Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights*

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Abstract

For decades, some governments have fiercely opposed any statute of the Societas Europaea that foresaw German-type co-determined supervisory boards. Considering firms as pools of specific investors, we ask about the conditions that are necessary to secure the interests of ‘specific human capitalists’ in an efficient way, if the real capital owners’ right to residual control does not solve the ex-post bargaining problems over the sharing of quasi-rents. We disregard contract-theoretic approaches as solutions to the ex-post bargaining conflicts and suggest a constitutional approach to this major problem in the theory of the firm. From a constitutional perspective, the (non-executive) board members of the German Aufsichtsrat (Supervisory Board) – unlike the Betriebsrat (Works Council) – essentially dispose only of marginal, extremely symbolic, i.e., non-enforceable rights to represent worker investors. Legally, however, these rights are to be used first in the interests of the corporation and only secondarily in the interests of partial investors. Marginal and symbolic rights as well as fiduciary duties will make a difference in distributive bargaining, if they are legally imposed. Who is to be heard and to be involved in decision-making and what is counted as a legitimate argument or action – these are basically questions of political culture that in principle leave room for efficient international diversity. Option rights in the European directive on the Societas Europaea should thus be considered as an apt and wise decision.

Zusammenfassung

A. Introduction

Co-determination regulations have been the main area of conflict in the more than 25 years of debates on setting up a uniform legal status for the European public corporation (*Societas Europaea*). All recent proposals provide free contracting about the degree of co-determination. Only in the case of failure to reach a solution is a legal default position offered. After the British and Austrian, the German government also suggested that in that case the farther-reaching national co-determination model of the involved partners would apply (BREIT 1998). But in May 1999, even this compromise failed again in the European Council of Ministers, repeatedly, on a veto by the Spanish government. What are the possible benefits of co-determined boards that help to maintain this controversy? Could mandatory co-determination even be efficient? (And why would Germany be the only country to recognise the advantages of mandatory co-determination in corporate governance?)

Most economists today will have a definite answer and consider the German singularity as an inefficient aberration – reason enough for us to challenge that view. Neither the few available empirical studies (cf. JUNKES/SADOWSKI 1999 for an overview) nor the appreciation expressed by lawyers (cf. KÜBLER 1994) state a major impact of the board itself or of the employee representatives that are imposed by law. Why then the impasse?

It would be interesting to follow up a remark by GOTTESMAN, who comments laconically upon the 19th century decision to treat suppliers of capital but not suppliers of labour as “owners” of the enterprise: “The legal ordering was not inevitable; it was merely conventional.” (GOTTESMAN 1990: 2792).¹ However, we will develop an argument not in terms of the histories of labour and corporate laws in different countries, but, in order to understand the German insistence on mandatory co-determination, we take as our point of departure the general organisational problem of employees as inside investors. In explaining a historical particularity, there is always the danger of becoming too idiographic or of presenting ad hoc arguments. We try to avoid this risk by referring to general theories of the firm and by looking for functional equivalents in American corporate law – though again in a non-orthodox view. We start our reasoning – which many may view as “tightrope walking” – with the assumption that firm-

¹ We could also try to exploit the analogy to the less controversial protection of bank interests via board representation (cf. TITZRATH 1997).
specific human capital is generally important for German companies. We then ask whether the fear of being disadvantaged in the ex-post bargaining over the distribution of the jointly created value may be allayed in comprehensive contracts. This is not to be expected. On the contrary, corporate governance is often understood as a consequence of contract failure regarding the collective decisions at hand: namely as a constitution, which provides procedural representation and participation rights and imposes fiduciary duties. The behavioural impact of such procedural rights and obligations of trustees will be discussed. As the marginal character of the workers’ rights can never lead to decisional impasses, we conceive them as establishing a bargaining or political arena. Where reasoned action creates legitimacy, the legally created need to argue and to comply with the rules of corporate citizenship may foster agreement and support. Seen as part of a consensual corporate culture, the quasi-parity co-determination of German supervisory boards may induce efficient levels of specific investment. The legal default rules of recent drafts of the European directive for the *Societas Europaea* take account of these nation- and company-specific effects. Arguably then, the intended institutional fit is an efficient choice.

