not command full attention in Germany until the 1980s. Corporate governance was certainly not a major issue in the debate that preceded the adoption of the 1976 law on codetermination in Germany. The emphasis was on social governance, and the implications of codetermination for corporate governance were of secondary importance.³ Furthermore, the corporate governance debate is not a homegrown but an imported controversy, as revealed by the widespread use in Germany of the English terms "corporate governance" (sometimes translated as *Unternehmensführungskontrolle*) or "shareholder value." The interest in Ger-

1. V. Gierke (1868) as quoted in Kübler, Schmidt, and Simitis (1978, pp. 114).

2. Berle and Means ([1932] 1991). For a recent comprehensive treatment of the relationship between managers and owners in the United States, see Roe (1994).

3. Hopt (1994, p. 211). For an early critical analysis of the possible impact of German codetermination on corporate governance, see Mertens and Schanze (1979).

many in firm-level governance is largely the result of the growing interest among scholars in comparing systems of corporate governance.

Until the 1980s, Germany was preoccupied with the antagonism between labor and capital and hence paid little attention to the fact that the interests of capital may be divided between the interests of shareholders and the interests of management. Since then, there has been a growing sense in Germany that management is operating in a control vacuum, and that as a result firm-level governance has fallen prey to a number of deficiencies, most notably some blatant failures in monitoring company management. Legislative reforms were enacted in 1998 to improve existing control mechanisms.⁴ However, the reforms have stopped short of questioning the concept of codetermination and its impact on the functioning of the supervisory board, that is, the board that holds ultimate responsibility in the German corporate structure. The consensus is still that codetermination has succeeded in establishing not only social governance but also social peace (*Sozialfrieden*), and that any attempt to alter the institutional setting currently in place would endanger this achievement. In fact, earlier proposals to reduce the number of supervisory board members mandated by the law have already been dropped from the current reform agenda, because of mounting opposition from labor unions and their political allies, who regard this as an attack on the principles of codetermination.

This chapter attempts to assess the impact of codetermination on firm-level governance. The discussion opens with a brief overview of the historical evolution of codetermination in Germany. It then turns to the concept of governance externalities produced by codetermination within a framework of coalition building among multiple parties, and examines the empirical evidence of the impact of codetermination on the relationship between shareholders, employees, and management in the German governance setting.

The Evolution of German Codetermination

In Germany today, codetermination is practiced on two levels: at the shop-floor level, through workers' councils, which give employees the right to obtain information and to participate in decisions that directly affect their workplace; and at the corporate level, through employee and union repre-

4. Law on Control and Transparency of Enterprises, April 27, 1998, RGBI I, p. 786.

sensation on supervisory boards. Firm-level participation dates back to the last decade of the nineteenth century.⁵ A July 1891 amendment to the law on entrepreneurial activities (*Gewerbeordnung*) stipulated that workers' councils could be established within companies on a voluntary basis. During World War I, labor unions and the Social Democratic party seized an opportunity to make these councils mandatory when a "law on support services for the fatherland" (*Gesetz über den vaterländischen Hilfsdienst*) was passed to force the male population not actively involved in warfare to participate in military production. These groups persuaded the government to include provisions that made mandatory the creation of workers' councils and worker's arbitration bodies. Once the law went into effect, the antagonism between employees and labor union representatives intensified, and the union representatives were accused of siding with capital and the war hawks and of compromising the workers' rights and interests.⁶ These early signs of a potential conflict of interest between organized labor and employees in the realization of codetermination are interesting to note, for they arise again later. The timing of the introduction of mandatory codetermination also suggests that serious political and economic crises play an important role in shaping a nation's social and legal institutions.⁷

After World War I, Germany's Weimar Constitution gave workers' councils constitutional recognition not only as entities of the firm, but also as political organizations that represented the interests of labor. Hence these councils were called on to play a political role in state administration on the regional and federal level.⁸ However, subsequent legislation put this provision into effect only at the firm level. In 1920 Germany passed a law creating workers' councils in firms, then in 1922 passed another law establishing that workers' councils were to send delegates to the supervisory board in joint stock companies, thereby extending workers' participation beyond the shop floor.⁹ These laws were rescinded under the fascist regime, as the overriding *Führerprinzip*, the principle of an undisputed central leader, precluded participatory models.

5. For an overview of the historical development of codetermination, see Kübler, Schmidt, and Simitis (1978, pp. 113–19); and Decision of the Constitutional Court on Codetermination, in Collection of Constitutional Court Decisions (BVerfGE), vol. 50, pp. 290, 294–97 (Codetermination Decision).

6. Thum (1991, p. 25).

7. Roe (1996).

8. Thum (1991, p. 30).

9. The two laws are the *Betriebsrätegesetz*, enacted February 4, 1920, RGBl, p. 147, and the *Gesetz über die Entsendung von Betriebsratsmitgliedern in den Aufsichtsrat*, enacted February 15, 1922, RGBl, p. 209.

The development of codetermination after World War II was strongly influenced by Germany's experience with fascism. One of the pillars of fascist power had been the alliance between powerful private capital—particularly the coal and steel industries concentrated in the Ruhr valley—with the political regime. Konrad Adenauer, chancellor of Germany and head of the Christian Democratic party, declared in 1947 that "the Ruhrindustry—and by that I mean coal mining and the entire heavy metal industry—has politically exploited the tremendous economic power that was accumulated in the years leading to 1933 to the detriment of the German people."¹⁰ The prevailing view at the time was that political democracy must be combined with social constraints over the use of private capital, a concept that has been termed "economic democracy" (*Wirtschaftsdemokratie*).

The 1949 Constitution explicitly provided in Article 15 for the possibility of nationalizing industries. Moreover, it established a constitutional link between the protection of private property and the social context in which private property rights are realized. Article 14 of the 1949 Constitution guarantees the right to private property and inheritance but stipulates that "the contents and scope of property rights shall be determined by the law." In addition, section 2 of the same article explicitly states that property is not only a right but also an obligation, and that the exercise of private property rights shall also benefit society as a whole.

Political leaders in postwar occupied Germany also wished to prevent a dismantling of the nation's large industries, which were thought to be indispensable for postwar reconstruction. To appease the occupying powers as well as the European neighbors while preserving key industries, a governance structure was designed that combined features of social governance, in the form of codetermination, with multilateral governance through the integration of former war industries into a European organization. The European Coal and Steel Community—known in Germany as the *Montanunion* (where *Montan* refers to coal and steel)—that emerged from this multilateral effort became the centerpiece for further European integration.

