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ABSTRACT

A system of shared corporate governance between shareholders and workers, codetermination has been mostly ignored within the U.S. corporate governance literature. When it has made an appearance, it has largely served as a foil for shareholder primacy and an example of corporate deviance. However, over the last twenty years—and especially in the last five—empirical research on codetermination has shown surprising results as to the system's efficiency, resilience, and benefits to stakeholders. This Article reviews the extant American legal scholarship on codetermination and provides a fresh look at the current state of codetermination theory and practice. Rather than experiencing the failures predicted by our law-and-economics framework of shareholder primacy, codetermination has fared better than alternative systems, particularly with respect to the ravages of the Global Financial Crisis. At a time when corporate leaders, politicians, and academics are rethinking the shareholder primacy model, the Article presents an updated perspective on codetermination and invites U.S. scholars to reexamine their prior assumptions.

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I. INTRODUCTION

European codetermination—the system of corporate governance where shareholders and employees share control—has long stood in contrapose to our Anglo-American system of shareholder primacy. The contrast was not as stark in the middle of the twentieth century, when a third of U.S. employees were represented by unions, and corporate executives ruled with relative autonomy. But as shareholders grew more assertive and academics pressed for a more robust adherence to the primacy norm, the presence of employee representatives on the corporate board became a point of divergence between Anglo-American and Continental European companies.[1] And by century's end, the United States had introduced its corporate governance model into the former Soviet-bloc countries and endeavored to make it the international standard.[2] Pure and unadulterated shareholder wealth maximization was ascendant.

Academic attention to codetermination's alternative governance model has been, at best, somewhat spotty. Since the 1970s, codetermination has surfaced in U.S. legal scholarship primarily as a counterexample, and occasionally as a bête noire, for advocates of the dominant paradigm.[3] Even supporters of stakeholder governance—whose vision of the corporation involves paying attention to the fortunes of all corporate constituents—have not paid it too much attention. It can come across as an unusual creature, an odd duck—a tapir in a world of horses, pigs, and cows.

Shareholder primacy, however, is losing some of its shine, and the corporate governance establishment is just starting to look around for other models.[4] In the

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[1] *See* CHRISTOPHER M. BRUNER, CORPORATE GOVERNANCE IN THE COMMON-LAW WORLD: THE POLITICAL FOUNDATIONS OF SHAREHOLDER POWER (2013) (discussing the divergences between these models).
[2] Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprise Fiascoes*, 75 N.Y.U. L. REV. 1720, 1721 (2000) ("After the fall of Russian Communism, state enterprises were privatized rapidly, stock markets created, and a corporate legal code adopted.").
[3] *See* Part III.B *infra*.
[4] *See, e.g.*, David Gelles & David Yaffe-Bellany, *Shareholder Value Is No Longer Everything, Top C.E.O.s Say*, N.Y. TIMES (Aug. 19, 2019),

meantime, codetermination has not disappeared—in fact, it seems to be thriving. While the 2008-2009 financial crisis crippled economies across the globe, systems with codetermination were more resilient than most.[5] In particular, Germany, with its distinctive and well-known version of worker participation, has been an island of economic stability over the last twenty years. At a time when academics, politicians, and business leaders are engaged in a dramatic rethinking of the shareholder-oriented consensus, codetermination has been hiding in plain sight.

While American scholars have had a small but somewhat steady diet of articles and book chapters on codetermination, this literature is significantly undersized, especially relative to the attention lavished on the minutiae of shareholder primacy. A deeper dive into the workings of codetermination is critical now that ESG investors are pushing for more than happy talk and the shareholder primacy model is losing its grip. Fortuitously, a surge in economic research on codetermination provides a rich vein for investigation by corporate law scholars, who have immersed themselves in economic analysis since the 1970s.

This paper explores codetermination, with a focus on German codetermination, in theory and practice. Part II establishes the basics of codetermination and briefly reviews both the U.S. and German experience with employee representation. Part III explores codetermination in theory, particularly within the literature on shareholder primacy from the last forty years of research. Part IV discusses the recent economic literature on codetermination, particularly its effects on economic performance, shareholders, and other stakeholders. We believe that American scholars need to make codetermination part of the corporate governance research agenda, and we hope this article provides an entry point for our cohort.

II. WHAT IS CODETERMINATION?

Shareholder primacy is so entrenched in American corporate law and scholarship that it sometimes seems difficult to imagine any other way of thinking about the corporation. This lack of imagination may help explain why arguments for the exclusive shareholder franchise continue to plod along in the

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https://www.nytimes.com/2019/08/19/business/business-roundtable-ceos-corporations.html.