B. Co-Determination and the (Mal-)Functioning of German Boards

The main duty of the supervisory board (Aufsichtsrat) in the German two-tier corporate governance system is to select and appoint the executive board (Vorstand), to supervise it and, if necessary, to dismiss its members (§ 84 and § 111 AktG). Certain transactions of the executive board may be subject to the supervisory board’s explicit approval. For public corporations with more than 2000 employees – which are our focus – the Co-Determination Act of 1976 prescribes a varying size of the supervisory board (12, 16 or 20 members) depending on the number of the corporation’s employees. The composition is a quasi-parity representation of shareholders and employees – “quasi” because in the case of a tie, the chairman of the supervisory board, who is always a shareholder representative, has a double vote. The employee side must include at least one blue- and one white-collar worker, one managerial employee and two trade unionists. The exact size of each group depends on the composition of the whole corporation (§ 7 and § 15 MitbestG). The employee representatives receive their mandate from the workforce. Shareholder representatives are
elected at the general meeting of shareholders (§ 101 AktG). A single person can hold up to ten supervisory board mandates – a regulation especially relevant for shareholder representatives and trade unionists. The Corporation Law requires at least four supervisory board meetings per year (§110 AktG), and usually there are no more than this (cf. BERNHARD 1995: 311).

Practitioners view these regulations with ambivalence. During the recent merger of Daimler-Benz and Chrysler, CEO Jürgen Schrempp expressed a positive attitude: “Apart from tax law and other considerations, our positive experience with the favourable underlying political and economic conditions and in principle with co-determination in Germany (...) spoke in favour of choosing a German Aktiengesellschaft.” But co-determined boards by no means necessarily or always work well, as is shown by many newsworthy supervisory board failures (THEISEN 1993).

The theoretical discussion about the efficacy and efficiency of co-determined supervisory boards is also ambiguous. Referring to mandatory co-determination, JENSEN/MECKLING (1979: 474) present a remarkably simple and straightforward economic argument: “The fact that stockholders must be forced by law to accept co-determination is the best evidence we have that they are adversely affected by it.” If this reasoning was true, the legal dilution of property rights should lead to inefficiencies (for an elaboration, cf. SADOWSKI et al. 1997: 25 n.). ROE (1998a) even argues that mandated co-determination undermines widespread ownership and, therefore, is to blame for the underdeveloped securities markets in Germany.

Some legal experts state an important role for the supervisory board as a whole: “It is obvious that the supervisory board carries an essential, if not the central role in the system of controlling management.” (BAUMS 1995:12). Others see its role as marginal, if not irrelevant. KÜBLER (1994: 548) describes the supervisory board as “typically weak”, since it is expelled from operating management, with no discretion over its own personnel, therefore being dependent on management or a majority shareholder.

For our own analysis of how the co-operation of physical and human capitalists could be organised and legally protected by a co-determined supervisory board, we will choose a resource-pooling or team-production perspective, bearing in

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mind that its role is somehow similar to the one of non-executive or outside board members for American corporations.

C. Supervisory Boards in the Theory of the Firm

I. Firms as Pools of Specific Investors

1. The Importance of Specific Human Capital for the Competitiveness of German Firms

There is a widespread understanding that the intensity of specific human capital and organisational capital investments is a major growth factor in industrialised economies, particularly in those with negligible natural resources like Germany. Economic theories of endogenous growth stress capital-skill complementarities (e.g. PRESCOTT/BOYD 1987). Sociological studies of “international business systems” underline the importance of legal and political regimes to foster specialised quality production. This production policy is often ascribed to German companies, by providing skills, in-company voice institutions, and functioning labour markets and by tempering “short-termist” financial markets (e.g. LANE 1995, STREECK 1991 for Germany).

Theories of resource based business strategies reflect a similar concern for the intangible sources of competitive edge. Specific, if not tacit organisational knowledge is thought to create major strategic advantages, since learning, positive scale effects and complementarities are hard to imitate or to catch up with. The more such synergies are based on company-specific arrangements of co-ordination, co-operation and compromise, the less visible, the less transferable and therefore the more advantageous they should be (cf. SCHNEIDER 1999).

