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Codetermination: A Poor Fit for U.S. Corporations

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Abstract

The idea that a corporation's employees should be allowed to elect some of the corporation's board members, a system known as codetermination, has moved to the forefront of U.S. corporate law policy. Elizabeth Warren's Accountable Capitalism Act calls for employees of large firms to elect 40% of all board members. Bernie Sanders's Corporate Accountability and Democracy Plan goes even further and states that 45% of Board Members should be elected by workers. Both Warren's and Sanders's plans are loosely modeled on the German law on codetermination, which for many decades has allowed employees of large German corporations to elect up to half of all board members. It is therefore unsurprising that Senator Sanders points to Germany's successful economic development as evidence that economic progress and mandatory codetermination can go hand in hand. However, this Article argues that codetermination promises to be a poor fit for U.S. corporations. While Germany arguably reaps significant benefits from codetermination, legal, social, and institutional differences between Germany and the United States make it highly unlikely that the United States would be able to replicate those benefits. Furthermore, the costs of codetermination would probably be much higher in the United States than they are in Germany.

Keywords: Codetermination, Corporate Governance, Corporate Objectives, Shareholder Value, Comparative Law, United States Corporations, Sanders Proposal, Warren Proposal, German Law

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The idea that a corporation's employees should be allowed to elect some of the corporation's board members, a system known as codetermination, has moved to the forefront of U.S. corporate law policy. Elizabeth Warren's Accountable Capitalism Act calls for employees of large firms to elect 40% of all board members. Bernie Sanders's Corporate Accountability and Democracy Plan goes even further and states that 45% of Board Members should be elected by workers.

Both Warren's and Sanders's plans are loosely modeled on the German law on codetermination, which for many decades has allowed employees of large German corporations to elect up to half of all board members. It is therefore unsurprising that Senator Sanders points to Germany's successful economic development as evidence that economic progress and mandatory codetermination can go hand in hand.

However, this Article argues that codetermination promises to be a poor fit for U.S. corporations. While Germany arguably reaps significant benefits from codetermination, legal, social, and institutional differences between Germany and the United States make it highly unlikely that the United States would be able to replicate those benefits. Furthermore, the costs of codetermination would probably be much higher in the United States than they are in Germany.

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INTRODUCTION

The debate on the future of corporate law has recently seen a dramatic shift towards a stakeholder model.[1] Senators Elizabeth Warren and Bernie Sanders have both endorsed the idea of giving the employees of large corporations a voice in corporate governance.

Under Senator Warren's Accountable Capitalism Act,[2] which would apply to corporations with more than $ 1 billion in gross receipts, a corporation's employees would elect 40% of corporate directors.[3] Senator Sanders's proposal is aimed at corporations that are publicly traded or have assets or revenues of at least $100 million. According to Sanders's proposal, corporations' employees are to elect 45% of corporate directors.[4]

Warren's and Sanders's plans both represent a stark departure from America's traditional focus on shareholder primacy. Admittedly, shareholder primacy is a multifaceted concept with different shades of meaning.[5] However, most scholars would agree that, as a matter of legal policy, directors should at least *primarily* focus on maximizing shareholder wealth.[6]

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[1] See, e.g., David J. Berger, *Reconsidering Stockholder Primacy in an Era of Corporate Purpose*, 74 BUS. LAW. 659, 662 (2019).

[2] Accountable Capitalism Act, S. 3348, 115th Cong. (2018).

[3] *Id.* § 6 (b) (1).

[4] Bernie Sanders, Corporate Accountability and Democracy [hereinafter Sanders, Accountability], https://berniesanders.com/issues/corporate-accountability-and-democracy/ (last visited March 7, 2020).

[5] *See, e.g.*, Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 1952, 1981-2000 (2018) (tracing the development of the shareholder primacy maxim over time); Robert B. Thompson, *Anti-Primacy: Sharing Power in American Corporations*, 71 BUS. LAW. 381, 386-92 (2016) (distinguishing different types of shareholder primacy).

[6] Much of the critique directed against shareholder primacy only targets the view that directors should manage the corporation *exclusively* for the benefit of shareholders. The literature correctly points out that this extreme version of shareholder primacy is unlikely to be efficient. *E.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 673 (2006). However, some scholars argue that a stakeholder model would be more desirable as a matter of legal policy. *E.g.*, David G. Yosifon, *The Law of Corporate Purpose,* 10 BERKELEY BUS. L.J. 181, 228 (2013) (advocating a model that "encourage(s) good faith attention to the interests of multiple corporate stakeholders"). *Cf.* Lynn A. Stout*, The Toxic Side Effects of*

Delaware courts have also explicitly embraced shareholder primacy and merely recognized certain limitations to this principle. Under Delaware law, corporate directors are required to act in the best interest of the shareholders,[7] though they can take into account the interest of other constituencies in defending against hostile takeovers,[8] unless the takeover triggers the so-called *Revlon* test.[9] As a practical matter, the shareholder primacy norm imposes only a weak constraint on corporate boards, given that the business judgment rule allows them substantial leeway in deciding which actions ultimately serve the shareholders' interest.[10] However, the structure of U.S. corporate law, in which the shareholders elect the members of the board, creates a powerful mechanism to ensure that shareholders rank before other constituencies in managerial decision-making.[11] The reforms proposed by Senators Warren and Sanders would fundamentally change this shareholder-centric governance model and thereby usher in, for the first time in U.S. history, a true stakeholder approach.

Shareholder Primacy, 161 U. PA. L. REV. 2003, 2020 (2013) (arguing that the losses that shareholder primacy imposes on non-shareholder constituents may outweigh its benefits to shareholders). But *see* Jeffrey N. Gordon, *Addressing Economic Insecurity: Why Social Insurance Is Better Than Corporate Governance Reform*, CLS Blue Sky Blog, Aug. 21, 2019, https://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/ (advocating a "kind of lifetime human potential insurance" and arguing that neither a "codetermination strategy" nor abolishing the shareholder primacy principle would adequately address economic insecurity).

[7] *E.g.*, eBay Dom. Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) (rejecting "a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders").

Most scholars agree that Delaware law, as a general rule, requires directors to focus primarily on shareholder wealth maximization. *See, e.g.*, Yosifon, *supra* note 6, at 226 (claiming that "[s]hareholder primacy is undoubtedly the law of Delaware").

[8] *See* Unocal Corp. v. Mesa Petroleum Co*.*, 493 A.2d 946, 955 (Del. 1985) (holding that in deciding whether a defensive measure is reasonable in relation to the threat posed, directors can, inter alia, consider the takeover's impact on "'constituencies' other than shareholders").

[9] See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding that once the break-up of the target company is inevitable, "concern for non-stockholder interests is inappropriate" and the goal must be to sell the corporation "to the highest bidder").

[10] *E.g.*, D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 280 (1998).

[11] *E.g.*, *id.* at 277.

The fact that Senator Warren's and Sanders's proposals would, if implemented, amount to a dramatic shift in U.S. corporate law, does not imply that they are inefficient or undesirable. In a way, they certainly capture the Zeitgeist. In 2019, the Business Roundtable published a statement, signed by 181 CEOs, that corporations ought to serve not just the interests of shareholders, but also those of other stakeholders.[12] Meanwhile, the newest book by French star economist Thomas Piketty, *Capital and Ideology*, also proposes codetermination, albeit in the name of democratizing the economy.[13]

But would codetermination work? The closest analogue to the proposals advanced by Senators Warren and Sanders is the German system of mandatory codetermination, which already allows employees of firms with more than 2,000 employees to elect half of the board members.[14] In fact, Senator Bernie Sanders explicitly invokes German codetermination as a model, pointing out that his proposal is "similar to what happens under 'employee co-determination' in Germany, which long has had one of the most productive and successful economies in the world."[15]

This Article therefore analyzes the prospects for codetermination in U.S. corporations, taking into account the German experience.

We argue that while codetermination may work reasonably well in Germany, there are compelling reasons to think that it would be a poor fit for the United States. Drawing on the economic theory underlying codetermination, we show that many of the core benefits that Germany reaps from codetermination are much less likely to materialize in the United States.[16] Additionally, the costs of codetermination

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[12] Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'* (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[13] THOMAS PIKETTY, CAPITAL AND IDEOLOGY 495-504 (2019).

[14] *Infra* Part I.A.

[15] Sanders, *Accountability*, *supra* note 4.

[16] *Infra* Part IV.

would likely be much more substantial in the United States than in Germany.[17] In sum, while mandatory codetermination may well be an efficient and desirable regime for Germany, the United States would be ill-served by following in Germany's footsteps.

This Article is structured as follows: Part I summarizes the German law on codetermination. Part II highlights the differences between the German rules on codetermination and the proposals by Senators Sanders and Warren. Part III analyzes the economic scholarship on the impact of Germany's codetermination regime on firm productivity, wages, and shareholder wealth and shows that the results are, by and large, inconclusive. Part IV argues that if the United States were to adopt a mandatory codetermination regime, U.S. corporations and workers would be unlikely to reap some of the core benefits that codetermination yields in Germany. Part V addresses the potential costs of codetermination and demonstrates that these would likely be much higher in the United States than they are in Germany.

I. THE GERMAN LAW ON CODETERMINATION

Laws on board-level participation of workers exist in many jurisdictions worldwide, notably in Europe.[18] However, the "German model" is unique in that it is far reaching,[19] and it has become the reference model for reforms in other states, including in the U.S.

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[17] *Infra* Part V.

[18] See the surveys on the European Trade Union Institute website http://www.worker-participation.eu/National-Industrial-Relations/Across-Europe/Board-level-Representation2 (last visited March 12, 2020).

[19] *See, e.g.*, Franklin Allen et al., *Stakeholder Governance, Competition, and Firm Value*, 19 REV. FIN. 1315, 1316 (2015) (calling Germany "[t]he most striking example" of a stakeholder model).

The German law on codetermination mainly relies on two statutes:[20] the 1976 Codetermination Act[21] and the 2004 One-Third Participation Act,[22] which revised and replaced the 1952 Works Constitution Act.[23]

Table 1: Board-Level Codetermination and Board Structure in European Countries

Country	Percentage	Board	Country	Percentage	Board
Austria	1/3	2-tier	Hungary	1/3	either
Croatia	1 rep.	Either	Luxembourg	1/3	1-tier
Czech Rep.	1/3	2-tier	Norway	1/3	1-tier
Denmark	1/3	2-tier	Slovakia	1/3	2-tier
Finland*	1/4	Either	Slovenia	1/2	either
France**	1 rep.	Either	Sweden	3 rep.***	1-tier
Germany	½	2-tier			

Note: This table displays the maximum number of employee representatives that must be included on corporate boards. If that percentage differs depending on a corporation's size, we focus on the largest corporations. Special rules for particular industries or for companies that are fully or partially owned by the government are disregarded. * In Finland, the number of employee representatives is determined by agreement between management and workers. However, if no agreement is reached, the employees are entitled to elect one fourth of all board members. ** In France, employees have the right to elect one board member, but that board member only has an advisory function. ** In Sweden, the law allows employees at companies with more than 1000 employees to elect 3 representatives to the corporate board. However, the shareholders can determine the total number of board members and can therefore determine the fraction of employee representatives. In practice, about one third of board members tend to be employee representatives. *Source*: worker-participation.eu

[20] The German law on codetermination involves other statutes as well, but they are of marginal importance to this Article. In particular, Germany has enacted a special statute on codetermination governing stock corporations in the coal and steel industry, the so-called Coal and Steel Codetermination Act of 1951. Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie [Law on the Participation of Workers in the Supervisory Boards and Managing Boards of Companies in the Coal, Iron and Steel Industries], May 21, 1951, Bundesgesetzblatt I at 341 [hereinafter Coal and Steel Codetermination Act]. For a summary of this statute see Jens C. Dammann, *The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the U.S. Model?,* 8 FORDHAM J. CORP. & FIN. L. 607, 619 (2003) [hereinafter Dammann, *The Future of Codetermination*].