The institutional basis for workers' participation was created with the enactment of legislation on corporate codetermination in the coal and steel industries in 1951 and by a 1952 law on the internal organization of the firm (*Betriebsverfassungsgesetz*). The 1952 law revived firm-level employee participation of the sort that had existed in the Weimar Republic. The 1951 law on Montan-Codetermination granted employees equal representation on supervisory boards in the coal and steel industry, while the 1952 law gave

10. Quoted in Kübler, Schmidt, and Simitis (1978, p. 120).

employees in companies in other industries the right to delegate employees to the supervisory board if the companies had more than 500 workers and required the board to reserve one-third of its seats for employees. Later, the 1976 Codetermination Law would extend equal employee representation on the supervisory board to all of the largest companies in Germany irrespective of the industry sector.

Codetermination in the Montan Industries (1951)

The 1951 Law on Montan-Codetermination applies to companies involved in mining and processing coal and steel that have more than 1,000 employees.¹¹ This law is still in force. Codetermination was realized by granting workers representation on the supervisory board. According to German corporate law, the supervisory board, the members of which are elected by the shareholders, is in charge of appointing and dismissing the executive board of the corporation, supervising the executive board, and providing the management body with advice. The supervisory board is precluded by law from day-to-day management of the corporation, which is done by the executive board. However, because the supervisory board appoints the executive board, it has the ultimate power to exert control over the company's management.

The 1951 law increased the size of supervisory boards to accommodate employee representatives. Companies were mandated to create a supervisory board with eleven members.¹² Under this law, five members are elected by the shareholders, and five members by the employees of the company. The law thus creates two "benches" within the supervisory board: the shareholder bench and the employee bench. Four members of each bench must be rank-and-file shareholders or employees, and the fifth member an outsider. He or she must not be a member of an employers' federation or a labor union, and must not have occupied the position of either a shareholder or an employee in the company in the twelve months preceding the appointment. Additional restrictions apply to the employees' representa-

11. Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (sog. Montan-Mitbestimmungsgesetz) of May 21, 1951, RGBl, I, p. 347, hereinafter quoted as MontanG.

12. This applied irrespective of the legal form of the company. Although only joint stock companies have a supervisory board according to the general provisions of German corporate law, companies organized as limited liability companies with a work force exceeding 2,000 also had to create such a body.

tives. The three employee representatives must include at least one blue-collar and one white-collar worker elected in separate procedures. The members of the employee bench must be approved by the relevant labor union association. The eleventh member, the so-called neutral man who serves as the chairman of the supervisory board, is elected by the shareholder meeting upon recommendation by the five shareholders and the five employee representatives already elected. To be nominated, a candidate has to obtain at least three votes from each bench, and the law provides an elaborate conciliation procedure in case a proposal fails. The Montan-Codetermination Law also affects the composition of the executive board, which is in charge of day-to-day management. It legislates the inclusion of a special workers' director, the *Arbeitsdirektor*, and gives the employee bench additional weight in appointing this director. The appointment of the *Arbeitsdirektor* requires not only a majority of votes of the supervisory board, but also the majority of votes from the employee bench. The *Arbeitsdirektor* has the same rights as other directors, but is expected to specialize on aspects of corporate management that are of particular concern to employees, such as working conditions, wages, and benefits.

The Effects of Montan-Codetermination

From a firm-level governance point of view, the particularly interesting feature of codetermination is that it allocates control functions to agents whose positions are determined by their interests as employees, not as providers of capital or holders of cash flow rights. The interests of these agents may well be at odds with those of shareholders. For employees, the survival of the company, the protection of the workplace, as well as their wage and nonwage benefits are naturally of primary interest.¹³ Shareholders, by contrast, are likely to focus on the monetary value of their investment.

The empirical evidence on the functioning of supervisory boards under the 1951 law is rather limited. Most empirical studies on codetermination that were conducted in the 1950s and early 1960s studied the impact of workers' participation on the self-esteem of workers, rather than looking at possible conflicts on the board.¹⁴ This research agenda reflected the per-

13. Hansmann (1990, 1996).

14. For a summary and critique of the major studies conducted in the first ten years after the adoption of the Montan-Codetermination Law, see Dahrendorf (1965). A few exceptions to the rule that research focused on the social aspects and ignored the implications for corporate governance did exist. See, for example, Brinkmann-Herz (1972, 1975).

ceived purpose of codetermination: the integration of workers as active participants in the corporate enterprise. In the late 1960s, however, especially with the ascendance of the Social Democrats to the government in 1969, a debate began about whether to extend codetermination to all large companies. This debate resulted in a more systematic study of the effects of the 1951 law.

The most comprehensive study was sponsored by the government, which established a special commission to study the effects of codetermination (the Commission).¹⁵ The Commission found that the potential antagonism between shareholders and employees had not led to constant conflicts or inertia. This may have been due to the division of labor that evolved between shareholders and employees on the board: the shareholder bench focused on investment decisions and financial returns, while the employee bench concentrated on the working conditions for the company's work force. Parties from both sides found the relationship cooperative and assessed the results of codetermination as positive.¹⁶ In its analysis of the economic effects of codetermination, the Commission did not find that codetermination had a detrimental effect on company performance. In particular, companies that were not subject to codetermination did not seem to have performed better, although such comparisons were always complicated by the fact that, by definition, companies not subject to codetermination were in sectors other than coal and steel and might face different issues.

Although the Commission arrived at an overall positive assessment of codetermination, it also pointed out several negative tendencies. Codetermination, it suggested, was likely to favor strategies that shielded companies from competition, such as high investment or cartelization.¹⁷ Especially when a company comes under stress, the interests of management and employees tend to converge: their joint primary interest is the survival of the firm. As a result, both support high investment strategies to foster employment and give the appearance of a thriving company, and both tend to view exogenous factors that endanger the company strictly from the company's point of view. One of the arguments in support of codetermination had been that it would act as a deterrent against cartelization, because employees would resist mergers to protect their own interests. The Commission in fact confirmed that employees frequently delayed merger decisions to ensure that the interests of the work force were taken into

15. Mitbestimmungskommission (1970), also commonly referred to as Biedenkopf-Bericht.

16. Mitbestimmungskommission (1970, pp. 54).

17. Mitbestimmungskommission (1970, pp. 71, 78, and 158).

consideration. However, employees generally supported cartelization if the increase in the company's market share was expected to yield positive effects for the employees and union representatives.