Current management “philosophies” and human resource management texts even demand that employees not only should be viewed as investors who possibly embody important specific human capital, but also that they should be empowered to become “co-entrepreneurs”. WUNDERER (1999) would like to see only minor differences between sub-contractors and “co-entrepreneurs”, he states: “Anyone who wants his employees to become lasting co-entrepreneurs must consider them as partners, and he must refrain from using them like an owner of investment goods.” (WUNDERER 1999: 123).
For our analysis, we take for granted that employees do (often) invest into company-specific human capital to a major degree, that those investments are not negligible for corporate performance, and that their willingness to engage in specific investments depends on their ability to reap future benefits.\(^3\)

2. **Specific Investments and the Theory of the Firm**

According to the seminal article presented by Coase (1937), the distinguishing feature of firm transactions as opposed to market transactions is the suppression of the price mechanism. Instead, resources are allocated through power or authority, with underlying contracts to establish the relationships between different parties within the corporation. If the contracts between physical and human capitalists were complete, there should be nothing unique to the set of constraints that shape the *ex post* bargaining over the rents generated in the course of the relationship – the corporate governance system (cf. Zingales 1998: 497). In fact, there would be no ex post bargaining at all and corporate governance would not differ from contractual governance – hence the firm would be nothing else than a “nexus of contracts” (Alchian/Demsetz 1972) – and contract theory would be the appropriate theoretical tool.

Williamson (1985) already noted that the more specific the investments within the firm are, the more incomplete the underlying contracts will be. When employers and employees undertake co-specific investments, they find themselves in a situation of bilateral monopoly: They cannot completely contract *ex ante* upon the division of the return of their investments – the quasi-rent. Therefore they face the threat of an ex post-expropriation of their piece of the pie by the other partner who may happen to be more powerful at the moment of bargaining. One source of power stems from the “residual right of control” (Hart 1995: 30), the right to make decisions in situations not covered by the initial contract, the right that establishes authority in a relationship between the principal and the agent.\(^4\) This “network of specific investments that cannot be replicated by the market” (Zingales 1998: 498) is the economic core of a firm, it

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\(^3\) Roberts/Vanden Steen (2000) and Itami (2000) argue in favour of similar premises.

\(^4\) The residual right of control does not necessarily mean the same as residual income rights. Top-managers are often paid on a profit-sharing basis, so they have a residual income right. Nevertheless, the residual right of control is held by the stockholders, since they have the right to decide, e.g. about the dismissal of the managers (cf. Hart 1995: 63 nn.)
is more than just a nexus of comprehensive contracts – and it demands another
type of theory than the theory of comprehensive contracts.

Just to draw on one extreme example of the incompleteness of even explicit
labour contracts that are intended to contractually protect specific human capital
investments: For so-called (collective) employment guarantees, the lawyer
EHMANN (1994: 189) concludes that “the final reason for the disobliging
character of employment guarantees is that these guarantees cannot be binding in
a market environment, since unforeseeable circumstances may arise for either
side”.

3. From Contractual to Constitutional Theories of the Firm

Given the shortcomings of incomplete contracting in offering “securitisation-
mechanisms”6 for co-specific investment returns in specific bilateral situations,
CHE/HAUSCH (1999: 125) state that “if committing not to renegotiate the contract
is impossible, then contracting has no value, i.e., the parties cannot do better than
to abandon contracting altogether in favour of ex post negotiations.” Their
analysis is based on the assumption that co-specific investments are not purely
“selfish”, i.e., generate a direct benefit only for the investor, but are
“cooperative”, that is either generate a direct benefit only for the trading partner
(purely cooperative) or for both the investor and the trading partner (hybridly
cooperative). This conclusion as well as the fact that courts generally seem to be
unwilling to enforce non-renegotiation clauses (ibid.: 132) makes the under-
investment problem difficult if not impossible to solve on a contractual basis.