[21] Gesetz über die Mitbestimmung der Arbeitnehmer [MitbestG] [Codetermination Act], May 4, 1976, Bundesgesetzblatt BGBl I at 1153 [hereinafter Codetermination Act].

[22] Zweites Gesetz zur Vereinfachung der Wahl der Arbeitnehmervertreter in den Aufsichtsrat Article 1 [One-Third Participation Act], May 18, 2004, BGBl I at 974 [hereinafter One-Third Participation Act].

[23] Betriebsverfassungsgesetz [Works Constitution Act], Jan. 15, 1952, BGB1 I at 13 [hereinafter Works Constitution Act].

A. THE 1976 CODETERMINATION ACT

German stock corporations have a mandatory two-tier board structure consisting of the managing board and the supervisory board. The managing board is in charge of day-to-day operations.[24] The supervisory board appoints the members of the managing board,[25] monitors the managing board's work,[26] and has the power to remove managing board members for cause.[27]

Under Germany's main codetermination statute, the 1976 Codetermination Act, half of the members of the supervisory board are elected by the shareholders, the other half by the employees.[28] It is therefore common to speak of "parity codetermination." However, the balance is tilted slightly in favor of the shareholders:[29] if the board is deadlocked, the chairperson of the board holds the swing vote.[30] This rule tends to give an edge to the shareholder representatives because if the board cannot agree on a chairperson, the shareholder representatives elect the chairperson.[31]

Moreover, it is worth noting that the German Codetermination Act does not treat employees as a monolithic group. Rather, at least one of the workers' representatives must be a managerial employee.[32] As a result, the employee

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[24] Aktiengesetz [Stock Corporation Act], Sept. 6, 1965, BGBl. I 1089 [hereinafter German Stock Corporation Act], § 76(1).

[25] *Id.* at 84(1).

[26] *Id.* at 111(1).

[27] *Id.* at 84(3).

[28] *Id.* at 7(1). Only German employees can stand for election, and only German employees have the right to vote, even in German companies with a clear majority of non-German employees. Whether this is compatible with European anti-discrimination laws is highly questionable. See, *e.g.*, the contributions in MATHIAS HABERSACK, CASPAR BEHME, HORST EIDENMÜLLER & LARS KLÖHN (EDS.), DEUTSCHE MITBESTIMMUNG UNTER EUROPÄISCHEM REFORMZWANG (2016). The Court of Justice of the European Union (CJEU) nevertheless upheld the German rules in a landmark judgment in 2017: CJEU, Case C-566/15 (Konrad Erzberger v. TUI AG), Judgment of Jul. 18, 2017, http://curia.europa.eu/juris/celex.jsf?celex=62015CJ0566&lang1=en&type=TXT&ancre=.

[29] Dammann, *Future, supra* note 20, at 620-21.

[30] Codetermination Act, *supra* note 21, at 29(2).

[31] *Id.* at 27(2).

[32] *Id.* § 11(2).

representatives may not always represent identical interests and may therefore not always vote as a block.[33]

German stock corporations are subject to the 1976 Codetermination Act if they have more than 2000 employees.[34] A different statutory regime applies to firms in the coal and steel industries.[35] Charitable, political, and news organizations are exempt.[36]

While the vast majority of publicly traded firms are organized as stock corporations, privately held firms are typically incorporated as limited liability companies, so-called *Gesellschaften mit beschränkter Haftung* (GmbH). Crucially, the 1976 Codetermination Act applies to limited liability companies as well, as long as these have more than 2,000 employees.[37] Unlike stock corporations, limited liability companies do not, by default, have a two-tier board structure. However, a limited liability company that is subject to the 1976 Codetermination Act is required to have both a managing board and a supervisory board.[38]

B. THE 2004 (1952) CODETERMINATION ACT

Companies with 2,000 or fewer employees do not fall under the 1976 Act. However, they may be subject to codetermination under the so-called One-Third Participation Act of 2004,[39] which replaced and revised the Works Constitution Act of 1952.[40] The One-Third Participation Act applies to corporations and limited liability companies that have at least 500 employees.[41] It gives employees the right

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[33] *E.g.*, Henry Hansmann, *Worker Participation and Corporate Governance*, 43 TORONTO L.J. 589, 602 (1993) (noting that managerial employees sometimes side with management).

[34] *Id*. § 1(1)(2).

[35] Coal and Steel Codetermination Act, *supra* note 20.

[36] Codetermination Act, *supra* note 21, § 1(4).

[37] *Id*. § 1(1).

[38] Codetermination Act, *supra* note 21, § 6(1).

[39] *Supra* note 22.

[40] *Supra* note 23.

[41] One-Third Participation Act, *supra* note 22, § 1(1).

to elect one third of the company's supervisory board members and is thus somewhat less far reaching than the 1976 Act.[42]

II. THE PROPOSALS BY SENATORS WARREN AND SANDERS

The proposals made by Senators Warren and Sanders come quite close to Germany's 1976 Codetermination Act. However, this should not distract from the fact that there also remain important differences.

A. SCOPE OF APPLICATION

Perhaps the most obvious difference concerns the scope of application. Senator Warren's bill would apply to corporations and limited liability companies (LLCs), as long as they are engaged in interstate commerce and have more than $1,000,000,000 in gross receipts.[43] Senator Sanders's proposal targets corporations that are publicly traded, have at least $100 million in annual revenues, or at least $100 million in balance sheet total (total assets).[44] By contrast, the 1976 Codetermination Act focuses on whether the company has more than 2,000 employees and applies to both corporations and limited liability companies.

These different criteria can lead to very different outcomes. Table 2 illustrates this point by applying the various approaches to public corporations which are headquartered in the United States and included in Standard & Poor's Compustat, a database commonly used for empirical research in economics and finance.[45] For the purpose of this exercise, we treat U.S. corporations and limited liability companies as the equivalent of German stock corporations (Aktiengesellschaften) and German limited liability companies (GmbHs), respectively.

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[42] *Id.* § 4(1).

[43] Accountable Capitalism Act, *supra* note 2, § 2 (2).

[44] Sanders, *Accountability*, *supra* note 4.

[45] We disregard the "interstate commerce" requirement contained in the Accountable Capitalism Act, since Compustat data do not allow us to ascertain whether that requirement is met. However, as a practical matter, it is safe to assume that the vast majority of publicly traded corporations do not limit their business to one state.

Compustat relies on data from companies' financial statements filed with the SEC. Therefore, Compustat does not include privately held firms. Accordingly, Table 2 only highlights the differences of the various approaches with respect to publicly traded firms. Even for these firms, however, the differences are substantial. The Sanders plan applies to all 3,330 public corporations headquartered in the United States and included in the Compustat database for the year 2018. By contrast, Warren's Accountable Capitalism Act would cover about 40% fewer companies, as would the 1976 Codetermination Act. The differences become much smaller, however, if one focuses on the number of employees covered or the combined market capitalization or assets of covered firms. This is because the large public corporations that are within the scope of all three plans account for the bulk of employees, assets, and market capitalization.

Table 2: Coverage of Public Corporations

	Number of companies	Market Capitalization (in $ trillion)	Employees (in millions)	Assets (in $ trillions)
Sanders	3,281	24.77	31.07	42.38
Warren	1,243	23.16	29.22	39.51
1976 Act	1,324	22.72	30.21	38.21

Note: All financial variables are obtained from Compustat. Firms that are incorporated outside the United States are dropped, as are partnerships. The numbers for the Warren bill and the 1976 Act include limited liability companies, whereas limited liability companies are excluded under the Sanders plan. Both to capture gross revenues (Sanders) and gross receipts for tax purposes (Warren), we use the Compustat variable total revenues (Warren), since firms' income tax returns are not publicly available.[46]

The policy goals underlying these different criteria are not always obvious. The German approach, which focuses on the number of employees, is perhaps the most intuitive: codetermination is meant to protect employees, and a greater number of

[46] We drop firms for which the variables employees ("emp"), total assets ("at"), market capitalization, ("prcc_f" * "csho"), or total revenues ("revt") are not available in Compustat. This reduces the dataset by 446, 0, 1, and 7 observations, respectively. If one does not drop firms for which the number of employees are missing, the Accountable Capitalism Act covers 1,246 firms with mean assets of $ 39.64 trillion and a mean market capitalization of $ 23.23 trillion, whereas the Sanders proposal would apply to 3,332 firms with mean assets of $ 42.60 trillion and a mean market capitalization of $ 24.87 trillion.

employees means that there are more people who need protection. We suspect that Senator Warren's proposal focuses on gross receipts in large part because they are readily apparent from a corporation's tax return; similarly, Senator Sanders's focus on annual revenues, balance sheet totals, and a firm's status as a public corporation may partially be motivated by ease of administration. In addition, a switch to mandatory codetermination is bound to trigger substantial compliance costs, and a corporation's gross receipts or balance sheet totals may be an indicator of that corporation's ability to shoulder these costs.

B. BOARD COMPOSITION

The U.S. proposals also differ from German codetermination law with respect to their impact on corporate boards. Part of the difference pertains to the general structure of boards. Germany has traditionally relied on a two-tier board structure, and German codetermination law only requires that one of the two boards, namely the supervisory board, include employee representatives. By contrast, U.S. corporations have a one-tier board, and the codetermination proposals that Senators Warren and Senators have put forth do not purport to change this structure.

Moreover, it is important to note that the two U.S. proposals differ slightly from German law with respect to the number of employee representatives. The 1976 Codetermination Act allows employees to elect 50% of all board members, whereas Senator Warren's plan calls for employees to elect 40% and Senator Sanders's plan 45%.[47]

III. THE EMPIRICAL SCHOLARSHIP ON CODETERMINATION

Germany's continued economic success suggests, at the very least, that codetermination does not constitute an insurmountable obstacle to prosperity. However, perhaps German firms would be doing even better without codetermination. Since the enactment of the 1976 Codetermination Act, numerous empirical studies have sought to analyze the impact of codetermination on

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[47] Accountable Capitalism Act, *supra* note 2, § 6 (b) (1); Sanders, *Accountability*, *supra* note 4.

shareholder wealth, firm productivity, wages, and job security. Nonetheless, even after decades of research, the empirical evidence on the effects on codetermination can best be described as inconclusive.[48] Existing studies face substantial methodological challenges. Moreover, perhaps in part because of the econometric hurdles they face, the pertinent literature has yielded mixed and often inconsistent results.