In addition to the investigation of the Commission, several academic studies analyzed codetermination at this time. From a firm-level governance point of view, the most interesting data are provided in a study by Dorothea Brinkmann-Herz.¹⁸ The study looked at supervisory boards in companies subject to codetermination and those not subject to it. The study confirmed what was already well known about the supervisory board, namely, that with or without codetermination, the supervisory board plays primarily an acclamatory role in the appointment of the executive board. Candidates are selected in an informal procedure, in which a key role is played by the chairman of the executive board, but in which individuals and even outsiders sometimes participate. When the actual election for the executive board takes place, the supervisory board is usually presented a single candidate for each post to be filled. The ability of the supervisory board to exert influence on the executive board after it has approved its members is not very significant, either. In practice, information from the executive board was often found to be insufficient or was provided too late to allow detailed analyses by the supervisory board.

According to the results of Brinkmann-Herz's study, the effect of codetermination under the 1951 Montan legislation was not that it reduced the effectiveness of an otherwise well-functioning governance system. Rather, it introduced new internal dynamics into the supervisory board, and into the relationship between the supervisory board and the executive board, without changing the overall passive role of the supervisory board. The division of the supervisory board into two benches led to the formation of two subgroups with separate decisionmaking processes. Employees met in advance and determined a coherent voting strategy, while this was not necessarily the case for the shareholder bench. The two benches showed relatively little interaction with each other: as noted already, the employee bench specialized in social and employment-related topics, while the shareholder bench remained in charge of financial issues and major business strategies.

These results suggest that a codetermined company gives social and employment-related issues greater weight when determining the strategies for the corporation, but that labor does not conquer the domain of capital. The observed communication patterns show that both benches relate inde-

18. Brinkmann-Herz (1972; 1975, esp. p. 64). See also Edwards and Fischer (1994, pp. 210-14).

pendently to the eleventh member of the supervisory board, the neutral man, and to the executive board. As a result, a four- or even five-party configuration has emerged, consisting of the shareholder bench, the employee bench, the "neutral man," the executive board, and within the executive board, the *Arbeitsdirektor* (special workers' director) versus the chairman or the other members.

The 1976 Model and Its Evolution

When the results of the Brinkmann-Herz study were published in the first half of the 1970s, the discussion about the extension of codetermination to all large companies was already in full swing. Different models for the future of codetermination were developed by the three major political parties: the Christian Democrats (CDU), the Social Democrats (SPD), and the Liberals (FDP), as well as by the National Federation of Labor Unions (DGB). The participation of all major political powers in the formulation of new codetermination concepts suggests a consensus had been reached about the need for and desirability of an expansion of codetermination. The main arguments in favor of codetermination were the same as those used in 1951 to justify Montan-Codetermination: it would empower employees who provide the production factor and thereby enable them to become equal partners with capital in the capitalist production process. Firm-level participation was considered too low to achieve this goal, since employees on workers' councils had little input into decisions that had substantial bearing on policy change. The solution was to have workers participate in decisions that concern key strategies of the company, as these decisions ultimately determine their fate.

One intriguing aspect of the political debate was that all parties devoted considerable attention to minuscule variations in the design of the codetermination models under consideration, while ignoring even the limited evidence available on how the 1951 law had fared in practice. The question of whether the anticipated goal of effective social governance could be met with the chosen prescription was hardly ever posed. As Brinkmann-Herz put it with respect to the labor unions:

In their long struggle to prepare public opinion and the political arena for an extension of codetermination, [the unions] identified effective codetermination with the model of equal representation on the supervisory board. Any attempt to question this identity therefore would undermine all efforts to expand codetermination together with the successes

that had already been achieved.¹⁹

The structural issues that were most disputed among the political parties and labor unions were whether there should be a director on the executive board in charge of social and employment affairs (the *Arbeitsdirektor*); whether the board should include a third bench, with representatives of the state, the region, or the municipality; whether the board should include representatives from the labor unions who are not simultaneously employed by the company on the employee bench; how many representatives should be named to the two benches; whether a "neutral man" should be included; and what should be the ratio of white-collar to blue-collar workers on the employee bench.²⁰ The Social Democrats, the National Federation of Labor Unions, and the various individual labor unions typically favored a stronger role for outsiders on the supervisory board, be it representatives of the state or the labor unions. For example, the Social Democrats recommended that up to half of the representatives on the employee bench should be outsiders proposed for election by labor unions. Alternatively, a third bench with representatives of the public interest was proposed by the white-collar labor union and the Catholic labor movement so as to have representatives that could mediate between the other two benches when necessary. In addition, the Social Democrats sought to strengthen the influence of employees over the company's management by mandating a two-thirds majority for electing members to the executive board.

The Christian Democrats, the conservative party, also came out in support of giving employees and shareholders equal representation on the supervisory board, and of including outside representatives on the employee bench. They suggested that the supervisory board be increased to twenty members—ten on the shareholder bench, and ten on the employee bench—and that it include at least one white-collar worker, five blue-collar workers, and four outsiders elected by the employees, but that these should be proposed by the labor unions.

The Liberal party, the FDP, was opposed to having outsiders on the employee bench and placed greater weight on the role of white-collar workers on the supervisory board. One of the two models advocated by different factions within this party suggested that shareholders and blue-collar workers have equal representation but that two additional white-collar

19. Brinkmann-Herz (1975, p. 107).

20. For a discussion of the details of individual proposals that are touched on here and in the following paragraphs, see Brinkmann-Herz (1975, pp. 28–33).

workers be included. The FDP's proposal regarding white-collar workers met with stiff opposition from the labor unions. The position of their major clientele, said the unions, would be undermined by representatives who were inclined to side not with their constituency, but with the company's management, and thus with capital.

All models that were proposed called for a director in charge of social and employment issues—an *Arbeitsdirektor* along the lines of the coal and steel model—on the executive board of the company. Except for the labor unions, however, none of the proposals made the election of this director subject to approval by the majority of the employee bench, as was the case in the Montan model.

In 1976 Germany finally adopted the Law on Codetermination, after more than seven years of public debate.²¹ It applies to all companies with more than 2,000 employees outside the Montan industries, which continue to be regulated by the 1951 law. The 1976 law provides for equal representation of employees and shareholders on the supervisory board. The size of the supervisory board mandated by the law varies from twelve members in companies with up to 10,000 employees, to sixteen members in companies with 10,000 to 20,000 employees, and twenty members in companies with more than 20,000 employees. Shareholder representatives are elected by the corporate body designated by the relevant law. For a joint stock committee, this would be the shareholder meeting; for a limited liability firm, it would be the assembly of partners, and so on. The representatives of the employment bench are elected by delegates who are elected by the two employee subgroups, which are made up of blue- and white-collar workers. White-collar workers receive special notice. Their representation on the employee bench is the result of a delicate compromise between the majority party at that time, the Social Democrats, and its coalition partner, the Liberals. The latter were the major advocate for the interests of white-collar (often management) employees. Instead of reserving a fixed number of seats for white-collar workers, as originally proposed by the Liberal party, the law stipulates that the employee bench shall represent blue- and white-collar workers in proportion to their representation in the company.