Agents who must rely on the exit threat to protect their rents will avoid
specialising their resources in order to maintain the credibility of their exit threat.
A solution should therefore be to accord the residual right of control to agents
who do not negatively influence the degree of specialisation in the team. Who
could that be and how could that be achieved? If specific contractual
arrangements fail to work, one should have at least procedures and a constitution

5 “Der letzte Grund für die Unverbindlichkeit von Erklärungen, die den künftigen Bestand
eines Betriebes betreffen, ist also der, daß betriebliche Bestands- und Standortgarantien in
einer marktwirtschaftlichen Ordnung im Falle veränderter Umstände keinesfalls Bestand

6 The word “securitisation” usually describes routines to protect the creditor of a loan with
collateral in case of the debtor’s default. Such attempts emerged during the 1980’s (see e.g.
SAUNDERS 1997: 600 n.). We transfer this idea to specific investments, especially specific
human capital investments.
for running the organisation and sharing the gains. Constitutions set the rules of the game: who is a member, allowed and obliged to what, the terms of separation, etc. Writing a constitution by the investors-to-be means *bargaining about the constitution* between them, and that creates the same problems of potentially inefficient results as ex post bargaining about investment rents. How then can spontaneous bargaining about a corporate constitution lead to a result that resolves the problems of bargaining about rents?

In distributional conflicts about contractually unprotected quasi-rents, it is at least optimistic, if not naive, to expect an efficient voluntary agreement about the firm's constitution. A selfish rational agent will prefer a constitution that strengthens his absolute position in ex post bargaining, even if this is detrimental to the firm value. One cannot then expect an efficient constitution of the corporation as a result of a bargaining process between co-specialised investors. Investors will find themselves locked in a sub-optimal position. Are legal interventions an efficient way out?

**II. Institutions for the Efficient Protection of Non-Contractible Investor Interests**

Let us take a look at the role of legally mandated “mediators”. In order to maximise the corporate value-added, ZINGALES (1998) proposes the involvement of a third party. It could determine the level of specialisation of resources and secure the appropriate share to each investor without carrying the costs of specialisation. Being a third party legally obliged to the common interest of all investors and definitely not being the agent of one single investor (investor group) makes that third party a trustee for the whole group of investors that is the firm.

It is rarely denied that a certain legal protection is necessary for outside investors. Their investment “... is sunk and nobody – especially the managers – needs them” (SHLEIFER/VISHNY 1997: 748). As a detailed contract enforcement is impossible, situations could abound in which “managers constantly threaten shareholders (...) to take ever less efficient actions unless they are bribed not to” (ibid.: 743)”. To reduce such disincentives, compulsory legal protection of shareholders, in particular minority shareholders, are considered necessary in most countries: the right to leave and to be compensated, minimal membership
rights, the right to participate in shareholders assemblies, to appeal rights and the right to sue other partners for not keeping their promises, for instance.7

We will use a similar argument for the possible justification of the German co-determined *supervisory board*. In order to avoid an ad hoc rationalisation, we use the US corporate governance system – which is often held to be superior to the German system (ROE 1998a) – as a reference and we identify mediating or trustee relationships in the governance of US corporations. Looking for functional equivalents in Germany, we turn to supervisory boards as institutional attempts to secure or “securitise” specific investments.

1. The Role of Non-Executive and Outside Board Members in US Corporate Law

Neglecting differences in corporate law between the states, the basic model of the US corporate law separates executive and supervising functions within one single board. Commonly the chief executive officer is also the chairman of the board, which gives him considerable autonomy and influence; other managing officers also belong to the board as executive directors (cf. BAUMS 1995: 14). The greater share of the board usually consists of non-executive, or outside, directors.8 The shareholders’ influence on the election of non-executive directors is far from substantial. Often the so-called nominating committee proposes new members of the board. In the general meeting, the board presents the nominating committee’s recommendations for election, but the shareholders have very little actual influence: “shareholders almost always vote for the slate proposed by management. Moreover, this slate is approved by, if not chosen by, the very CEO these directors are supposed to monitor” (HERMALIN/WEISBACH 1998: 96).

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7 In Germany, such claims are nowadays brought forward with verve, e.g. by WENGER/HECKER/KNOESEL (1997). More hesitantly, however: WALTZ (1993: 62ff.), who defies not only the noncontractability assumption, but also the need to suppose an interest of the corporation itself to limit opportunistic behaviour of majority partners and managers. Since Wenger advocates minority shareholders’ protection, he surprisingly does not accept the necessity to protect human capitalists. On the contrary, he even sees massive inefficiencies resulting from certain worker protection arrangements (see e.g. WENGER 1989, MONISSEN/WENGER 1989). Nor do SHLEIFER/VISHNY (1997) ascribe to employees the same need for legal protection as they do in favour of financial investors: “The employees ... get paid almost immediately for their efforts, and are generally in a much better position to hold up the firm by threatening to quit than the shareholders are” (ibid.: 751).