A. CORRELATION STUDIES

Early studies on codetermination typically looked for correlations between codetermination and variables such as firm performance or wages.[49] For example, in a seminal 2004 paper, Gary Gorton and Frank Schmidt showed that parity codetermination is associated with an average 31% decline in firms' market-to-book ratio.[50]

The obvious problem with such studies is that correlation does not prove causation. Instead, observed correlations may be due to unobserved ("omitted") variables. This problem is particularly conspicuous in the context of codetermination: to fall under the 1976 Codetermination Act, a firm must have more than 2,000 employees, and there are reasons why some firms have more employees than others. For example, a company that can automate much of its

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48 *Cf.* John T. Addison & Claus Schnabel, *Worker Directors: A German Product that Did Not Export*, 50 INDUSTRIAL RELATIONS 354, 361 (2011) (noting the sparseness of empirical scholarship on codetermination).

49 *E.g.*, Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence From German Corporate Boards*, 82 J. FIN. ECON. 673, 686 (2008) (using a sample of 400 publicly traded German firms and finding that codetermination is associated with a higher Tobin's q); Gary Gorton & Frank Schmidt, *Capital, Labor, and the Firm*, 2 J. EUR. ECON. ASSOC. 863 (2004) (focusing on the 250 largest German public corporations and finding that firms that are subject to parity codetermination have a 31% lower market-to-book ratio); Andreas Bermig & Bernd Frick, Board Size, Board Composition and Firm Performance, Working Paper, University of Paderborn, 2010, https://d-nb.info/1036553361/34 (running fixed effects regressions using panel data on 294 firms for the years 1998 to 2007 and finding no consistent impact of codetermination on Tobin's q).

50 Gorton & Schmidt, *supra* note 49, at 879.

production may be able to reduce the number of workers and thereby increase its profitability. Thus, the ability to automate can be an omitted variable that causes the firm's stock price (and hence its market-to-book ratio) to rise while also leading to a decline in the number of employees, thereby preventing the application of the 1976 Codetermination Act. In this example, a negative correlation between parity codetermination and market-to-book ratio may result, but that correlation does not imply that codetermination *causes* a decrease in book value.[51]

B. Difference-in-Differences

One common econometric approach to overcome the limitation of correlation studies is to identify a so-called natural experiment, meaning some exogenous event, and apply a difference-in-differences analysis.[52] The intuition behind a difference-in-differences approach is straightforward: one identifies a group of subjects that the event impacts, the so-called treatment group, and another group that the event does not impact, the so-called control group. By comparing outcomes in the two groups before and after the fact, one can ascertain the event's impact.

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[51] To reduce the problem of unobserved variable bias, some studies use panel data (meaning datasets containing observations for the same set of firms at different points in time). Panel data have the advantage that they allow for the use of firm fixed effects, meaning that one can compare a company's performance at a given time to that same company's *average* performance. This approach makes it possible to filter out the impact of time-invariant firm-level variables, even if one cannot observe these variables. For example, if a company's ownership structure does not change over time, then that ownership structure cannot be the reason why the company performs better in one year than in others. However, the use of firm fixed effects cannot exclude unobserved variable bias resulting from variables that change over time. Furthermore, there can be many unobserved changes in a firm's economic, legal, and institutional environment that may both impact the firm's performance and cause firms to fall above or below the 2000-employee threshold. Accordingly, even if regressions control for firm fixed effects, observed correlations can tell us very little about the impact of codetermination.

[52] For a relatively recent analysis of the strengths and weaknesses of difference-in-differences approaches see, *e.g.*, Michael Lechner, *The Estimation of Causal Effects by Difference-in-Difference Methods*, 4 Foundations & Trends in Econometrics 165 (2011); Sebastian Bunnenberg & Steffen Meyer, *Trusting Difference-in-Differences Estimates More: An Approximate Permutation Test*, Working Paper, Feb. 22, 2017, available at https://ssrn.com/abstract=2805116.

Several well-known studies on codetermination employ this technique, typically using the enactment of the 1976 Codetermination Act as the treatment event.[53] However, even with respect to the 1976 Codetermination Act, they these studies yield contrary results, finding either a negative or a positive impact on firm productivity or no impact at all.[54] Similarly, different studies have yielded different results on whether or not the enactment of the 1976 Act led to higher wages.[55]

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[53] E.g., Felix R. FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 J. ECON. 365 (1993) (using a sample of 112 German corporations, comparing their performance in 1975 and in 1983, and finding that parity-codetermination is associated with lower productivity) [hereinafter FitzRoy & Kraft, *Economic Effects*]; Frank A. Schmid & Frank Seger, *Arbeitnehmermitbestimmung, Allokation von Entscheidungsrechten und Shareholder Value* [*Codetermination, Allocation of Decision Rights, and Shareholder Value*], 68 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 453 (1998) (using a sample consisting of data for 160 publicly traded corporations in the years 1976, 1987, and 1991 and focusing on firms' market-to-book value as a dependent variable); Kornelius Kraft & Marija Ugarković, *Gesetzliche Mitbestimmung und Kapitalrendite (Codetermination and Return on Equity)*, 226 JAHRBÜCHER FÜR NATIONALÖKONOMIE 588 (2006) (using a sample of 179 firms for the years 1971 to 1976 and 1981 to 1986 and finding a small but statistically significant positive correlation between parity codetermination and return on equity); Michael A. Gurdon & Anoop Rai, *Codetermination and Enterprise Performance*, 42 J. ECON. BUS. 289, 299 tab. 6 (1990) (using a sample of 63 firms and observations for the years 1970, 1975, 1980, and 1985 and finding that parity-codetermination is associated with a statistically significant decline in productivity while also finding an increase in profitability, though the statistical significance of the latter depends on the years observed).

[54] FitzRoy & Kraft, *Economic Effects*, *supra* note 53 (using a sample of 112 German corporations, comparing their productivity in 1975 and then again in 1983, and finding that the treatment group experienced a statistically significant decline in both productivity and profitability relative to the control group); Felix R. FitzRoy & Kornelius Kraft, *Co-determination, Efficiency and Productivity*, 43 BRIT. J. INDUSTRIAL REL. 233 (2005) (analyzing a sample of 179 large manufacturing firms in the years 1972-76 and 1981-85, and finding that switching to parity-codetermination was associated with an increase in productivity); Kornelius Kraft, *Productivity and Distribution Effects of Codetermination in an Efficient Bargaining Model*, 59 INT. J. INDUSTRIAL ORG. 2018, 458 (2018) [hereinafter Kraft, *Productivity*] (using a sample of 179 large manufacturing firms and finding no impact on productivity). Other authors have focused on firms' market-to-book ratios as a mater of firm performance. *See, e.g.*, Schmid & Seger, *supra* note 53, at 453 (using a sample of 160 firms, and finding that the introduction of the 1976 Codetermination Act resulted in an 18% decline in market-to-book ratios for treatment group firms).

[55] FitzRoy & Kraft, *Economic Effects*, *supra* note 53, at 374 (finding no statistically significant evidence that the enactment of the 1976 Codetermination Act impacted wages but noting that it may

This variation in findings is not particularly surprising if one takes into account the limitations of difference-in-differences studies. Such studies are potentially much more useful than mere correlation studies. However, they remain highly vulnerable to unobserved variable bias.[56] Any change in an unobserved variable that coincided with the treatment event and had a different impact on the treatment group and the control group can mask as a treatment effect. This general weakness of difference-in-difference studies looms large in the context of codetermination. Firms that have enough employees to trigger the application of the 1976 Codetermination Act and are therefore part of the treatment group differ from firms in the control group, which by definition have fewer employees. As a result, any change in the institutional, legal, or economic environment that occurred between the first and the second date of observation and that influences large firms differently compared to small firms can be mistaken for a treatment effect. To name just one example, the year 1979 saw the beginning of the second oil crisis, which was triggered by the Iranian Revolution in 1979 and compounded by the war between Iran and Iraq that began in 1980. There is no reason to believe that the oil crisis impacted larger firms in the exact same way that it affected smaller firms.

C. EVENT STUDIES

Event studies are the workhorse of empirical corporate finance. They focus on the stock market's reaction to events and can thus be used to evaluate the impact of new legislation. Like difference-in-differences studies, event studies require a

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have increased job security); Kraft, *Productivity, supra* note 54, at 458 (finding that the 1976 Codetermination Act increased workers' bargaining power vis-à-vis employers).

[56] JEFFREY M. WOOLDRIDGE, ECONOMETRIC ANALYSIS OF CROSS SECTION AND PANEL DATA 148 (2nd ed. 2010) (noting that the treatment event must not be systematically related to unobserved variables that may affect the dependent variable). Another limitation is that difference-in-differences studies rely on the so-called parallel trend assumption, meaning that the treatment group firms and the control group firms must have developed in a parallel fashion prior to the treatment event. *E.g.*, Ashesh Rambachan & Jonathan Roth, *An Honest Approach to Parallel Trends*, Working Paper, Dec. 18, 2019, at 1, available at https://scholar.harvard.edu/files/jroth/files/roth_jmp_honestparalleltrends_main.pdf.

treatment event, such as the enactment of new legislation. Ideally, that treatment event impacts some firms but not others, creating a treatment group and a control group. As noted above, the 1976 Codetermination Act fits this mold since it only applies to firms with more than 2,000 employees, thereby leaving public firms with fewer than 2,000 employees as the treatment group.

In an event study, a certain period before the event, the so-called estimation window, is used to predict firms' stock price returns during the so-called event window, which often includes the day of the event itself plus one or two days. By subtracting a firm's *predicted* stock return from its *actual* stock return during the event window, one obtains a firm's (cumulative) abnormal stock return. If the treatment group firms experience statistically significant abnormal returns relative to the treatment group firms, then, in the absence of confounding factors, it stands to reason that this difference is due to the event.

Several studies have used the event-study methodology to explore the impact of codetermination on shareholder wealth.[57] In general, these studies have either found no statistically significant results,[58] or they have found that introducing or extending parity codetermination is associated with statistically significant negative abnormal returns.[59]

However, whereas event studies are generally quite suitable to identify the shareholder wealth effects of legislation, they cannot necessarily answer the question of whether codetermination constitutes an efficient choice for German, let alone U.S. corporate law. Part of the problem is that Germany's social,

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[57] *E.g.*, Stefan Petry, *Mandatory Worker Representation on the Board and Its Effect on Shareholder Wealth*, 47 FIN. MGMT 25 (2018); Theodor Baums & Bernd Frick, *Co-Determination in Germany: The Impact of Court Decisions on the Market Value of Firms*, 1 ECON. ANALYSIS 143 (1998).

[58] E.g. Baums & Frick, *supra* note 57 (examining stock price reactions to 23 court decisions between 1974 and 1995 which either expanded or limited codetermination, but finding no statistically significant results).

[59] Stefan Petry analyzes the stock market's reaction to various legislative milestones on the way to the enactment of the 1976 Codetermination Act. Petry, *supra* note 57. He finds an average aggregate response of negative 1.5% in cumulative abnormal returns relative to firms in the control group. Other studies have come to similar conclusions. *Id.*

institutional, and legal landscape looks very different now from what it looked like in 1976. The fact that the 1976 Act may have reduced shareholder wealth at the time of its enactment does not necessarily imply that that is still true today.