The employee bench is not elected directly. Instead, the employees elect delegates, who in turn elect the members of the employee bench. These elections are held at company expense, at a cost that for large companies can

21. Gesetz über die Mitbestimmung der Arbeitnehmer (Mitbestimmungsgesetz), May 4, 1976, RGBl, 1153, often referred to as MitbestG.

range from 1 million to 5 million deutsche marks.²² A set of voting regulations was issued to provide some guidance for companies of different size and structure.²³ White- and blue-collar workers elect their delegates in separate procedures. Representatives of the labor union, who hold a minority position on the employee bench, are elected by the same delegates upon proposal by the labor union. Unlike the Montan-Codetermination Law of 1951, the 1976 law does not require that the elected members of the employee bench receive the approval of the relevant labor union.

Once the two benches are elected, the supervisory board elects its chairman from among the current members of the board. In contrast to the Montan Codetermination Law, the 1976 law does not stipulate that the chairman must be a "neutral man"; rather, the chairman may be recruited from either the shareholder or the employee bench. If the supervisory board is unable to arrive at a majority decision for one candidate—which is a common situation, given that labor and management unite behind their own candidates—then the chairman of the supervisory board shall be elected by the shareholder bench and his deputy by the employee bench. This arrangement typically prevails in practice. The affiliation of the chairman of the supervisory board is important, because in the event of a tie vote, he or she has the right to break the tie. Because of this bias toward the shareholder side, the model has been aptly characterized as "quasi-parity codetermination," as opposed to the "full parity codetermination" under the 1951 Montan Model.²⁴ Also, the members of the executive board of codetermined companies must be elected by a two-thirds majority, so as to ensure that a director may not be appointed against the vote of the employee bench.

Legal Appeals

The public debate over the 1976 codetermination law did not end with the adoption of the law. During the years preceding the enactment of the law, a strong opposition had formed, made up of employers' associations, corporations that were subject to the law, and shareholder organizations. A

22. Bamberg and others (1987, p. 97).

23. Special voting rules, for example, exist for holding companies. For further references, see Mertens and Schanze (1979, p. 80).

24. Hopt (1994, p. 204).

group of claimants made up of the German Federation for the Protection of Share Ownership, nine companies affected by the new law, and twenty-nine employer associations challenged the constitutionality of the law. Interestingly, the main challengers of the law were not shareholders, but companies and employers' associations made up of company executives as the legal representatives of companies that are members of these associations. It is therefore not surprising that the main issue in the entire proceeding was not whether codetermination would dilute shareholder value, but whether it interfered with the interests of the corporation and the way it was managed. The way in which a company is managed certainly affects shareholder value. However, the "interests of the company" is an ambiguous term that may in some contexts be a simple proxy for the interests of the company's management.

Germany's Constitutional Court upheld the law in 1979. The court stressed that the law was aimed at certain socioeconomic goals, and that the legislature had a right to determine these rules, even if they limit the rights of individuals or entities. These rights have to yield to the "public interest," unless the goals themselves or the means used to implement them are either unconstitutional or evidently not able to reach the goals, and for this reason present an unjustified limitation of the rights of said individuals or entities.²⁵ These arguments are in line with the generally restrained position of the Constitutional Court in judging the constitutionality of legislative acts. However, the court's terminology and its legal arguments show that it adopted the prevailing view of an enterprise as a joint undertaking of labor and capital and hardly recognized the potential for conflicts of interests between the different representatives of capital, management, and shareholders.²⁶ Throughout its ruling, the court used the term *Unternehmen*, or "enterprise," rather than "corporation." This is not only a question of semantics, but it reflects a century-old debate about the difference between the legal form of the corporation and the identity and rights of the enterprise for which it provides a shell. Many American legal scholars—after long deliberation—have concluded that the corporation beyond the legal fiction of the corporate entity with certain legal rights is a "nexus of contracts," but German legal scholars, judges, and politicians continue to see the enterprise behind the corporate shell as a unit with its own

25. Codetermination Decision, BVerfGE, vol. 50, pp. 290, 331.

26. Codetermination Decision, BVerfGE, vol. 50, pp. 290, 319, 352.

rights.²⁷ In this enterprise, the major antagonism is the one between labor and capital, not between owners and agents.

Codetermination and the Dynamics of Corporate Governance with Multiple Players

The debate preceding the adoption of the 1976 codetermination law and the model finally implemented focused on how to ensure social governance through worker participation. The implications of codetermination for firm-level governance were largely ignored. Whatever the underlying concepts that determine the contents of legal rules, once they are enacted they may have effects not anticipated by the legislators. The goal of codetermination was to give social governance the upper hand over private capital by strengthening the role of employees in the governance of firms. Taking this goal as a benchmark, we might expect various outcomes: the law succeeded and codetermination led to greater participation by employees in the firm's governance; the law did not succeed and employees played a negligible role in firm governance; or codetermination affected the dynamics of governance in ways that are hard to categorize as simple failure or success. It is difficult to prove whether the first or second propositions hold. Empirical studies are scarce. Moreover, all such studies face the problem that given the many known deficiencies of the supervisory board before the enactment of codetermination, it would be difficult to attribute the fact that employees do not exert the type of influence that was expected to a failure of codetermination.

The more interesting proposition to consider is whether the dynamics of firm governance changed in response to the introduction of codetermination. From a theoretical point of view, the effect of codetermination on corporate governance can be expected to generate two outcomes. First, it raises the cost of collective decisionmaking by increasing the heterogeneity of interests represented on the supervisory board. Second, it alters the relationship between the supervisory board and the management of the company from one of bilateral control—that is, a relatively unified supervisory board overseeing a relatively unified executive board—to a multiple-party arrangement characterized less by control and more by coalition building.

27. Jenson and Meckling (1976); Fama (1980); Easterbrook and Fischel (1991, p. 12). For a discussion of the debate between advocates of a "nexus of contracts" theory of the firm and advocates of an older view in the law, the "entity" theory of the firm, see chapter 2 in this volume.

The Cost of Collective Governance

Firm-level governance arises whenever a firm is not managed directly by a single owner. This happens when either multiple owners with diverging interests are involved in the management of the firm, or management is delegated to an agent. Where multiple owners are involved in the governance of firms, the cost of decisionmaking increases. The extent of this rise in costs depends on the diversity among the different types of owners, which in turn is determined by their relation to the firm as investors, producers, workers, or consumers.²⁸ Within each of these different groups, one may find different interests, but the spread of different interests is likely to be more pronounced in some groups than in others. Even though investors may differ by their tax status, interests as creditors, and preferences about risk and liquidity, they typically converge on the common interest of maximizing the value of their investment. The interests of different groups of employees tend to be more diverse, especially in large firms (which helps to explain why employee ownership is concentrated mainly in firms with relatively homogeneous employee profiles). Where multiple owners with diverging interests are involved in the governance of firms, the cost of collective governance will surely increase.