[5] *See* Part IV.A *infra*.

background of an awful lot of corporate governance scholarship. It has certainly kept many legal scholars from seriously considering alternative models. There are, however, good examples of such models, some of which have been around for a century. What's more: they specifically involve employee representation on corporate boards.

"Codetermination" is the umbrella term for systems in which workers play an official role in corporate governance. Germany has the most well-known system of codetermination, but other European countries such as Austria, Poland, Denmark, and Sweden have provided employees with a variety of the form.[6] The term itself reflects the principle of shared governance—the joint management of enterprise between capital and labor.[7] As a broader principle, codetermination sometimes encompasses other methods of worker-management cooperation, such as works councils or interest arbitration.[8] However, more frequently it refers specifically to designated worker representation on corporate boards.[9]

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[6] Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441, 478 (2014) ("Many other European countries including Austria, France, Poland, Denmark, Sweden, Finland, and the Netherlands have also adopted some type of codetermination regime."); Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 203 (1994) ("Labor participation on corporate boards exists in many European countries, albeit in very different forms and degrees.").

[7] Clyde W. Summers, *Employee Voice and Employer Choice: A Structured Exception to Section 8(a)(2)*, 69 CHI.-KENT L. REV. 129, 133 (1993) (finding that under codetermination, workers are "considered members of the enterprise and entitled to a voice in its decisions, with a share in the enterprise because of their contribution to its production and profitability").

[8] *Id.* at 135-36; *see also* Julian Constain, *A New Standard for Governance: Reflections on Worker Representation in the United States*, 24 FORDHAM J. CORP. & FIN. L. 409, 412-13 (2019) ("German codetermination operates in two distinct ways. First, it exists at the shop level through workers' councils; second, it exists at the corporate level through the representation of workers on supervisory boards.").

[9] *See, e.g.*, Edward B. Rock & Michael L. Wachter, *Tailored Claims and Governance: The Fit Between Employees and Shareholders*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 121, 147-48 (Margaret M. Blair & Mark J. Roe eds., 1999) (noting that codetermination "refers to employee representatives on the board of directors"); Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1753 (1990) (defining German codetermination as a system "under which workers in all large corporations are

In this survey we focus on German codetermination because of its notoriety, its comprehensive nature, and the importance of Germany to the international economy. First, however, we look to the history of codetermination and worker participation within the United States.

A. Codetermination in the United States

In the United States, corporate boards have been almost exclusively the domain of shareholders.[10] While the United States has some history of employee participation on corporate boards, it's pretty thin gruel.[11] Because state law dictates corporate governance, a system of codetermination would be up to the states to implement, absent future federalization. The oldest state codetermination law still in force is a 1919 Massachusetts statute that expressly allows a corporation to have employee representatives on its board.[12] That law, however, is permissive, and after a brief boomlet of participating companies at the time of its passage, there's not much evidence that Massachusetts corporations have made use of the option.[13] Corporate boards have remained free from mandated employee representation under state law.

Despite its absence from corporate law, the idea of employee board representation in practice has waxed and waned over the years.[14] As a general matter, unions have largely been uninterested or opposed to the idea, as they have feared that board representation might lead to cooptation, compromise, and

entitled to elect up to half of the company's board of directors"); Hopt, *supra* note 6, at 203; Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 936 (1993) ("Under the German system of codetermination, workers elect representatives to serve on supervisory boards of directors that engage in strategic corporate decisionmaking.").

[10] *See* Matthew T. Bodie, *Employees and the Boundaries of the Corporation*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 85, 86-87 (Claire A. Hill & Brett H. McDonnell eds., 2012) (discussing the general structure of American corporate governance and noting that employees have "no role").

[11] For a comprehensive rundown, see Ewan McGaughey, *Democracy in America at Work: The History of Labor's Vote in Corporate Governance*, 42 SEATTLE U. L. REV. 697 (2019).

[12] MASS. GEN. LAWS ch. 156, § 23 (2018); *see* McGaughey, *supra* note 11, at 718.

[13] McGaughey, *supra* note 11, at 718-19.