More importantly, an essential limitation of event studies is that they *only* capture the impact on shareholder wealth but not the impact of workers, even though workers are the intended beneficiaries of codetermination.

Finally, event studies face the challenge that they can only measure an event's impact on existing firms but not potential benefits for future firms. To use a simple example, imagine that a country imposes strict fuel standards for the first time. Such legislation may be bad news for existing car manufacturers. Still, it may offer benefits to entrepreneurs forming electric car companies *in response to* the new law, and event studies do not capture these benefits. It is entirely conceivable that codetermination allowed some new firms to flourish and go public that might not otherwise have achieved the same degree of success.

D. INSTRUMENTAL VARIABLES

Another strategy to identify the impact of legislation is using instrumental variables.[60] In essence, studies relying on instrumental variables correct the central weakness of correlation studies by replacing a potentially endogenous variable with an exogenous one. As noted above, finding a correlation between codetermination and other variables of interest, such as firm productivity, does not tell us much since there may be unobserved variables that explain both codetermination and firm productivity (unobserved variable bias).[61]

One could avoid these biases if it were possible, first, to find a purely exogenous variable that causes the 1976 Act to be applicable provided that, second, the only way in which this exogenous variable can impact firm productivity was through the application of the 1976 Codetermination Act. In that case, a correlation between

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[60] For a brief explanation of instrumental variables see, e.g., WOOLDRIDGE, *supra* note 56, at 112-14 .

[61] It is even conceivable that firm productivity (indirectly) causes the application of the 1976 Codetermination Act rather than the other way around (reverse causality).

the exogenous variable and firm performance would suggest that codetermination affects firm performance. However, despite attempts in this direction,[62] scholars have not been successful in identifying exogenous variables that have an impact on the level of codetermination but cannot influence firm performance in other ways. For example, there are many factors such as a firm's industry, that influence the number of employees and thereby, indirectly, the level of codetermination. However, a firm's industry also impacts a firm's performance regardless of the applicable codetermination regime.[63]

To conclude, decades of empirical research on codetermination lead to a sobering assessment: the results hardly yield a compelling case for or against codetermination.

IV. THE BENEFITS OF CODETERMINATION

Despite the inconclusive empirical case for and against codetermination, it is quite plausible to think that codetermination has allowed Germany to reap a number of important benefits. However, as shown in this Part, these benefits are unlikely to materialize in the United States to the same extent. As a consequence, and focusing on the benefits of codetermination alone, the case for introducing codetermination in the United States is weaker than in Germany. It gets even

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[62] Fauver and Fuerst have taken this approach to estimate the impact of codetermination on various variables of interest, most notably firm performance, as measured by Tobin's q. Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence From German Corporate Boards*, 82 J. FIN. ECON. 673, 700 (2008). They proceed as follows: in a first step, they use several firm characteristics such as a firm's industry to predict the number of a firm's employees. In a second step, they use this predicted value as an instrument for the level of codetermination and find a positive correlation with Tobin's q. *Id.* at 704.

[63] For example, Fauver & Fuerst, *supra* note 62, at 704, use Tobin's q to measure firm performance. However, for reasons that have nothing to do with codetermination, Tobin's q is known to correlate with industry. *See, e.g.*, Dong Wook Lee et al., *Does Capital Flow More to High Tobin's Q Industries*, Fisher College of Business Working Paper No. 2018-03-008, May 9, 2018, p. 10 (showing that the average difference in median Tobin's q between high funded and low-funded industries is 0.184 and that this difference is statistically significant at the 1% level). The correlation between industry and Tobin's q is unsurprising given that Tobin's q, to a large extent, measures a firm's growth opportunities. Lee et al., *supra*, at 1.

weaker when taking into account the costs of codetermination, which we will do in Part V.

A. COLLECTIVE BARGAINING

Henry Hansmann has famously argued that codetermination may yield important efficiency benefits in the context of collective bargaining.[64] Corporate boards typically know more about their companies' financial situation than the labor unions with whom they are bargaining over wages. This informational asymmetry can prevent the bargaining parties from reaching an agreement: Unions may suspect that employers may describe their firms' financial prospects too negatively in order to obtain lower wages. Meanwhile, employers may be unable to demonstrate their own sincerity in a credible way. Strikes, which can be costly both for the parties involved and other companies up or down the supply chain, may be the consequence. Codetermination, however, ensures that the employee representatives have access to the same information as other board members. As a result, mandatory codetermination can mitigate or eliminate the information asymmetry between employers and workers.[65]

However, the magnitude of this benefit depends on the role that collective bargaining plays in a country's economy. In the United States, this role is far smaller than in Germany, as well as in other European countries (Table 3).[66] In 2015, the most recent year for which coverage rates are available for both the United States and Germany, only 7.2% of private sector employees in the United States were covered by collective bargaining agreements, whereas the coverage rate

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64 Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1803 (1990).

65 *Id.* The role of codetermination in reducing asymmetric information in the context of collective bargaining is now widely accepted. *E.g.*, Luca Enriques et al., *The Basic Governance Structure; Minority Shareholders and Non-Shareholder Constituencies*, in THE ANATOMY OF CORPORATE LAW at 91 (Reinier Kraakman et al. eds., 3rd ed. 2017); Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441, 479 (2014).

66 Dammann, *Mandatory Law Puzzle*, *supra* note 66, at 480.

for private sector employees in Germany was 50.2 %. Other European countries that provide for mandatory employee representation on corporate boards such as Austria, France, Norway, or Sweden also tend to have much higher coverage rates than the United States. Meanwhile, the United Kingdom, where relatively few private sector workers are covered by collective bargaining agreements, requires no form of employee codetermination on corporate boards.[67]

Table 3: Percentage of Private Sector Employees Covered by Collective Bargaining Agreements

	Austria	Belgium	France	Denmark	Germany	Norway	Spain	Sweden	U.K.	U.S.
2017	94.0%	N.A.	N.A.	N.A.	N.A.	52.0%	59.0%	N.A.	15.2%	7.3%
2016	N.A.	90.0%	N.A.	74.0%	N.A.	54.0%	62.8%	85.0%	14.9%	7.3%
2015	N.A.	N.A.	90.2	N.A.	51.2%	N.A.	61.2%	84.0%	14.7%	7.4%

Note: All data are obtained from Jelle Visser, ICTWSS: Database on Institutional Characteristics of Trade Unions, Wage Setting, State Intervention and Social Pacts in 55 Countries Between 1960 and 2018 (Amsterdams Instituut voor ArbeidsStudies (Amsterdam Inst. for Advanced Labour Studies), Database No. 6.1, 2019), available at http://uva-aias.net/en/ictwss.

Of course, even the United States would benefit from the disclosure function of codetermination law, at least to some extent. However, given the low percentage of private sector workers covered by collective bargaining agreements, it stands to reason that the relevant benefits would be fairly limited.

B. FIRM-SPECIFIC INVESTMENTS

Scholars have argued that codetermination may encourage employees to make so-called firm-specific investments. [68] The basic idea is simple: Firms can often increase their productivity by persuading employees to acquire skills or knowledge that is useful as long as the employee works for that particular company, but has little value anywhere else. For example, a corporation benefits if an engineer

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[67] Reforms were considered by the former UK government led by Prime Minister Theresa May in 2016-2018. However, no political momentum towards this end could be achieved. See, *e.g.*, Larry Elliott, Theresa May misses a trick after U-turn on workers on boards, The Guardian June 10, 2018, https://www.theguardian.com/business/2018/jun/10/theresa-may-misses-a-trick-after-u-turn-over-workers-on-boards (last visited on March 23, 2020).

[68] See, *e.g.*, Erik G. Furubotn, *Codetermination and the Modern Theory of the Firm: A Property-Rights Analysis*, 61 J. BUS. 165, 170-174 (1988).

becomes acquainted in great detail with the corporation's particular manufacturing processes and patents even though the engineer may not be able or allowed to use that knowledge in subsequent positions at other firms.

From an employee's perspective, firm-specific investments are potentially risky. After all, the employer knows that the employee cannot take his firm-specific expertise elsewhere. Therefore, the employer may encourage employees to make firm-specific investments, but then refuse to compensate them for their increased productivity. The prospect of employer opportunism may lead the employee to abstain from making firm-specific investments in the first place, even where such investments would produce positive joint payoffs for the parties. Codetermination, the argument runs, is a mechanism that allows employers to make a credible commitment to reward employees for their firm-specific investments.

Part of the problem with this theory is that there is no empirical evidence to back it up: to date, no study has shown that codetermination makes employees more willing to make firm specific-investments.

Furthermore, it is worth noting that Germany has adopted many different rules that protect employees against ex-post expropriation by employers and encourage firm-specific investments. For example, whereas U.S. firms can fire employees at will,[69] German employment law adheres to the so-called for-cause termination rule under which employers need a specified (personal or business) reason to end an employment relationship.[70] Furthermore, many employees are covered by collective bargaining agreements that aim at providing employees with fair wages.

Additionally, German labor law does not just give employees a voice in the supervisory board. It also imposes an entirely distinct institutional structure, the so-called works councils that are designed to safeguard the rights of employees.

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[69] Dammann, *Mandatory*, *supra* note 65, at 480; Julie C. Suk, *Discrimination at Will: Job Security Protections and Equal Employment Opportunity in Conflict*, 60 STAN. L. REV. 73, 78-79 (2007).

[70] Kündigungsschutzgesetz [KSchG] [Protection Against Termination Act], Aug. 25, 1969, BGBl I at 1317, last amended by Gesetz [G], July 17, 2017, BGBl I at 1317, §1 (Ger.) (prohibiting terminations without cause).

Employees in companies with more than five employees have the right to elect a so-called works council,[71] and employers are required by law to either inform the works council or even seek its approval on many important managerial issues.[72] In their entirety, these rules offer a high level of protection to German employees, and it shows. For male workers between the ages of 18 and 60, the average job tenure is about four years in the United States versus seven years in the Germany.[73]

Adopting a German-style system of codetermination may be one step towards encouraging more firm-specific investment. However, it is not at all clear that mandatory codetermination is an important or even the most important factor to achieve this end and that adopting mandatory codetermination in isolation will make much of a difference.

C. NON-PECUNIARY BENEFITS

Codetermination on corporate boards may have non-pecuniary benefits in addition to more tangible, monetary benefits. Indeed, when the discussion on board codetermination took shape in post-war Germany in the late 1940s, "[t]he 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)."[74] Potential benefits of codetermination were seen in a "democratization" of political and business life, going much beyond Corporate Governance-related (efficiency) gains.

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[71] Betriebsverfassungsgesetz (Works Council Act) of October 11, 1952, BGBl I at 681, last amended by Gesetz [G], Dec. 8, 2018, BGBl I, at 2651, § 1(1)(1).