Firm-level governance may also entail agency costs, which arise when firm owners bring in professional managers to act as their agents.²⁹ Of course, the danger is that managers may pursue interests other than maximizing shareholder value, so that owners must find ways to control management and to align its activities with their interests. A variety of mechanisms may be helpful here. Internal mechanisms include corporate boards, whose task is to monitor management and give shareholders or boards the right to approve major decisions. Such internal mechanisms may be backed by judicial review, although the extent of judicial review varies considerably across different legal systems. Market mechanisms, including pressures through the product, managerial labor, and capital markets, also provide some checks on the management of firms.

Codetermination raises the costs of collective governance and agency costs. Although employees do not become owners of the firm, they are represented on the corporate board, whose task it is to monitor management. This increases the heterogeneity of interests on the board and consequently

28. The discussion in this paragraph draws on Hansmann (1996, esp. pp. 20, 89).

29. Jensen and Meckling (1976).

raises the cost of decisionmaking. The diversity of interests goes beyond the conflict between capital and labor; remember that the 1976 law puts not only blue- and white-collar employees on the employee bench, but also labor union representatives. It seems plausible that including employees on the supervisory board will raise agency costs, because it will be more difficult for a supervisory board of diverse and conflicting interests to monitor management. However, one party may gain a great deal from the cumulative effect of the higher cost of collective governance and increased agency costs: that party is management.

Corporate Governance as a Multiplayer Game

Codetermination not only adds to costs of firm-level governance, but it also alters the dynamics in ways that will tend to reduce the company's control over management.³⁰ An example of the dynamics that may unfold in corporate governance with multiple players is given by recent takeover scenarios in the United States, where not only management, current shareholders, and raiders participated, but labor unions played an active role by supporting different parties. The most important implication of the multiple-party paradigm is that the traditional focus of the corporate governance debate on the dichotomy between owners and managers loses much of its explanatory power, for "the public corporation should be viewed less as a 'series of bargains' than as a 'series of coalitions.'" In takeover scenarios where several labor unions participated, "every coalition that could be formed was formed: management allied with one union against another; the unions allied with each other and with management; and ultimately the unions allied with a powerful shareholder to outflank management." The major outcome of multiple-player governance in takeover situations is that all possible parties form unstable coalitions. As a result "the locus of power and authority within the corporation is less certain."³¹

The fact that labor unions become more active in extraordinary situations, such as takeovers, does not necessarily mean that they also play an active role in day-to-day governance. Still, to the extent that their participation in extraordinary situations is anticipated, this may alter the bargaining power of the other participants in the governance game. If management ceases to be the object of control and instead becomes one of

30. The title of this subsection is taken from the subtitle of an article by Coffee (1990).

31. Coffee (1990). The quotations in this paragraph are from pp. 1496, 1525, and 1496, respectively.

the multiple players who engage in building coalitions with changing partners, new possibilities arise for management to escape control.

German codetermination established multiparty governance as the standard model for firm-level governance in large firms. This model differs from the American takeover scenarios in several ways. First, whereas in the United States coalitions are formed in the wake of a hostile takeover, in Germany multiple parties participate in the corporate game in the long term. In the language of game theory, codetermination has provided the basis for repeat games.³² As a result, coalitions tend to be more stable.

Second, the position of the various players in Germany is protected or even mandated by legal and institutional arrangements. Labor union representatives as well as white- and blue-collar workers are represented on the employee bench of the supervisory board, because this is what the law provides. The relationship between management and employees is determined by additional legal arrangements and does not need to rely on implicit and typically unenforceable contracts. Payments to employees are part of a collective labor contract system (*Tarifvertragssystem*) to which labor unions, on the one hand, and employer associations, on the other hand, are parties.

According to German collective labor law, labor unions and the employers' federation bargain for wages and nonwage benefits for all companies under their jurisdiction on an annual basis. This bilateral agreement is binding until it is replaced by a new collective labor contract and may be extended to all companies in a certain industry sector by decision of the Ministry of Labor. Thus the parties and their relationships are bound by law, their flexibility is limited, and they cannot opt out of these explicit agreements.

Third, with labor union representatives on the supervisory board, the future of the individual company may not be the only objective for the board to bargain about. Strategies for an entire industry sector may also be at stake. This potential spillover effect of company affairs to industry affairs and vice versa is likely to reduce the willingness of all parties concerned to build coalitions with the other parties in the game. For example, management may be reluctant to disclose to union representatives information that might signal the bargaining position of the employers' associations in upcoming collective labor contract negotiations. Ideological constraints also influence the dynamics of coalition building. As long as employee representatives view themselves as advocates of labor opposed to the interests of capital, they are unlikely to bridge this gap and form coalitions with

32. Coffee (1990, p. 1543).

shareholder representatives for the purpose of controlling management. As a result, management gains the upper hand in the process of coalition building, because it is most flexible in selecting from among the opposite parties, and the position of both shareholders and employees as agents of corporate governance is weakened.

Empirical Evidence on the Effects of Codetermination

Empirical analysis of the functioning of codetermined supervisory boards is constrained by the lack of systematic data. Although numerous studies were conducted in the first five years after the law was enacted, no long-term studies have been undertaken.³³ Given the scarcity of data on the functioning of firm-level governance in Germany before the enactment of the 1976 law, there are also no well-controlled "before-and-after" studies. Furthermore, because all large corporations had to implement codetermination, it is difficult to sample firms with and without codetermination. It is true that a number of firms escaped codetermination by reorganizing into legal forms not covered by the law or by splitting into smaller units not subject to the law. But these measures entailed comprehensive restructuring of the companies involved, with the result that these companies are difficult to compare with those that implemented the new law.

The following analysis therefore relies primarily on two sets of behavioral data: a survey of structural changes in the by-laws of companies that had to implement the 1976 law; and court cases that dealt with instances in which the legality of such changes was challenged. Data about formal changes that companies adopted in response to codetermination do not provide information about the actual practices of codetermined boards. However, given the highly institutionalized character of the German corporate governance system, these changes do indicate how those affected by the new law sought to counter it.