[14] Brian Hamer, *Serving Two Masters: Union Representation on Corporate Boards of Directors*, 81 COLUM. L. REV. 639, 639 (1981) ("Employee representation on corporate boards of directors is not a new idea in the United States.").

weakness.[15] In the 1970s, however, labor engaged in several (ultimately unsuccessful) efforts for board representation at individual companies. In their role as shareholders, workers and union pension funds introduced proxy proposals for employee board representation at companies like Ford, AT&T, and United Airlines.[16] Unions were only successful in their efforts when working with management as part of overall labor negotiations. In 1973, a small railroad company agreed to board representation as part of a collective bargaining agreement.[17] In 1980, the United Auto Workers secured a board seat for its president at Chrysler, and a union member was elected at Pan American Airways in 1982.[18] Chrysler's board seat for the union president ended in 1991 but was then revived when it was purchased by the German corporation Daimler-Benz.[19]

The only other significant instances of employee board representation came through instances of employee ownership. Employee ownership refers to ownership structures through which employees hold a significant or majority stake in the enterprise. Workers could, of course, simply buy up the stock in their employer individually, assuming that the shares are publicly sold.[20] But the capital required for a meaningful percentage of equity are well-beyond most employees' means. Instead, different vehicles have been developed to facilitate employee participation in ownership.

The most common set of ownership vehicles falls under the category of ESOPs—employee stock ownership plans.[21] Rather than individual holders, the ESOP provides an investment vehicle which holds a controlling equity stake in

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[15] *Id.* ("Union and business leaders in this country, however, have consistently opposed employee representation, favoring instead exclusive reliance on the adversarial process of collective bargaining.").

[16] McGaughey, *supra* note 11, at 729-30.

[17] Davison Douglas, *Labor Unions in the Boardroom: An Antitrust Dilemma*, 92 YALE L.J. 106, 106 n.1 (1982).

[18] Id.

[19] Although framed as a "merger of equals," Chrysler was subsumed into Daimler-Benz and fell under the German laws of codetermination. *See* BILL VLASIC & BRADLEY A. STERTZ, TAKEN FOR A RIDE: HOW DAIMLER-BENZ DROVE OFF WITH CHRYSLER 238 (2000).

[20] Federal securities regulations would complicate matters if the employees constitute an investment group. *See* 15 U.S.C. § 78n(1) & (2).

[21] Robert Hockett, *Why (Only) ESOPs?*, 12 STAN. J.L. BUS. & FIN. 84, 88 (2006) ("In speaking of ESOPs (or 'plans'), one can be speaking of any of several distinct, cognate kinds of financial arrangement."). For an overview of different ESOP types, see JOSEPH R. BLASI, EMPLOYEE OWNERSHIP: REVOLUTION OF RIPOFF? 64-84 (1988).

the company. Essentially, a chunk of the employer's equity is transferred to the plan, and the plan pays back the corporation for the value of the shares. Most ESOPs fund the purchase of stock through debt that is secured through the stock as well as a pledge from the employer.[22] Employees participate in the ESOP not as shareholders but as beneficiaries. Because an ESOP plan falls under ERISA, it provides tax benefits as well as fiduciary obligations to its participants—the employees.[23] Publix Super Markets, the largest employee-owned company in the United States, is owned by employees through an ESOP as well as the company's 401(k) plan.[24]

Although ESOPs may appear to provide employees with participation in governance through ownership, the reality is much more removed. Because ESOPs are trusts, they are controlled and managed by trustees on behalf of the beneficiaries. Trustees control voting rights over the shares and need only vote in the employees' interests as beneficiaries of the trust.[25] This means that trustees need only try to maximize the value of the shares by pursuing traditional corporate governance strategies; there is no duty to workers qua workers.[26] Because of this structure, management officials have used ESOPs to secure their own power against hostile takeovers without providing any real voice to employees.[27]

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[22] Hockett, *supra* note 21, at 88-89.

[23] 29 U.S.C. § 1107; Hockett, *supra* note 21, at 88-89.

[24] Alicia E. Plerhoples, *Representing Social Enterprise*, 20 CLINICAL L. REV. 215, 228 (2013).

[25] See Matthew M. O'Toole, *The Disproportionate Effects of an ESOP's Proportional Voting*, 85 NW. U. L. REV. 824, 828 (1991).

[26] *See* Jedidiah J. Kroncke, *ESOPs and the Limits of Fractionalized Ownership*, 2017 U. CHI. LEGAL F. 287, 297 (2017) ("For public companies, ESOP employees could vote their shares as would normal stock owners, but for privately held companies, as were and are the majority of ESOPs, the trustee controlled the voting power of unallocated and allocated shares alike, except on issues of corporate sales or ownership realignments.").