8 Referring to a survey from 1990, CHARKHAM (1994: 188) states that 86 % of manufacturing industry boards and 91 % of the remainder consist of outside directors.
In a recent paper, BLAIR/STOUT (1999) develop the idea in the work of Zingales that US Boards, and in particular the outside members, must be understood as trustees of all specific investors, whose legal responsibility is to mitigate the fears of expropriation in ex post bargaining. Being fully aware of the scepticism that the effectiveness of any demand for fiduciary duties will raise in any modern economists’ mind, well trained in the principal-agent theory, BLAIR/STOUT (1999: 111) self-confidently claim: “Far from raising a problem, this arrangement may be an ingenious, if second-best, solution to the contracting problems inherent in team production.”

One idea of regulating trust relationships is “(...) that the basic rule should ensure that the interests of the trustee do not determine the solutions adopted” (GRUNDMANN 1998: 480). The obligation to act completely altruistically is unqualified, if a trustee did not pay for the assets he was entrusted with. “The gratuitous nature of the transfer justifies that such a duty be imposed by the law.” (ibid.: 493) Where there are several settlors, it may be difficult to weigh their interests, but the duty to purely altruistic standards remains (ibid.: 492).

What kinds of fiduciary duties are made explicit in US corporate law? First of all “the duty of loyalty” which prohibits any self-dealing and reaping of corporate opportunities; secondly, “the duty of care”, which requires members to act in the best interests of the corporation, including employees, creditors, and the community. According to the “business judgement rule” board members cannot easily be made liable to shareholders, but “... under certain circumstances, the law grants other stakeholders in the firm standing to sue directors for a breach of fiduciary duty” (BLAIR/STOUT 1999: 150). Especially in the case of insolvency, the interests of shareholders and creditors or employee investors no longer coincide, or, to put it differently, shareholder interests no longer represent the interests of the coalition of investors.9

It is hard to imagine that these legal obligations are fulfilled when there is too close a relationship between certain board members and certain interest groups forming the coalition that makes up the firm. From this point of view, it seems justified that the board of directors has a wide margin in deciding what is best for the firm. According to their – presumably unorthodox – reading of US corporate

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9 Many of these problems are matters of business judgement, not well suited for court decisions, cf. WILLIAMSON’S (1991: 164) notion of the law of forbearance ruling within firms: “Access to the courts being denied, the parties must resolve their differences internally. Accordingly, hierarchy is its own court of ultimate appeal.”
law, BLAIR/STOUT (1999: 135) regard in particular the non-executive board members as “trustees of the corporation itself ... whose job is to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together”.

Recently, shareholders in the US felt put at a relative disadvantage, and they tried to gain more influence. Such “shareholder activism” led to certain changes. The new possibility, for instance, of hostile “proxy contests”, gives shareholders a more direct influence on the election of directors. But in general, such modifications have not changed the situation substantially. MONKS/MINNOW (1995) state that even in the rare case of proxy contests, the nominating committee's proposition is accepted in 82% of the cases. After surveying 20 empirical studies on the impact of shareholder activism on values, earnings, operations, and governance structures of US firms, Karpoff concludes that some firms have made small changes in their governance rules, but he sees little evidence that these activities have on average increased firm value or had much effect on operations (KARPOFF 1998: 27).

2. Fiduciary Duties of the German Supervisory Board

It is difficult if not misleading to compare single elements of the US and the German corporate governance system (BAUMS 1995: 15, ROE 1998b). First, the supervising body Aufsichtsrat is legally separated from the managing body Vorstand. Joint membership is not allowed (§ 105 AktG). Second, shareholders elect, not only legally, but actually their representatives in the Aufsichtsrat. German banks are allowed to be owners of corporations, and they are usually authorised to vote on behalf of diffuse shareholders (due to the so-called Depotstimmrecht). Managing and supervisory boards therefore cannot be expected to be as intertwined in Germany as in the US.\footnote{It should be noted that Germany has seen a shareholder activism movement similar to that in the US. Some authors even argue that – despite the fact that the Aufsichtsrat is a more heterogeneous group in regard to non-executive directors – some observers have the suspicion of board coalitions between managers and employees conspiring to exploit shareholders (e.g. WENGER/KASERER 1998).}

Finally, since half of the supervisory board members are not elected in the general meeting but sent by the employees, the German Aufsichtsrat is a more heterogeneous group than the American board of directors – although union representation is not altogether alien to American boards (HUNTER 1998). It is unlikely that the members of the
(at least) two competing interest groups in the Aufsichtsrat forget about their different origins and interests. How can this heterogeneity and the resulting conflicts be overcome?