Formal changes in the corporate statutes are well documented: a comprehensive study conducted in the early 1980s surveyed all companies that had to adjust their constitutive documents to the law on codetermination and collected data on the composition of the two benches of the supervisory board in these companies. The study included all companies subject to the new law on codetermination irrespective of their legal form: this came to a total of 281 joint stock companies and 174 limited liability com-

33. For an overview over the available empirical studies see Kißler (1992, p. 150).

panies. However, since the more detailed data are available for joint stock companies, the following summary of the results of the study focuses on joint stock companies only.³⁴ Court cases also illustrate, albeit on a case-by-case basis, how companies and shareholders sought to soften the impact of codetermination. In addition, they demonstrate the limits of formal changes that were introduced to circumvent codetermination rules, as German courts upheld the principle of codetermination in the majority of cases.

The Composition of Codetermined Boards

The introduction of quasi-parity codetermination in 1976 extended labor representation in large companies from one-third of the seats—as required by the 1952 law on the internal organization of firms—to one-half. The bargaining power of labor clearly increased when employee representation rose to half and the law mandated that the appointment of the executive board by the supervisory board required a two-thirds majority.

In most companies, the majority of the supervisory board members elected by shareholders were made up of the following three groups: other companies with an equity stake exceeding 50 percent, the state, and foreign companies. This reflects the ownership structure of Germany's large joint stock companies, which is characterized by cross-shareholdings among companies, a significant share of state ownership, and a substantial share of foreign ownership. Somewhat surprisingly, representatives of companies without an equity stake ranked as the fifth largest group, right after those representing companies with an equity stake of less than 50 percent. This seems to suggest that codetermined companies have a substantial number of friendly directors on their supervisory boards.

The composition of the employee bench in the companies studied was largely predetermined by the codetermination law, as the law mandated the inclusion of white-collar workers as well as labor union representatives. The majority of seats on the employee bench are indeed occupied by employees of the company. Typically, they are also concurrently members of the company's workers' councils. The second largest category is made up of outsiders: labor union representatives who are not employees of the company. This outcome is remarkable because, according to the law, labor union representatives may also be chosen from among the employees. However,

34. Gerum, Steinmann, and Fees (1988).

unions argued strongly and apparently successfully that external labor union representatives were needed to represent general social interests and to counter "firm-egoistic" tendencies.³⁵ The third largest group in most cases—though significantly smaller than the other two—consists of members of the workers' councils of subsidiaries.

The interests of these three largest groups within the employee bench are likely to diverge on many of the issues the supervisory board must face. The interests of employees of the company may not be the same as those of the company's subsidiaries, or those of labor union representatives, who are likely to pursue sector or even economy-wide strategies rather than focus strictly on the interests of the company or its employees. However, employees must ensure that they vote together; if they split their vote, the outcome will often be determined by the shareholder bench. For this purpose, it is typical to have employee bench meetings before the meeting of the board. The additional time and effort put into the organization of separate employee bench meetings is a clear indication that collective governance in heterogeneous groups pushes up governance costs. Separate employee bench meetings also reduce the chance of building coalitions across the two benches; given the inclusion of white-collar workers on the employee bench, the crossing of party lines would otherwise not be an unlikely scenario. It is difficult to predict patterns of coalition building from the composition of the two benches alone. Still, it is fair to say that the shareholder bench is typically management friendly enough not to pose serious threats to the interests of management. The relation of management with the employee bench could be more controversial given the dominance of blue-collar employees and labor union representatives. However, employee representatives may choose the shareholder bench, not necessarily management, as their main target. Moreover, any antimanagement strategies that might emanate from the employee bench may be mitigated by white-collar representatives who can hold up the process of reaching a consensus among members of the employee bench.

The Powers of Codetermined Supervisory Boards and Their Committees

The introduction of codetermination led to a de facto reallocation of the powers and responsibilities of the supervisory board, the executive board,

35. Bamberg and others (1987, p. 147).

and the shareholder meeting. According to the corporate law, which was left unchanged, the executive board is in charge of day-to-day management of the company. The supervisory board appoints and "supervises" management but is prohibited from directly participating in the day-to-day management of the company. However, the by-laws of the corporation or regulations of the executive board may provide that the supervisory board shall approve decisions to be taken by the executive board. Finally, the shareholder meeting elects the members of the shareholder bench on the supervisory board, makes decisions about changes in the corporate by-laws, appoints the auditors, and relieves the members of the executive board as well as the supervisory board at the end of the fiscal year.

Available data show that many companies changed their by-laws or the rules governing the internal affairs of the supervisory board in expectation of the enactment of the 1976 law or shortly thereafter, usually in a way that restricted the powers and responsibilities of the supervisory board.³⁶ As a result of these changes, the number of transactions that required supervisory board approval was reduced, or the approval right was transferred from the supervisory board to the shareholder meeting. For example, supervisory board approval is not mandated by the law, but it used to be fairly common in major transactions before the enactment of the 1976 law. Of the 281 joint stock companies surveyed after the execution of the law, however, 104 (or 37 percent) lacked rules that required the approval of the supervisory board. Four of the companies surveyed even prohibited any transaction from being subjected to the approval of the supervisory board, which is in clear contradiction to German corporate law.

Without comparable data on companies without codetermination or on companies before the law was passed, it is difficult to assess whether these findings were caused only or primarily by the introduction of the codetermination law. It is intriguing that the coal and steel companies under the 1951 Montan-Codetermination Law, for example, were much more likely to give the supervisory board approval rights for many transactions than companies that introduced codetermination under the 1976 law. A closer analysis reveals that factors other than employee representation may have also affected the elimination of approval rights. The survey data show that companies with a high level of state ownership were more likely to include approval rights for the supervisory board, whereas companies owned by foreign investors were less likely to do so. Still, many of the

36. The discussion throughout this paragraph draws on Gerum and others (1988, p. 72).

changes were introduced around the time of the enactment of the Codetermination Law, which suggests at least a partial causal link.³⁷

The survey data also revealed a tendency to strengthen the shareholder bench. One strategy used to achieve this was to enact provisions in the by-laws mandating that the chairman of the supervisory board had to be elected from among shareholder representatives, which the 1976 law calls for only in the case of a stalemate. Another strategy was to elect more than one deputy chairman of the board. The purpose of the latter was presumably to dilute the influence of the first deputy who, according to the law, must be an employee representative whenever the chairman is a member of the shareholder bench. These changes provide evidence that companies, or possibly a coalition of shareholders and managers, sought to neutralize the impact of employee participation.