[72] *See id.* §§ 81, 90 (listing matters in which the employer has to inform the works council), §§ 87, 91 (listing matters in which the works council has a co-decision right)

[73] Kenneth A. Couch, *Tenure, Turnover, and Earnings Profiles in Germany and the United States*, 1 J. BUS. & ECON. RES. 1, 3 (2011). *See* U.S. BUREAU OF LABOR STATISTICS, Economic News Release: Employee Tenure Summary, USDL-18-1500, https://www.bls.gov/news.release/tenure.nr0.htm (stating that the median number of years that U.S. workers had been with their current employer was 4.2).

[74] Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE 163, 167 (Margaret M. Blair and Mark J. Roe eds. 1999).

One aspect of this goal related to the protection of human dignity. Article 1(1) of the German Constitution (*Grundgesetz* ("Basic Law")) stipulates that "Human dignity shall be inviolable".[75] Scholars argued that board codetermination would protect employees from becoming mere objects of business decisions which they cannot influence, let alone control.[76] Furthermore, the proponents of codetermination argued that the 1976 Act would lead employees to engage more with the affairs of their firm and develop a sense of responsibility—traits that were said to strengthen democracy.[77]

These are views on which reasonable minds can differ. Whatever the merits of the argument that, without codetermination, employees are relegated to being mere objects of decisions taken by others, it seems clear to us that board codetermination would not address the main concern of employees working today. Their main concern is not being treated in a de-humanizing fashion at their workplace in a (large) corporation. Rather, it is losing their job completely or being moved into the precarious position of a (seemingly) independent contractor in the gig economy.[78] This concern has become even more acute because of the COVID 19-pandemic. (Seemingly) independent contractors all over the world, including the US in particular, are facing the (economic) abyss. Of course corporations are hit by the crisis, too. However, at least large corporations operate as a kind of firewall between the crisis and the individual worker. Independent contractors do not have the benefit of this buffer. In addition, empirical research has demonstrated that employees in large corporations are paid better than those working in SMEs,[79]

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[75] An officially authorized English language version of the *Grundgesetz* can be accessed at https://www.gesetze-im-internet.de/englisch_gg/englisch_gg.html#p0019 (last visited on 23 March 2020).

[76] See Thomas Raiser, *Paritätische Mitbestimmung in einer freiheitlichen Wirtschaftsordnung* [*Parity Codetermination in a Free Market System*], 29 JURISTENZEITUNG [JZ] 273, 276 (1974).

[77] *Id*.

[78] For a balanced account of this development *see* JEREMIAS PRASSL, HUMANS AS A SERVICE: THE PROMISE AND PERILS OF WORK IN THE GIG ECONOMY (2018).

[79] *See, e.g.*, Christoph M. Schmidt & Klaus F. Zimmermann, *Work Characteristics, Firm Size, and Wages,* 73 REV. ECON & STAT. 705, 705 (1991) (noting that there is "substantial evidence from many countries" that larger firms pay higher wages than smaller firms); Nicholas Bloom et al., *The*

although that difference has been shrinking somewhat in recent years.[80] Against this background, advocating board codetermination in large corporations on the basis that this measure would help humanize and "dignify" workplace conditions in such corporations appears unconvincing.

A similar point can be made regarding the notion that democracy would be strengthened if board codetermination were introduced. This point should be seen in the political post-war context in Germany in the 1940s and 1950s. In light of the terrors of the Nazi regime, strengthening democratic processes at all levels of society made eminent sense.

The (current) political situation in the US is very different. When Germany introduced board codetermination, the US already had a long tradition of democracy.[81] Even today, many more federal, state, and local officers in the United States are elected than in Germany, including, for example, judges. We do not think that democracy in the US would be strengthened or participation in elections would be increased if even more elections, in this case of employees to corporate boards, were proscribed.

V. THE COSTS OF CODETERMINATION

Codetermination has costs as well as benefits. These costs are bound to arise in any country that adopts mandatory codetermination. However, as shown below, they are likely to be much greater in the United States than they are in Germany. As a consequence, and taking into account that any benefits of codetermination would be significantly smaller in the United States than in Germany, the case for introducing mandatory codetermination in the United States is extremely weak.

Disappearing Large-Firm Wage Premium, 108 AEA PAPERS & PROC. 317, 317 (2018) (noting that "[l]arge firms pay higher wages than smaller firms even after controlling for the quality of a worker").

[80] Bloom et al., *supra* note 79, at 317 (finding that the average wage premium that workers in firms with at lest 10,000 employees earn compared to firms with 100 or fewer employees has declined from 47% in the early 1990s to 20% by the early 2010s).

[81] The "classic" account is, of course, ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA (1835).

A. THE FUNCTIONING OF THE BOARD

One of the core challenges of mandatory codetermination is that it guarantees divided loyalties within the board: the shareholder representatives know that they must please the shareholders to get reelected, whereas the worker representatives know that their reelection depends on keeping employees satisfied. These different perspectives can make it harder for boards to work constructively towards the same end.

Skeptics may dismiss this reasoning by stressing the benefits of diverse boards. Boards, they may argue, can profit from a richer panoply of viewpoints, expertise and interests. However, this objection would misunderstand the argument we are making. We do not question the value of diversity. While a thorough discussion of the costs and benefits of board diversity would go beyond the scope of this article, we note that there exists a substantial body of theoretical and empirical scholarship suggesting that having directors with different experiences and viewpoints can, in principle, avoid problems like groupthink and thereby improve decision-making.[82]

However, the pertinent literature highlights the benefits of having people with different viewpoints and backgrounds work towards the *same* goal. By contrast, codetermination creates the risk that different directors pursue *conflicting* goals. In other words, we very much agree that diversity is helpful. Conflicting goals are what jeopardize the board's effectiveness.[83]

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[82] The legal literature now also recognizes the importance of diversity for the quality of decision-making. In particular, advocates of greater board diversity stress that such diversity reduces the danger of group think. *E.g.*, DOUGLAS M. BRANSON, NO SEAT AT THE TABLE: HOW CORPORATE GOVERNANCE AND LAW KEEP WOMEN OUT OF THE BOARDROOM 177 (2007); Seletha R. Butler, *All on Board! Strategies for Constructing Diverse Boards of Directors*, 7 VA. L. & BUS. REV. 61, 76 (2012); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 277 (2012).

[83] This point will continue to apply even if, at some point, humans on corporate boards are substituted by (artificially intelligent) autonomous machines. On the technological developments in this area and Corporate Governance implications *see* John Armour & Horst Eidenmüller, *Self-Driving Corporations?*, 10 HARV. BUS. L. REV. (2020) (forthcoming). The key Corporate Governance issue in an AI-driven corporation will become setting the corporation's goal function.

The beneficiaries of a less functional board might be a corporation's managers. If employee representatives and shareholder representatives on the board cannot agree on goals, strategies and/or supervisory measures, managers are likely to gain more leeway in pursuing self-interested actions—to the detriment of both shareholders and employees. Agency costs would likely rise. [84]

The rise and fall of cumulative voting illustrates the importance of board collegiality.[85] Cumulative voting can help minority shareholders elect some of their representatives to the board. Despite the potential salutary effect of minority shareholder representation on monitoring,[86] and even though minority and majority shareholders typically share the basic goal of maximizing shareholder wealth, practitioners viewed the resulting board composition as so detrimental to collegiality[87] that state lawmakers and corporate charters have largely turned their backs on it.[88] This modern practice finds empirical support in more recent empirical studies, which provide evidence that cumulative voting reduces firm value.[89] Obviously, cumulative voting rules are very different from

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This is easier if the goal function is shareholder value maximization and not some mix of goals or perspectives.

[84] On the agency costs associated with the separation of ownership and control see also *infra* Section B. On monitoring as the key function of the board see STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, OUTSOURCING THE BOARD 45-48 (2018).

[85] Cumulative voting enjoyed such recognition that many states made cumulative voting mandatory. *See* Jeffrey N. Gordon, *Institutions As Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 145 (1994) (noting that in the 1940's, no fewer than 22 states had mandatory rules requiring cumulative voting in corporate elections).

[86] For a relatively recent endorsement of cumulative voting see *id.* at 127 (arguing that institutional investors should revive cumulative voting).

[87] Charles W. Steadman & George D. Gibson, *Should Cumulative Voting for Directors Be Mandatory? A Debate*, 10 BUS. LAW. 9, 26 (1955).

[88] *See* Gordon, *supra* note 85, at 181 (listing numerous states that introduced mandatory cumulative voting but later repealed the relevant provisions). California and Hawaii still retain mandatory cumulative voting, but only for unlisted corporations. *See* CAL. CORP. CODE ANN. §§ 301.5, 708(a) (West) (mandating cumulative voting for unlisted corporations, while allowing listed corporations to opt out in their articles of incorporation or bylaws); HAW. REV. STAT. ANN. § 414-149 (Lexis) (mandating cumulative voting, but allowing public corporations to opt out).

[89] *See* Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 299–302 (2000) (finding that the

codetermination. However, the lesson from cumulative voting at the very least demonstrates that the issue of board collegiality needs to be taken seriously.

Of course, the problem that mandatory codetermination may undermine board collegiality is not limited to the United States. Rather, it exists in Germany as well. However, the two-tier board structure of German corporations keeps the conflict between employee representatives and shareholder representatives out of the managing board. Thus, this conflict does not undermine the smooth functioning of day-to-day management.

B. REMOVAL OF DIRECTORS

One of the most obvious problems in corporate law lies in the agency conflict between directors and the corporation, which we mentioned already in the previous Section. Directors are fiduciaries who are supposed to act in the best interest of the corporation.[90] Traditionally, that has meant that directors were supposed to act in the best interest of shareholders.[91] In a stakeholder model, it means that directors must act in the best interest of multiple constituencies.[92] But the problem remains the same: directors may be tempted to put their own interests ahead of those that

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rejection of shareholder proposals calling for cumulative voting was associated with statistically significant positive abnormal returns); James Nelson, *Corporate Governance Practices, CEO Characteristics and Firm Performance*, 11 J. CORP. FIN. 197, 220 (2005) (finding that firms' decision to abolish cumulative voting was associated with positive long-term abnormal returns, whereas the decision to adopt cumulative voting was associated with negative long-term abnormal returns). *But see* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 350 (1984) (finding that charter amendments which eliminated cumulative voting were associated with negative abnormal returns).

[90] *E.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

[91] *Id.*; Allen v. El Paso Pipeline GP Co., L.L.C., 113 A.3d 167, 180 (Del. Ch. 2014), judgment entered, (Del. Ch. 2014), aff'd, 399, 2014, 2015 WL 803053 (Del. Feb. 26, 2015).

[92] Note that Senator Warren's Accountable Capitalism Act defines the directors' duties accordingly. See Accountable Capitalism Act, *supra* note 2, § 5 (c) (defining the standard of conduct for directors and requiring directors to manage the corporation in a manner that "balances the pecuniary interests of the shareholders … with the best interests of persons that are materially affected by the conduct of the United States corporation").

they are meant to serve. For example, directors may use their influence to obtain excessive salaries; they may engage in empire-building, or they may entrench themselves in office, thereby preventing the corporation from getting better managers.