It should not come as great surprise that German corporate law requires fiduciary behaviour from the members of the corporate bodies, similarly to the US regulations. Both the members of the Aufsichtsrat and the Vorstand are “trustees of others interests” (KÜBLER 1994: 232). Mülbert leaves no doubt either: “As the collegial body supervisory board is under the obligation to serve the interest of the corporation, it is this corporate interest that each member of the supervisory board has to accept as the basic behavioural guideline” (MÜLBERT 1996: 115) and furthermore: “When voting, the member of the supervisory board has always and exclusively to vote in favour of the lasting interest of the corporation, even if this conflicts with his private interests”; finally: “The fact of being delegated by some group does not lead to any differentiation of obligations.” (ibid.: 116)

The German law explicitly states the obligation to mediate between shareholders and employees; it works on the assumption that only as long as a compromise is achieved, the corporation can serve the interests of any party, “because otherwise it would decay” (MERTENS 1977: 277). But under the usual economic assumptions, it is hard to believe that board members representing different stakeholder groups indeed act as trustees of the whole corporation – maximising total wealth – in the face of relatively effective group ballots. Without further elaboration, it is hard to see how non-contractible specific investments could be secured in this way.

In other words, when do we expect that each of the investor groups sets aside its partial interests and complies with its fiduciary duties?

11 “treuhänderische Sachwalter fremder Interessen”.
12 Even the stockholder interest in a narrow sense is not the sum of the interests of different stockholders, ‘... but a compromise between stockholders of different investment horizons, between speculators and savers, between entrepreneurial stockholders and rentiers’ (MERTENS 1977: 276).

Auch das Gesellschafterinteresse im engeren Sinne ist nicht die Summe der Anlegerinteressen, “…sondern ein Kompromiß etwa zwischen lang- und kurzfristig interessierten Anlegern, zwischen Spekulanten und Sparern, zwischen unternehmerisch und kapitalistisch orientierten Gesellschaftern” (MERTENS 1977: 276). Here, the company interest includes the interests of employees and the task of mediating between the interests of shareholders and of employees. If this mediation process fails, “…the company cannot operate to the advantage of either participant, because otherwise it would decay”. (ibid. 277).
3. Incentives for Fiduciary Behaviour of the Supervisory Board

We distinguish between economic incentives and legal sanctions to induce fiduciary behaviour of all board members.

**Monetary Incentives**

To align diverging interests, the principal-agent theory characteristically suggests the implementation of a profit-based remuneration. The *Aktiengesetz* does allow for such a compensation (§ 113 AktG).

If shareholder representatives own major shares of the company stock, their own profit interest will probably be a strong direct incentive to control management. In widely held corporations, the control incentives for the shareholder representatives can be expected to be weak. Furthermore, a certain degree of free rider behaviour can be assumed. Often “shareholder supervisors” do not even own shares themselves, but act on behalf of a corporation which holds shares in the corporation to be controlled. Therefore a rise in profits is hardly a strong incentive for shareholder representatives. Employee representatives, in turn, will have a considerable direct interest in monitoring management activities, since lasting job stability as well as wage premiums can be expected only in well managed companies.

In German practice, one can observe fixed as well as profit-based remuneration schemes (KNOLL/KNOESEL/PROBST 1997). It would be hasty to maintain that fixed compensation schemes are unable to provide incentives. In some companies, the fixed amount is reset annually in the general meeting, therefore presenting at least a theoretical motivational impact. More often, however, the directors’ percentage is increased according to a rule provided by the company’s articles of association – independent of the supervisors’ performance. (KNOLL/KNOESEL/PROBST 1997).¹³

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¹³ The average compensation for supervisory board members was about 17,000 DM per year in 1992. This figure differs strongly between industries and also between corporations. Banks and insurance companies are quite generous, e.g., the average compensation was 59,270 DM at the large German banks. Because of the possibility of accumulating up to ten of those positions, one can earn quite a lot of these sideline jobs, e.g. five supervisors earned more than half a million DM in 1992 (cf. Wirtschaftswoche Nr. 40, 1995: 66).