However, the composition of the codetermined supervisory boards, the composition of board committees and the powers of the supervisory board were all heavily litigated.³⁸ The general tendency of the decisions was to make it more difficult for companies to block the intended effects of codetermination. In 1982, the Supreme Court—which is distinct from the Constitutional Court—issued its first ruling in a case that dealt with new regulations for the supervisory board adopted by the shareholder meeting.³⁹ Under the by-laws of the corporation in this case, the supervisory board was to elect not only the chairman and his deputy, but also a second deputy, and this second deputy had to be elected from the shareholder bench. The chairman, the two deputies, and an additional member elected by the employee bench were to form a presidium whose task was to propose candidates for the executive board to the supervisory board. In case of a stalemate, the chairman was given two votes. The court held that the election of a second deputy chairman from the shareholder bench was a violation of the 1976 law, because it undermined the equality of all members of the supervisory board. The court also voided the provision on the creation of a "presidium" of the supervisory board. It argued that the creation of subcommittees of the supervisory board was the prerogative of this body, not of the shareholder meeting.

In a second ruling issued on the same day, the Supreme Court declared the by-laws of another company void.⁴⁰ Under the rules in that case, the

37. See Ulmer (1977).

38. For details, see chapter 7 in this volume.

39. Supreme Court of 25.2.1982, in *Der Betrieb*, no. 14 (1982), p. 742.

40. Supreme Court of 25.2.1982, in *Der Betrieb*, no. 14 (1982), p. 747.

supervisory board reached a quorum and was thus able to adopt binding decisions if a minimum of 50 percent of the members of the shareholder bench, including the chairman of the supervisory board, were present. The court regarded this as a violation of the principle of equality, which requires that all members of the supervisory board have equal weight, irrespective of the constituency that elected them.

In both decisions the Supreme Court remained within the framework set by the Constitutional Court for interpreting the codetermination law. In other words, both decisions abided by the precept that shareholders and employees should participate equally in the corporation through representation on the supervisory board, and that it is the duty of the courts to uphold this intention. The fact that the law gives shareholder representatives the right to elect the chairman if the two benches cannot agree on a candidate, and that the chairman—who is typically a shareholder representative—has the decisive vote in deadlock situations does not weaken the underlying principle of equal representation. In all other matters every member of the supervisory board must have strictly equal rights.⁴¹

In a subsequent decision in 1984, the Supreme Court had to deal with the by-laws of a limited liability company that was subject to codetermination.⁴² The by-laws of the defendant in this case stipulated that the supervisory board elects the members of the executive board but also provided that the details of the employment contract between the corporation and the members of the executive board, including salary level and benefits, should be determined not by the supervisory board, but by the shareholder meeting. The court declared that provision to be void. It argued that the rights of the supervisory board to appoint the members of the executive board are seriously curtailed if it cannot take into consideration salary as well as other aspects of the employment contract. In voiding this provision, the court prevented the transfer of important rights of the supervisory board to the shareholder meeting and thus safeguarded its control rights over management.

One of the most disputed and most litigated issues of the 1976 law was the extension of parity or quasi-parity representation to the various committees of the supervisory board. The codetermination law was followed by a noticeable trend toward delegating the preparation of decisions to board committees.⁴³ The creation of supervisory boards with up to twenty

41. See also the commentary by Kallmeyer (1982).

42. Supreme Court of 14.11. 1983, in *Der Betrieb*, no. 2 (1984), p. 104.

43. *Münchener Handbuch* (1988, §29 Rn 3 6).

members that resulted from codetermination would have given grounds to create smaller bodies where actual deliberation and decisionmaking could take place. However, the prospect of reducing the influence of employees on the board's activities by creating committees that favored shareholders created additional incentives for the proliferation of committee activities. Most disputes concerning supervisory board committees focused on the committee in charge of executive affairs. Survey data suggest that shareholder representatives came to dominate these committees. In 79 percent of the 281 joint stock companies, shareholders occupied either the majority of seats or determined the outcome of votes by controlling the chairmanship with two votes in case of a stalemate.

The allocation of positions in favor of shareholder representatives on supervisory board committees was upheld by the courts. The Supreme Court as well as the majority of appellate courts argued that nothing in the 1976 law suggested that equal representation had to be extended to all aspects of the work of the supervisory board.⁴⁴ In particular, the courts held that the allocation of two votes to the chairman of such committees did not violate the 1976 law, which after all included a similar provision. Even where the election of committee members resulted in the dominance or exclusive representation of shareholders, this did not necessarily contravene the letter or the spirit of the law. The limit was that shareholder dominance should not go as far as systematically excluding employee representatives from committees. In several companies, shareholder representatives attempted to exclude employee representatives from such committees altogether on the grounds that employee representatives lacked the necessary expertise to become involved in the details of appointment procedures and employment issues, and that employees of the company should not participate in the appointment of those who acted as their employers. The Supreme Court ruled that these arguments were flawed and that regulations

44. Supreme Court of 25.2.1982, *Wirtschaftsmittelungen* (WM) 1982, 363 (Dynamit Nobel AG); Appellate Court (Hamburg), 6.3. 1992, *Der Betrieb* (DB), 1992, 774 (Hamburg-Mannheimer Versicherungsverein); Supreme Court, 17.5.1993, *Der Betrieb* (DB) 1993, 1609 (Hamburg-Mannheimer Versicherungsverein). See also Appellate Court (Hamburg), 25.4.1984, *Der Betrieb* (DB), 1567 (Beiersdorf AG). The case dealt with changes in the supervisory board's regulation regarding the committee for executive board affairs. The number of committee members was reduced from four to three, and the election procedure foresaw that each of the twelve members of the supervisory board received one vote for each of the total number of candidates nominated. In the actual elections—whose validity was disputed in the case—only one of the four candidates was an employee representative and the three members elected were all shareholder representatives.

that excluded employee representatives from key committees, such as committees for executive board affairs, did contradict the 1976 law.⁴⁵ Still, this decision left earlier decisions intact that denied employees equal participation in supervisory board committees.

Thus despite many attempts by shareholders and company management to reduce the influence of employees and labor unions through formal changes of the company law, in most cases the letter of the law prevailed. The only device the courts granted shareholder representatives that could be used to expand their rights in relation to employee representatives was the right to delegate decisions to committees that were not subjected to the same standards of codetermination as the board itself. These results suggest that the 1976 codetermination law was implemented without many compromises.

The Functioning of Codetermination Today

In the absence of empirical data, the following information on the current functioning of codetermination has been gleaned from selected interviews with representatives of labor unions, political parties, and legislators.⁴⁶ Because this information is largely anecdotal, it must be treated with caution. As a well-known legal scholar and expert in corporate law once said: "There is no subject that people lie about as much as they do about codetermination!" The social consensus is still that codetermination is a great achievement because it contributed to, if not caused, social peace between labor and capital. However, the responses do suggest certain trends in connection with the general themes of the current debate.