Corporate law and private ordering offer various ways in which corporations can minimize agency costs. These include performance-based compensation,[93] an active market for corporate control,[94] or active monitoring by institutional investors.[95] One crucial tool of disciplining directors is the threat of removal. Admittedly, Delaware law allows corporations to blunt that threat by classifying boards: if the board is classified, directors can only be removed for cause,[96] and among publicly traded corporations, classified boards used to be the rule rather than the exception.[97] However, in one of the more significant developments in corporate law, shareholders have managed to push back against the proliferation of classified boards. As Marcel Kahan and Ed Rock have shown, between 2003 and 2009 the percentage of S&P 100 corporations with classified boards declined from 44% to 16%.[98] Moreover, there are good reasons why shareholders dislike staggered

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93 E.g., Gregg D. Polsky, Controlling Executive Compensation Through the Tax Code, 64 WASH. & LEE L. REV. 877, 890 (2007); George G. Triantis, *Slack Policy and the Laws of Secured* Transactions, 29 J. LEG. STUD. 35, 39 (2000).

94 Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 850 (1993); Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 787 (2008); Triantis, *supra* note 93, at 39.

95 Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003).

96 DEL. CODE ANN. tit. 8, § 141(k).

97 Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1335 (2013) (examining a random sample of 373 IPO charters of firms that went public between 2000 and 2012 and finding that "65.6% of firms with large customers . . . and 60.6% of firms without large customers" have classified boards).

98 Marcel Kahan & Edward Rock, *Embattled Ceos*, 88 TEX. L. REV. 987, 1009 (2010) tab.2.

boards. A substantial number of empirical studies have examined the impact of staggered boards and have found that they tend to reduce firm value.[99]

Against this background, the question arises whether codetermination facilitates the removal of directors or makes it more difficult. Germany's 1976 Codetermination Act allows the removal of employee representatives (on the supervisory board), but requires a three-fourths majority of the employees to vote in favor of removal.[100] That is a hard-to-overcome threshold. However, the existence of an incompetent board member may not be excessively harmful, given that the supervisory board is not entrusted with the day-to-day management of the corporation.

Sanders's proposal does not mention the rules that would govern the removal of employee representatives, and neither does Warren's Accountable Capitalism Act. The obvious challenge is that any procedure allowing the removal of an employee-elected board member will necessarily be clumsy. The removal decision has to be left to the employees, or else their right to elect representatives would be undermined. However, employees would face the same collective action problem that shareholders do when it comes to getting informed and voting. Crucially, whereas the existence of institutional investors greatly reduces the collective action problem with respect to shareholder voting,[101] no equivalent mechanism exists to overcome collective action problems on the part of employees.

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[99] *E.g.*, Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) (concluding that staggered boards are associated with a lower Tobin's q); Alma Cohen & Charles C. Y. Wang, *How Do Staggered Boards Affect Shareholder Value: Evidence From a Natural Experiment*¸110 J. FIN. ECON. 627 (2013) (finding that staggered boards reduce firm value). Some researchers have questioned the claim that staggered boards reduce firm value. *See, e.g.*, Yakov Amihud & Stoyan Stoyanov, *Do Staggered Boards Harm Shareholders?*, 123 J. FIN. ECON. 432 (2017) (examining the results by Cohen & Wang, *supra*, and claiming that their results become statistically insignificant once one controls for penny stocks, OTC stocks, and stocks of firms with a market capitalization of less than $10 million). For a rebuttal of this critique see Alma Cohen & Charles Y. Wang, *Reexamining Staggered Boards and Shareholder Value*, 125 J. FIN. ECON. 637 (2017) (defending the results from their 2013 article).

[100] Codetermination Act 1976, *supra* note 21, at § 23.

[101] E.g., Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 169 (2000); John C. Coates

In sum, therefore, it seems highly likely that mandatory codetermination would at the very least make the removal of employee directors very difficult. Because of America's single-tier board structure, this problem would be much more severe in the United States than it is in Germany.

C. BANKRUPTCY GOVERNANCE

Mandatory codetermination might also have a significant impact on "bankruptcy governance," complicating decision-making processes especially in a Chapter 11 restructuring in the US.

The starting principle in both US and German corporate bankruptcy laws is creditor governance.[102] Key decisions, such as the approval of a restructuring plan, require the consent of (a majority of) the creditors.[103] Their money is on the line. As the new residual claimants on the distressed corporation's income stream, creditors should have the decisive say on how the corporation's assets are to be used post-bankruptcy.

Codetermination on corporate boards complicates bankruptcy governance. On the one hand, one could argue that employee involvement in the strategic decision-making of a corporation is important especially in bankruptcy. After all, it is not only the creditors' money that is on the line but also jobs. Difficult decisions on the future of the distressed firm should be put on a broad foundation, if possible. On the other hand, bankruptcy requires swift decision-making and action. Firms lose vale while subject to a bankruptcy process—day by day.[104]

IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 860 (1999); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 689 (2006).

[102] See, *e.g.*, Horst Eidenmüller, *Comparative Corporate Insolvency Law*, in THE OXFORD HANDBOOK ON CORPORATE LAW AND GOVERNANCE 1003, 1018-1020 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

[103] *Id*. at 1026-1027.

[104] On the costs of bankruptcy proceedings see, *e.g.*, Michelle J. White, *The costs of corporate bankruptcy: A U.S.—European comparison,* in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 467 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

Against this background, under German bankruptcy law, the codetermination scheme that applies outside bankruptcy does not apply in court-supervised bankruptcy proceedings. Normally, an insolvency administrator is appointed who has all the powers to manage the firm's assets that—outside bankruptcy—would be exercised by the management and the supervisory board.[105] This includes going concern sales. German bankruptcy law has Debtor-In-Possession (DIP) proceedings similar to the US.[106] However, even in corporate restructurings these are rarely used. In the period from March 2012 to March 2017, DIP proceedings were running in less than 3.5% of all company insolvency proceedings.[107] Hence, codetermination on corporate boards is practically irrelevant in German corporate restructurings, allowing the insolvency administrator to take swift decisions.

This would be very different in US law and practice if the Sanders or the Warren proposals were adopted. Chapter 11 corporate restructurings are almost always DIP proceedings.[108] Not even in the Enron bankruptcy was a trustee appointed. The consequence is simple: the governance system which applies outside of bankruptcy continues to apply in bankruptcy. With respect to codetermination, this means that the debtor's decision-making process on proposing a restructuring plan would be fraught with difficult discussions between shareholder and employee representatives. This would surely be a significant economic cost of the codetermination regime were it introduced in the United States.

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[105] See Section 90 of the German Insolvency Code, the "|Insolvenzordnung" (InsO).

[106] See Sections 270-285 InsO.

[107] See FLORAN JACOBY ET AL., EVALUIERUNG: GESETZ ZUR WEITEREN ERLEICHTERUNG DER SANIERUNG VON UNTERNEHMEN V. 7. DEZEMBER 2011 at 8 (2017), available at https://www.bmjv.de/SharedDocs/Downloads/DE/News/Artikel/101018_Gesamtbericht_Evaluierung_ESUG.pdf;jsessionid=246E9C1CE0F6CD3BBF5801923332AE93.2_cid289?__blob=publicationFile&v=2 (last visited on March 20, 2020).

[108] *See, e.g.*, Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 54 (2003) (pointing out that in most Chapter 11 cases, the debtor remains in control of the firm as a DIP).

D. THE MARKET FOR CORPORATE CONTROL

Codetermination may also weaken the market for corporate control. The threat of hostile takeovers is an important mechanism to prevent managerial opportunism.[109] However, mergers also come with the prospect of workforce reductions, which means that employee representatives are likely to oppose them. This is consistent with the experience in Germany, where codetermination is generally viewed as an obstacle to the market for corporate control.[110]

Of course, such opposition can be efficiency-enhancing to the extent that the merger's benefits to the shareholders are outweighed by externalities that the merger imposes on the merging firms' employees. However, we know of no empirical evidence showing that this is typically the case. More importantly, assuming that employee representatives seek to maximize their chances of reelection, there is no reason to believe that they will take into account the benefits accruing to shareholders when deciding whether to oppose a merger. Rather, as long as the merger threatens to reduce employment, a utility maximizing employee representative is likely to vote against it regardless of whether the benefits to the shareholders outweigh the costs to the employees.

In principle, this conflict of interests exists in Germany as well as in the United States. However, there are compelling reasons to think that opposition to takeovers is much less of a problem in Germany. The main reason is that there have traditionally been very few hostile takeovers in Germany. A 2017 study that

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[109] Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1465 (2019); Klick & Sitkoff, *supra* note 94, at 787. The empirical evidence largely supports the view that the market for corporate control helps to reduce agency costs. See,e.g., Scott B. Smart et al., *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. ACCT. & ECON. 94, 113 (2008) (providing evidence that the use of dual-class shares is associated with lower firm value). Furthermore, several studies have shown that classified boards, which help to reduce the threat of hostile takeovers, are associated with lower firm value. *See* the sources cited *supra* note 99.

[110] *See, e.g.*, NICO RAABE, DIE MITBESTIMMUNG IM AUFSICHTSRAT [CODETERMINATION IN SUPERVISORY BOARDS] 177 (2010) (comparing the German codetermination regime to a poison pill).

examined all German takeovers between 1981 and 2010 in which the acquirer was a public company identified only five hostile takeovers in total.[111] The same study showed that the overall level of takeover activity was quite low. Between 1981 and 2010, there were 338 acquisitions in total; in 2010, the most recent year included in the study, the authors found a total of eight mergers.[112] Of course, these numbers could be higher if it were not for codetermination. However, there are many other obstacles to the development of an active takeover market. For example, even though share ownership is now more dispersed in Germany than it was even twenty years ago, many public corporations still have shareholders with ownership stakes exceeding 25%.[113] That makes hostile takeovers quite difficult. In other words, while Germany's codetermination regime may render hostile takeovers more challenging, it is not clear that the number of hostile takeovers would be much higher in its absence. Herein lies a major difference between Germany and the United States. For example, between 1981 and 2010, the United States saw 60,244 mergers in which the acquirer and the target were publicly traded corporations.[114] The United States thus has a particularly vigorous market for corporate control and thus stands to lose much more from imposing codetermination.

E. MANDATORY CORPORATE LAW

One of the less obvious costs of codetermination lies in the need to reduce the flexibility of corporate law to prevent regulatory arbitrage. Corporations may seek to find some way around the mandatory codetermination rules, and thus lawmakers need to adopt additional mandatory rules to prevent the codetermination regime from being circumvented. This problem exists in both Germany and the United

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[111] Ferdinand Mager & Martin Feyer Fackler, *Mergers and Acquisitions in Germany: 1981-2010*, 34 GLOBAL FIN. J. 32, 35 (2017).

[112] *Id.*

[113] *See* Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 AM. J. COMP. L. 493, 510-515 tab.1 (2015) (listing the corporations that constitute the DAX 30 and their largest shareholders).

[114] Statement based on data on completed mergers from Refinitiv SDC Platinum, https://www.refinitiv.com/en/products/sdc-platinum-financial-securities.

States, but the costs of adding mandatory law are likely to be much higher in the United States than they are in Germany.