The effect of the compensation on employee representatives activities can also be expected to be rather small, since at least union members keep only up to 5100 DM of their annual director’s compensation. The rest is handed over to the Hans Böckler Foundation, and there are tendencies to take away all the compensation received by union delegates.
In their empirical study, Knoll, Knoesel and Probst came to the conclusion that supervisory board remuneration in Germany does not provide any relevant incentives.

**Incentives by Legal Sanction**

In Germany, the statutory liability of the members of the supervisory board seems to be very extensive (§ 147 AktG). All members of the supervisory board are collectively liable unless individual members can proof their own innocence (§ 93 AktG). However, there has not been a single conviction of a supervisory board or its members for the last 50 years (THEISEN 1998: 264). A board reform from 1998, however, strengthens the enforcement mechanisms for board member liability (HOPT 1998: 255-6). The old Aktiengesetz granted the right to sue the whole supervisory board or individual members only to the executive board or to individual shareholders with 10 % of the shares or at least two million DM of the nominal value of the shares (THEISEN 1998: 264). With the new legislation, ownership of 5% of shares is sufficient to sue board members for damages to be paid to the corporation, the other conditions remaining unchanged. A law suit can be filed only upon suspicion of grossly negligent behaviour ("große Pflichtverletzung") (cf. HOPT 1998: 256). Up to last year, statutory liability was a weak incentive in the German corporate governance system. We doubt that the reforms will bring a major change.

Beyond those generally low-powered and laggard incentives for fiduciary behaviour to act in the corporation’s interest or in the interest of the pool of specific investors respectively, what else could mitigate the problems of team investments? We agree that employee representatives – like bank representatives – in the Aufsichtsrat make this body heterogeneous and perhaps cumbersome, but that legally constituted body at least establishes a non-voluntary forum for ex-post bargaining. In bargaining, much can be gained by an arena for the regular exchange of information, the articulation of interests and the need for reasoned action. The bargaining procedure should meet further conditions to avoid high bargaining costs or even bargaining failure in the sharing of quasi-rents.

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14 These recent legal changes – known as KontraG – attempt to strengthen the supervisory board as a whole.

15 KNIGHT (1992) points out that distributional conflicts and their solution are at the origin of many kinds of legal institutions and often are not the results of bilateral negotiations, but rather resulting from “third-party power”.

D. Bargaining under Marginal and Symbolic Rights and Duties: The Co-determined Board as a Political Arena

In German as in US corporate law, shareholders in general “… are seen in the best position to represent the interests of the coalition that comprises the firm” (BLAIR/STOUT 1999: 143).

In times of crises or change, however, one faces the possibility of unforeseen externalities. Plant closure decisions, although profitable for shareholders, may destroy workers’ share in quasi-rents without compensation. Mandatory board representation could at least ensure that workers can voice their non-contractual claims and perhaps their resistance against “theft” by the breach of trust (implicit contracts) in hostile take-overs (cf. SHLEIFER/SUMMERS 1988). But when legitimate claims of employee investors are neglected, their voice is the more likely to make a difference if it is raised collectively and must be heard legally. This right is essentially constituted through co-determined supervisory boards.

Though legal in nature, board representation rights are usually not brought to the courts. Instead, they change bargaining positions in the political arena, in which the common investors meet. The simple act of legally constituting an actor who – although in principle being unable to ever reach a majority – not only can cast his vote, but also has to be heard and has rights to be informed and consulted, does make a difference compared to pure market-power-based bargaining relationships, all the more so where, as in German boards, the norm of unanimity of formal voting prevails. Compromising is apparently often understood as a precondition for specific investments in continuing relationships.