From the comments of representatives of different parties, the government, and labor unions, people still seem to think that the positive aspects of codetermination outweigh its negative aspects. The most important positive aspect, according to all sides, is that it involves employees in a company's decisionmaking process at a relatively early stage. Although this prolongs decisionmaking in matters that affect employees negatively, such as a proposed downsizing or company closing, the consensus is that employee participation significantly reduces the potential for conflict when these measures do take effect. In other words, codetermination may delay such decisions, but it does not prevent them, and it facilitates their implementa-

45. See most recently Supreme Court, 17.5.1993, in *Der Betrieb (DB)* 1993, 1609.

46. I am grateful to Dr. Rüdiger von Rosen of the Deutsche Aktieninstitut for providing me with numerous contacts. As many of them wished to preserve confidentiality, I would like to thank all of them here for their cooperation. Interview notes are on file with the author.

tion after they have been adopted. In this setting, employee representatives on the supervisory board are likely to find themselves in a difficult position. They are forced to participate in a process that is likely to have negative effects for the company's employees, yet they must do so and must also pledge the continued support of a constituency whose interests are opposed to such measures. It may be that the involvement of external employee representatives plays an important role in avoiding a pure defense strategy by the workers. Given the more general interests of the labor unions that represent entire industry sectors, there is also potential for antagonism among employee representatives, as the closure of one company may be the price paid for the survival of another. However, differences among representatives are typically solved in the meetings of the employee bench that precede the meeting of the supervisory board and are therefore not disclosed. At the board meeting, employees always vote together.

In light of the sociopolitical objectives of codetermination, the greater involvement of employees does indeed suggest that the concept has met with some success. However, a related goal of codetermination is to give employees an opportunity to participate in long-term strategies. This broader goal has only partly been met. Employee representatives on the board continue to "specialize" in employee matters, such as the workplace, social concerns, wages, and benefits.

They have not made the leap to participating in business strategy connected with, say, production abroad. Representatives of labor unions admit this and see the greater involvement of employees in these decisions as their main task for the future. Apparently employees have had even less influence in product selection and marketing strategies. A major problem, according to labor union representatives, is that employee representatives are unqualified to deal with matters such as accounting and finance. The lack of skills needed to exercise management control in these areas is part of a broader criticism of the current supervisory board structure. Indeed, it is widely recognized that all members of the supervisory board need to be able to approach their control duties with greater "professionalism." To improve the qualifications of employee representatives, the National Federation of Labor Unions has established training programs for board members. Still, a DGB representative suggested to me that the most difficult task is to persuade long-standing labor union functionaries that they need to improve their qualifications and to expand their perception of their role beyond promoting workers' interests in the narrower sense. In view of these ideological obstacles, training programs will not suffice to promote firm-level governance through employee participation.

Even though people across the political spectrum acknowledge that social governance has benefited from codetermination, many interviewees were of the opinion that codetermination also affects firm-level governance in a way that makes it harder to control management. Three concerns were frequently mentioned by interviewees: the fractionalization of the supervisory board, the dilution of the supervisory board's powers and influences, and the coalition building (or collusion) by one of the two benches with company management.

The fractionalization of the supervisory board is most closely associated with "bench meetings." The practice of holding bench meetings before the full board meetings, which first emerged in the coal and steel companies subject to Montan-Codetermination, is common among codetermined companies today. Shareholder and employee benches meet separately and both benches typically invite the chairman of the executive board to brief them about the company's situation. As a result, the chairman often reports to board members three times: to the shareholder bench, to the employee bench, and to the entire board. The actual decisionmaking process takes place in separate bench meetings, and the meetings of the supervisory board serve mainly as a forum for exchanging the different conclusions reached and to vote on them, some would say to rubber-stamp decisions already agreed upon by management with at least one of the benches. Separate meetings are a logical solution to the diversity of interests represented on each bench of the board. However, having the decisionmaking processes take place outside the supervisory board does not alleviate the danger that management may use its monopoly over information to influence the decisionmaking process in its own favor. Moreover, it reinforces the purely acclamatory function of the corporate board. It should be remembered that back in the 1950s the supervisory board was already being criticized for acting as merely an acclamatory body, and so codetermination should not take all the blame for this situation. Still, the practice of separate board meetings has caused things to deteriorate, not improve. Much of the blame for this has been placed on the fact that external labor union delegates have a place on the board, which is said to have fostered a more aggressive tone between the two benches, although open hostility has faded over time. In fact, some evidence suggests that company employees focus primarily on their company, while union representatives frequently pursue sectoral or national union policies and the interests of the unions.⁴⁷

Although the courts have by and large prevented statutory changes from being used to mitigate employee influence on the supervisory committee, there are other ways to ensure that employees do not interfere with the interests of shareholders or company management. Most important among these are measures to control and limit the information flow to the supervisory board and to marginalize its role by holding meetings infrequently. Before the amendment of the corporate law in 1998, which now mandates quarterly board meetings for publicly traded companies, the supervisory board had to meet at least once every six months, but should have met once a quarter.⁴⁸ Further evidence of the control of the flow of information can be seen in the distribution of the auditor's report before the 1998 legal change. According to a 1965 amendment to the German corporate law, the auditor reported not to the supervisory board but to the executive board, which in turn was supposed to provide this information to the supervisory board.⁴⁹ This change has now been revised so that the auditor reports to the supervisory board. Only in a few corporations do all members of the supervisory board actually receive the auditor's report.⁵⁰ Frequently, the auditor's report was only handed out during a meeting and immediately collected at the end of it, a practice that has become known as "table presentation" (*Tischvorlage*). The justification for this practice is the fear that employees and labor union representatives, in particular, may misuse the information provided in the report outside the company for their own sectorwide or national strategies. This fear is not just hypothetical; in a number of cases, information about pending merger decisions and the like has indeed been leaked by union representatives.⁵¹

Conclusion

In the absence of extensive survey data, it is difficult to draw firm conclusions about the impact of codetermination on firm-level governance. However, there is some preliminary evidence to indicate that while codetermination has not caused many of the problems that plague corporate governance in Germany today, it has certainly reinforced them and added to the

48. Hopt (1994, p. 206).

49. Before that, the auditor reported directly to the supervisory board. See Götz (1995, p. 341).

50. For further references, see Götz (1995, p. 343).

51. Hopt (1994, p. 206).

47. Hopt (1994, p. 206).

lack of control over management that already existed. With two benches of equal size representing capital and labor, codetermination has tended to pit these groups against each other (even if they do not engage in open conflict), rather than unite them in the task of controlling management. Thus it has set the rules for multiple-party corporate governance in such a way that the net beneficiaries are those who ought to be controlled: the company's management.⁵²

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52. This possible outcome was suggested by Mertens and Schanze (1979, p. 83) at the time the 1976 law was enacted.

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