1. Preventing Circumvention

Regulatory arbitrage can occur in one of several ways. Corporations can reincorporate offshore, they can convert into domestic entities such as partnerships to which the codetermination rules do not apply, or they can amend their charters and bylaws in ways that minimize the impact of codetermination. We address these different approaches in turn.

a) Reincorporation

Firms seeking to avoid codetermination can (re)incorporate in a foreign jurisdiction that does not impose any codetermination requirement.

The German experience with this problem is telling. Based on the so-called "Freedom of Establishment" as guaranteed by the Treaty on the Functioning of the European Union,[115] German entrepreneurs are free to incorporate or reincorporate in another Member State, adopting a non-domestic corporate form.[116] Even more importantly in our context, since 2004, corporations incorporated in one of the European Union (EU) Member States can reincorporate as a European *Societas Europaea* (SE), a European stock corporation. An SE is governed, in the first instance, by the rules of the European SE Regulation.[117] In addition, the laws on stock corporations of the jurisdictions in which the SE is incorporated apply to the extent that the SE Regulation has gaps or permits this.[118] Different from German

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[115] Consolidated Version of the Treaty on the Functioning of the European Union art. 238(3), Dec. 13, 2007, 2010 O.J. (C 83) 47 [hereinafter TFEU], arts. 49 (granting freedom of establishment), 54 (extending the freedom of establishment to corporations).

[116] Jens Dammann, *Homogeneity Effects in Corporate Law*, 46 ARIZ. ST. L.J. 1103, 1143 (2014).

[117] Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) ("SE Regulation"), O.J. L 294, Nov. 10, 2001, at 1.

[118] *Id.* art. 9.

law, an SE can have either a one-tier (administrative board) or two-tier board structure (management board and supervisory board).[119]

Issues of employee involvement in an SE, including employee representation on the board, are governed by a separate legal instrument, a European Directive.[120] When an SE is formed, shareholder and employee representatives must negotiate the terms of employee involvement.[121] Crucially, if these negotiations fail, the most stringent participation regime in place in one of the entities involved in forming the SE will be implemented in the governance structure of the SE.[122]

After a slow start, the SE has become very popular amongst European firms. As of March 21, 2020, 3,284 SEs existed in the EU.[123] These comprise leading Eurozone companies such as Airbus, Allianz, BASF, E.ON, Fresenius LVMH Moët Hennessy Louis Vuitton, SAP, Schneider Electric and Unibail-Rodamco, but also many SMEs.

As a corporate form, the SE is popular especially amongst German and Czech firms. As of December 31, 2017, 2,054 SEs had been established in the Czech Republic and 491 in Germany.[124] Most of the Czech SEs are not operative, and the operative ones chose the SE form primarily to downsize the board.[125] The key drivers for German SE formations are different. German firms reincorporate as SEs primarily to avoid board codetermination or mitigate its effects.[126] If a firm

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[119] *Id.* art. 38(b).

[120] Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees ("SE Directive"), O.J.L 294, Nov. 10, 2001, at 22.

[121] *Id.* Section II.

[122] *Id.* art. 7.

[123] *See* European Company (SE) Database – ECDB, http://ecdb.worker-participation.eu/ (last visited March 21, 2020).

[124] *See* Anders Carlson, *SE Companies – Bologna 2018-03-12/13*, available at http://www.worker-participation.eu/European-Company-SE/Facts-Figures (last visited March 21, 2020).

[125] Horst Eidenmüller & Jan Lasák, *The Czech Societas Europaea Puzzle*, 12 J. CORP. L. STUDIES 237 (2012).

[126] Horst Eidenmüller, Andreas Engert, & Lars Hornuf, *Incorporating Under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage*, 10 EUR. BUS. ORG. L. REV. 1 (2009).

reincorporates as an SE before it crosses the 500-employee threshold, it can avoid board codetermination altogether. If it reincorporates before it crosses the 2,000-employee threshold, it can freeze the level of codetermination at one third of the members of the supervisory board. And even if it already has more than 2,000 employees, it can downsize the (supervisory) board and achieve an international composition of the employee representatives on the board. The shareholders now have fewer and more diverse employee representatives to negotiate with, which is an advantage—the former can "divide and rule" (*divide et impera*).

In summary, the possibility of reincorporating as an SE has been used by many German firms to avoid or mitigate the effects of domestic codetermination laws. Crucially, there is nothing that the German lawmaker can do about this development. European law is superior to Member States' laws.

In the United States, the danger that firms reincorporate in foreign jurisdictions exists as well, and the consequences are potentially worse. U.S. tax law already creates substantial incentives to incorporate offshore. The reason is that if a corporation is incorporated in the United States, it is deemed to be a U.S. resident for tax purposes.[127] This means that, in principle, the corporation will have to pay taxes in the United States on its worldwide income.[128] By contrast, if the corporation reincorporates in a foreign jurisdiction, the situation changes. The corporation will still have to pay taxes in the United States, but only on its U.S. income, not on its worldwide income.[129] Accordingly, corporations that do business in multiple countries often find it cheaper to incorporate in a foreign low-tax jurisdiction, thereby lowering their U.S. tax burden.[130] This opportunity for tax arbitrage has given rise to so-called "corporate inversions," in which U.S.

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[127] I.R.C. § 7701(a)(4) (2018).

[128] E.g., Eric L. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649, 1661 (2015).

[129] *Id.* at 1685.

[130] *Id.* at 1650-51.

corporations merge into a foreign subsidiary, thereby shifting their place of incorporation abroad.[131]

Until now, corporate law has provided U.S. corporations with an important reason not to follow this approach: incorporating abroad means accepting a foreign jurisdiction's corporate law, and many firms prefer U.S. corporate law, which offers enormous flexibility and legal certainty.[132] However, if the United States were to enact a mandatory codetermination regime, this situation might well reverse. Rather than persuading U.S. firms to stay incorporated locally, such legislation could prompt them to reincorporate abroad in greater numbers than before. Moreover, the consequences would be more severe than in Europe. Not only would such firms escape the reach of corporate law, but they would also pay fewer taxes in the United States. Europe avoids the latter consequence due to a different approach to international taxation.[133] To prevent corporations from avoiding codetermination by reincorporating abroad, federal law would likely have to provide that the U.S. rules on codetermination apply to all firms that are headquartered in the United States.

b) Conversion

Corporations seeking to avoid codetermination could also convert into different entity types. U.S. corporate law offers a variety of non-corporate entity types that

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[131] *Id.*

[132] *Id.* at 1652 (arguing that even though U.S. multinational corporations would prefer lower taxes, they have a preference for Delaware corporate law and governance, which provides an important incentive not to reincorporate offshore).

[133] The bilateral tax treaties between EU Member States are generally modeled on the Model Double Taxation Convention on Income and Capital (MDTC) of the Organisation for Economic Co-operation and Development (OECD) (hereinafter OECD Model). Jens Dammann, *A New Approach to Corporate Choice of Law*, 38 VAND. J. TRANSNATL. L. 51, 71 (2005) [hereinafter Dammann, *Approach*). The OECD model provides that both a corporation's place of incorporation and its place of management are sufficient to establish tax residency. OECD Model, *supra*, arts. 3(1)(d), 7(1). However, if these two criteria diverge, the place of management determines a corporation's tax residency. *Id.* art. 4(1). As a result, if a corporation is headquartered in one Member State and moves its place of incorporation to another Member State, this move does not impact its tax status. Dammann, *Approach,* at 71-72.

offer limited liability, a large degree of flexibility regarding governance arrangements, and the option of becoming publicly traded. This particularly includes limited liability companies, partnerships, and business trusts. Currently, the use of these forms for publicly traded entities is the exception rather than the rule.[134] For example, publicly traded LLCs and partnerships can mainly be found in the energy sector, where, under certain conditions, they offer the benefit of pass-through taxation.[135] However, if federal law subjected corporations to codetermination while imposing no such requirement on other entity types, the popularity of non-corporate entities could skyrocket. Unlike Senator Sanders's proposal, Senator Warren's Accountable Capitalism Act partially addresses this problem in that it applies to limited liability companies as well as to corporations. However, neither proposal applies to limited liability partnerships or business trusts. Yet in order to prevent the rules on mandatory law from being circumvented, they would have to apply to such other entities as well.

c) Corporate Charters and Bylaws

Even corporations that do not change their state of incorporation or their entity type may take measures to minimize the impact of codetermination. One way of doing so is to shift responsibilities from the board of directors as a whole to particular board committees that the employee representatives are not part of.[136] Furthermore, the corporation can adopt bylaws that adjust quorum and majority

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[134] *See, e.g.*, Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 222 (2015) (searching SEC filings and concluding that as of 2013, only twenty LLCs were publicly traded); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded Lps and Llcs*, 37 J. CORP. L. 555, 567 (2012) (searching SEC filings as of 2011 and finding 12 LLCs and 73 limited partnerships).

[135] As a general rule, publicly traded partnerships and limited liability companies are treated like C-corporations for tax purposes, meaning that they are subject to corporate income taxation. I.R.C. § 7704(a) (2018). However, publicly traded partnerships and LLCs avoid this consequence and retain pass-through taxation if they make at least 90% of their income from certain sources including, in particular, income from exploration and mining of natural resources such as oil or gas. *Id.* § 7704 (c)-(d).

[136] *Cf.* DEL. CODE ANN. tit. 8, § 141(c)(allowing the board to establish committees by board resolution).

requirements for board decisions in such a way as to reduce the de facto role of workers' representatives. For example, if a board has traditionally adhered to a supermajority requirement for board decisions,[137] that corporation may instead shift to a simple majority requirement, given that this will allow the shareholder representatives to take decisions against the will of the employee representatives.

To prevent firms from blunting the impact of codetermination by the charter or bylaw provisions, a federal statute would have to impose minimum requirements regarding the decision-making process of corporate boards. German law has, in fact, taken this approach. For example, the German law requires that employee representatives and shareholder representatives be treated equally.[138] Furthermore, the German Stock Corporation Act sharply limits the supervisory board's ability to delegate matters to committees. Numerous important responsibilities such as the appointment of removal of officers, the calling of a shareholder meeting, or the approval of financial statements, cannot be assigned to committees at all.[139]

2. The Cost of Preventing Regulatory Arbitrage

There is no question that federal law could be designed to address the various opportunities for circumvention outlined above. However, the costs of doing so would very likely be much greater in the United States than they are in Germany. The reason is that U.S. corporate law and German corporate law pursue very different regulatory strategies. Delaware corporate law is far more flexible than German corporate law.[140] Delaware law largely consists of default rules. By contrast, the provisions of the German Stock Corporation Act are mandatory unless provided otherwise.[141]

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[137] *Id.* § 102(b)(4)(allowing the certificate of incorporation to impose supermajority requirements for board and shareholder decisions).

[138] See Bundesgerichtshof (Federal Supreme Court), Judgment of Feb. 25, 1982 (II ZR 145/80), NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1530-31 (1982).

[139] German Stock Corporation Act, *supra* note 24, at 107(3).

[140] Dammann, *Mandatory Law Puzzle*, *supra* note 65, at 448-55.

[141] German Stock Corporation Act, *supra* note 24, § 23(5).