It is worth noting how the political interactions in supervisory boards usually evolve. There is general consent that the Chairperson of the Board may exert a major influence during the informal preparations of formal board meetings, and he has to come to terms himself with the Vice-Chairperson, who by law is one of the employee representatives and who in fact is very often chairperson of the (group) works council – thus vested with substantial powers and endowed with detailed insider knowledge. The informal contacts of the very few board

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16 FREEMAN/LAZEAR (1995) and FRICK (1997) attribute major efficiency advantages to legally mandated employee representations as their credibility to report authentically bad news should be much higher than that of employer-enthroned employee representatives; such credibility would save unnecessary quarrels and time.
members who prepare the formal meetings certainly constitute the core of the board. In such a non-anonymous, small group reliability in keeping one’s promises counts as long as a common will to bridge conflicts of interest prevents purely ritual communications. The legal duties of discretion and the other fiduciary duties support some degree of openness in communications between the different groups. OSTROM/WALKER (1997: 66) summarise their findings on arrangements to provide efficient amounts of local public goods: “As we have found in both field and laboratory settings, nonbinding, face-to-face communication can be a very effective institution for facilitating cooperation”. This is also true for boardroom performance, as is shown by WESTPHAL (1999) and McNULTY/PETTIGREW (1999).

If neither monetary incentives nor the liability threat are sufficient to guarantee adequate control, the reputation of the supervisory board representatives might be the decisive motivator. Misconduct reduces the probability to be re-elected onto the same supervisory board and perhaps the chances of being elected to other boards. It is also conceivable that future career opportunities are hampered. A supervisory board member would presumably work the harder the more he stood to lose in the case of a revealed control failure.

The possibility of being part of a certain group, i.e. an “elite”, might be another incentive to work hard (cf. ALBACH 1988: 208 ff.): “The co-ordination elite co-ordinates the single interests of the social groups to what one could call the public interest. … As the co-ordination elite of the economy I define that group of individuals who meet frequently in different supervisory boards. … The co-ordination elite is open. There are constant new entrances into the elite and constant losses of its membership. … If the member of the co-ordination elite loses the confidence of its constituency, then the affiliation to the elite ends, even if the official status to a specific job is unchanged. … This is not done by a formal act, but informally. The member loses his communication relations.”

Even under the exaggerating assumption that all co-determination rights are only ceremonial and symbolic, invoking more than guaranteeing “the interest of the corporation itself”, one should not a priori infer the meaninglessness of these unenforceable rights for bargaining outcomes. As Niklas Luhmann once suggested, law first of all has an impact on what is to be expected by others, and indirectly only influences what they will do. Purely symbolic regulations or

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17 WINDOLF (1994: 88ff.), having identified these networks, also empirically stresses the concentration of power, but speaks, however, of “cliques” instead of “elites”.
constitutions would per definitionem lack any legally normative power, but they can have an impact on collective decision-making “that is not specifically legal in nature” (NEVES 1998: 51). It is exactly the meaning of symbolic and exhorting constitutional texts to find formulas that bridge conflicting interests. “Compromising by formula” or “soft law” may result in wishful thinking or ideological camouflage. On the other hand, ceremonial clauses may help to keep in mind the common interests of the conflicting parties, i.e., the norms and duties required for or at least conducive to the common endeavour. State constitutions as well as guidelines for corporate behaviour often have such programmatic, educational functions.18 Likewise, “the ponderous language of moral censure in fiduciary cases can wound the defendant” (COOTER/FREEDMAN 1991: 1073).

Whenever action is influenced by perceptions and attitudes of what is to be considered a focal point or what is legitimate, it is scarcely surprising and almost tautological that a common history and a common legal tradition shape the symbolic expression of standards or norms of harmony. For the German co-determined board, it would be rash to infer its inefficiency or its evolutionary inferiority from its international singularity. The latest draft directive of the Societas Europaea would have allowed for national and company options to form boards with or without co-determination. It thus showed comprehension not only of the national diversity of symbolic rights and duties, but also of their substantial, though informal impact on constituting political arenas for the bargaining of specific investors. In this respect,19 it should have passed.

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18 HÄBERLE (1999: 24), a public law specialist, resumes: “The success story of the preamble of the German Constitution is rightfully often praised.”

19 There are, however, other perspectives. SCHMIDT/SPINDLER (1999) suggest that, in times of crisis, the permission to opt out of a coherent and efficient national corporate governance may well be used, even if it were inefficient in the long term.
Bibliography