The fact that Delaware corporate law is more flexible than German corporate law is unsurprising. Around the world, Delaware law is known for its heavy reliance on default rules. A 2003 study by Katharina Pistor, Yoram Kleinan, Jan Kleinheisterkam, and Mark West is revealing in this context.[142] The study compares the corporate law regimes of Chile, Colombia, Delaware France, Germany, Israel, Japan, Malaysia, and Spain.[143] Of all these jurisdictions, the study concludes, Delaware has the most flexible law by far.[144] Accordingly, scholars and practitioners generally praise Delaware corporate law for its flexibility.

The flexibility of Delaware corporate law implies, however, that Delaware corporate law also has the most to lose when it comes to the imposition of mandatory corporate law: German corporate law heavily relies on mandatory law anyway, so preventing corporate charters and bylaws from circumventing codetermination creates little or no extra costs. By contrast, for the United States, the enactment of additional mandatory corporate law norms means sacrificing at least in part one of its main benefits.

F. RISK-TAKING

Codetermination law also discourages certain types of risk-taking. This incentive can be troublesome for any country, but it promises to be particularly daunting for the United States.

1. Codetermination and Risk-Taking

It is a well-established principle in corporate finance that, given efficient capital markets, a corporation seeking to maximize shareholder wealth should choose the most profitable investment, defined as the investment with the highest net present value, regardless of the investment-specific or firm-specific risk involved.[145] The

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[142] Katharina Pistor et al., *Innovation in Corporate Law*, 31 J. COMP. ECON. 676 (2003).

[143] *Id.* at 689-91.

[144] *Id.* at 689.

[145] *E.g.*, RICHARD A. BREALY, STEWART C. MYERS, & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 645 (10th ed. 2011).

reason is that shareholders can easily eliminate investment- and firm-specific risks by diversifying their investment across firms.[146] Hence, rational shareholders will be unwilling to accept lower profits in exchange for lower firm-specific risk. After all, why pay for a reduction in firm- or investment-specific risk by accepting lower profits if the shareholder themselves can eliminate such risks without incurring any costs by simple diversification?

Employees, on the other hand, are in a very different situation. They cannot easily protect themselves against firm-specific risks. If the firm goes bankrupt, employees may lose their jobs. Moreover, labor markets are notoriously inefficient, preventing employees from easily finding new jobs. The reasons are myriad. For example, an employee may have invested heavily in firm-specific expertise that is without value to other firms. The employee may find it difficult to move because of their family. And of course, new employers may have insufficient information about new job applicants and may therefore refrain from offering them salaries that are in line with the value they are able to add.

Moreover, whereas employees stand to lose much if a firm goes bankrupt, their upside from a particularly profitable investment is limited. If a firm is particularly profitable, the profits are reaped, first and foremost, by the shareholders, given that they are the residual claimants. Of course, working for a profitable firm has upsides. If a firm continues to be particularly profitable, employees may benefit in the form of higher wages or promotions. However, the key point is that a firm's existing employees only stand to gain a fraction of the upside of risky business decisions.

Given that employees suffer disproportionately if a firm goes bankrupt, yet stand to reap only a small fraction of the upside if the firm does particularly well, one cannot fault employees for caring about the risks inherent in the firm's investments. Specifically, employees will want their firms to refrain from making investments that are so risky as to jeopardize the survival of the firm. Codetermination ensures that employees' attitude towards risk also influences the

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[146] *Id.* at 646.

decision-making process at the board level.[147] Employee representatives who are seeking to get reelected will hardly want to jeopardize their prospects by agreeing to investments that workers oppose. Thus, employee representatives will generally try to prevent corporate boards from "betting the farm." Empirical evidence is consistent with this narrative. Thus, it has been shown that firms in the United States on average face a higher probably of bankruptcy than firms in stakeholder countries such as Germany.[148]

2. *Extreme Risk-Taking as a U.S. Specialty*

Making investments that put an entire firm's existence in jeopardy are not the only way of fostering innovation. Some firms specialize on incremental innovation that ultimately achieves the same goal but involves less risk. Moreover, large firms can spread their risk across many different investments. However, there is no question that firms focusing on high-risk-high-reward innovation have played a very substantial role in the world economy over the last decades. For example, Tesla's Elon Musk is almost legendary for taking risks that could have spelled the end of the company. And many hugely successful firms are heavily dependent on a single product or service. Uber or Facebook are paradigmatic examples.

Moreover, we are not arguing that all-or-nothing investments are the domain of the United States alone. However, it is worth noting that the United States economy has specialized, to some extent, on fostering firms that are willing to bet the farm. By this we mean that the United States has, over time, developed various institutional features that are complementary to extreme risk-taking at the firm

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[147] Franklin Allen et al., *Stakeholder Governance, Competition, and Firm Value*, 19 REV. FIN. 1315, 1317 (2015) (arguing that "stakeholder firms are more concerned with avoiding bankruptcy since this prevents their stakeholders from enjoying their benefits"). *Cf.* Michael A. Gurdon & Anoop Rai, *Codetermination and Enterprise Performance*, 42 J. ECON. BUS. 289, 290 (1990) (pointing out that employees may be more interested in maintaining stable employment than in maximizing profits).

[148] Franklin Allen, Elena Carletti, & Robert Marquez, *Stakeholder Governance, Competition, and Firm Value*, 19 REV. FIN. 1315, 1319 (2015) (using the so-called Black-Scholes-Merton model to calculate the probability of a default for each public corporation and finding that the risk of a default is almost twice as high for U.S. corporations (10.4%) as for German firms (6.6%)).

level. One of these features is a very active environment for startups.[149] The United States boasts a particularly large number of angel and venture capital investors that are skilled at evaluating, financing, and monitoring startup firms. Furthermore, the United States has the most developed capital market in the world and is thus able to quickly infuse new firms with massive amounts of capital.[150]

Moreover, the sheer size of the U.S. economy puts the United States in a particularly good position to weather the potential downside of high-risk investments at the firm level. For small countries, the loss of even a single firm can be devastating. For example, before its decline, the Finnish mobile phone producer Nokia contributed about four percent to the country's total GDP.[151] By contrast, the United States economy is large enough to deal with the collapse of even large firms. The implosion of Enron, for example, had tragic consequences for its employees, many of whom also owned Enron stock.[152] However, Enron's employees accounted for only a tiny fraction of the U.S. workforce.[153]

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[149] Stefano Breschi et al., *A Portrait of Innovative Startup Across Countries*, OECD Science, Technology & Industry Working Papers 2018/2, at 19 fig.1 Panel A (showing the number of startups by country), https://pdfs.semanticscholar.org/9c0d/af99fe0caf9e1a33caae25df2c49834b0152.pdf.

[150] *See* Dammann, *Mandatory Law Puzzle*, *supra* note 66, at 489-90 fig. 2 (listing the world's top stock exchanges by total market capitalization)

[151] Derek Scally, *Finland Is Struggling to Find a Way Towards Growth in Post-Nokia World; Microsoft's Takeover Felt Like Your Parents Had Sold a Sibling To Pay The Bills*, IRISH TIMES, April 17, 2015, at F.6.

[152] Paul L. Jim, *Don't Paint Nest Eggs in Company Colors*, N.Y. TIMES, March 30, 2018, at BU.5; Karen Alexander, *The Perils of Owning Your Company's Stock*, N.Y. TIMES, April 12, 2005, at C.3. *See* Gretchen Morgenson, *Lopsided 401(k)'s, All Too Common*, N.Y. TIMES, Oct. 5, 2003 at 3.1 (noting that the Enron 401(k) plan had invested 60% of its total assets in Enron's stock).

[153] Prior to its bankruptcy, Enron had about 21,000 employees. *E.g.*, Justin R. Kaufman, *Halting the Enron Train Wreck: Using the Bankruptcy Code to Rescue Retirement Plans*, 76 TEMP. L. REV. 595, 596 (2003). In the fourth quarter of that same year, total nonfarm employment in the United States was about 131,502,000. David S. Langdon et al., *U.S. Labor Market in 2001: Economy Enters a Recession*, MONTHLY LAB. REV. 1, 3 tab.1 (Feb. 2002). Thus, Enron accounted for about 0.015% of nonfarm employment in the United States.

Admittedly, Germany is hardly at the other end of the spectrum. Currently, Germany is the fourth largest economy in the world.[154] Its industrial giants are spread across different fields, including car manufacturing, machinery, software and pharma. Moreover, the size of its stock market is hardly negligible. In other words, even if the United States is particularly well-equipped to foster risk-taking at the firm level, there is little reason why Germany should be reluctant to encourage such risk-taking. However, this does not change the fact that, relatively speaking, the United States is better positioned than Germany to tolerate high-level risk taking at the firm level. This means that, all else equal, it has more to lose from codetermination, which discourages such risk-taking.

CONCLUSION

The idea that corporations ought to be managed primarily in the best interest of shareholders has long had its critics. However, the practical relevance of that debate has remained limited for decades. The business judgment rule has long assured that managers have substantial autonomy in protecting other stakeholders. However, managerial autonomy finds its limit in the basic governance structure of U.S. corporations. As long as shareholders retain the right to select corporate managers, corporations will ultimately be managed in their interest. Moreover, there is little reason to believe that the commitment to shareholder wealth maximization has weakened. On the contrary, over the last decades, the rise of institutional investors and legal reforms such as say-on-pay or proxy-access have arguably increased shareholders' power over corporations.

Now, however, important voices are calling for a fundamental shift away from the shareholder primacy model and towards a more stakeholder-oriented approach to corporate governance. Two of the most influential figures on the political left, Senator Elizabeth Warren of Massachusetts and Senator Bernie Sanders of

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[154] The World Bank, World Development Indicators: Table 4.2: Structure of Output, http://wdi.worldbank.org/table/4.2 (last visited March 24, 2020) (displaying information on 2018 GDP by country).

Vermont, have put forth proposals that would allow the employees of large corporations to elect 40% or even 45% of all corporate directors. These proposals essentially build on the German system of codetermination, in which employees of large companies can elect one third or half of all board members, depending on the size of the company.

This Article has shown that such a move would be ill-conceived. We do not question that Germany has fared well with codetermination. On the contrary, Germany has enjoyed many decades of prosperity, technical innovation, and social peace. Codetermination has either furthered Germany's progress or at least not prevented it. This achievement is all the more remarkable since Germany also weathered an unusual shock in the form of German unification. Any corporate law system that allows a major economy to flourish for many decades cannot be all bad.

However, we have argued that while mandatory codetermination may well be an efficient choice for German firms, there are compelling reasons to believe that its adoption would be less desirable for the United States. Given the different institutional, social, and economic environment, some of the core benefits of codetermination are unlikely to materialize in the United States. At the same time, some of the indisputable costs of codetermination would likely be much higher in the United States than they are in Germany.

Of course, it is conceivable that the pertinent institutional, economic, and social differences diminish over time. For example, perhaps labor unions will once again play a dominant role in setting U.S. wages, which would allow codetermination to play an important role in avoiding conflicts between unions and employers. Perhaps U.S. securities law and capital markets will become less effective at allowing investors to monitor corporations, which would render codetermination more attractive as an alternative monitoring mechanism.

At this point, however, there is no reason to believe that these and other relevant changes will occur anytime soon. For the foreseeable future, therefore, proposals seeking to import mandatory codetermination ought to be put to rest.

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