[27] Jeffrey M. Hirsch, *Labor Law Obstacles to the Collective Negotiation and Implementation of Employee Stock Ownership Plans: A Response to Henry Hansmann and Other "Survivalists"*, 67 FORDHAM L. REV. 957, 960 (1998) ("Because an ESOP can provide significant tax advantages to a company that needs increased cash flow, an employer can create an ESOP that owns a majority of the company but gives employees virtually no voice in managerial policy-making."); Julie Lynn Kaufman, *Democratic ESOPs: Can Workers Control Their Future?*, 5 LAB. LAW. 825, 825 (1989) (arguing that "the majority of ESOPs are structured to skew stock ownership heavily towards management" and "ESOP trusts thus become a means of perpetuating and entrenching current managerial control").

There are few examples of ESOPs in which employee representatives participated on the corporate board. In some cases, that representation has been pursued by unions.[28] In the mid-1990s, United Airlines restructured itself through an ESOP purchase of 55 percent of the company.[29] As part of the transaction, which was negotiated with the union representatives of the pilots and the machinists, two of the twelve directors' seats were filled by union representatives.[30] That meant that along with one other employee director representing non-union management and administrative employees, worker directors only held a quarter of the board, despite the ESOP's majority stake.[31] United filed for bankruptcy in 2002 and the ESOP was ultimately dismantled.[32]

Workers cooperatives are another way to operationalize employee ownership.[33] Cooperatives are businesses owned and run by and for their members, and worker cooperatives limit their membership to employees.[34] Like corporations, they are formed under state statutes. Unlike corporations, which are structured for shareholder governance, worker cooperatives are specifically

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[28] Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 78 (1988) ("Unions also have tried to obtain direct ownership in corporations through the creation of employee stock option plans with employee stock trusts, so as to have direct input into corporate decisions.").

[29] Jeffrey N. Gordon, *Employee Stock Ownership in Economic Transitions: The Case of United Airlines*, 10 J. APPLIED CORP. FIN. 39, 52 (1998).

[30] *Id.* at 54 ("The board consist [ed] of [twelve] members: five 'public directors,' four 'independent directors,' two 'union directors,' and one 'salaried and management' director (the latter three directors known collectively as 'employee directors').").

[31] *Id.*

[32] *See* Bill Fotsch & John Case, *United's Troubles Could Have Been Avoided*, FORBES (Apr. 17, 2017), https://www.forbes.com/sites/fotschcase/2017/04/17/uniteds-troubles-could-have-been-avoided/#40bea9d4c062; Farhad Manjoo, *United's ESOP Fable*, SALON.COM (Dec. 13, 2002), https://www.salon.com/2002/12/12/esop/.

[33] Linda D. Phillips, *Worker Cooperatives: Their Time Has Arrived,* 40 COLO. LAW. 33, 33 (2011).

[34] Alicia Alvarez, *Lawyers, Organizers, and Workers: Collaboration and Conflict in Worker Cooperative Development*, 24 GEO. J. ON POVERTY L. & POL'Y 353, 358 (2017) ("The International Co-operative Alliance (ICA) defines a cooperative as 'an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise.'").

designed to provide employee governance.[35] Each coop member participates in management decisions and receives income distributions along the lines of a traditional owner.[36] These governance rights are not transferable and terminate once the employee leaves employment. Because worker cooperatives must forego outside capital investment, they are not suited for enterprises of any substantial size and are relatively uncommon.[37] Large cooperatives such as Land-O-Lakes, Ace Hardware, and REI tend to have a wider membership that includes consumers or other non-employee stakeholders.

Stock options have also proven a popular method to give employees a stake in the success of the business. Along with other types of bonus plans, stock options allow employees to participate in the employer's growth by providing profits based on increases in the share price.[38] While proponents have touted the benefits of employee stock options for incentivizing an ownership culture,[39] options provide no governance power. Voting rights are only obtained if the option is exercised, which requires a purchase with additional funds. Most employees only exercise their options to cash in on the increase and then immediately sell; they are not long-term holders.[40] And that is probably a good thing. Investing in employer stock leaves the employee extremely vulnerable to the employer's financial health. Workers with significant stock ownership are essentially doubling down on one company—the exact opposite of a diversification strategy recommended for personal savings.[41] The experiences of

[35] Ariana R. Levinson, *Founding Worker Cooperatives: Social Movement Theory and the Law,* 14 NEV. L.J. 322, 323 (2014) ("The pure worker cooperative involves a legal structure in which each employee has one equal share in the entity and one vote.").

[36] Scott L. Cummings, *Developing Cooperatives as a Job Creation Strategy for Low-Income Workers*, 25 N.Y.U. REV. L. & SOC. CHANGE 181, 186 (1999).

[37] G. Mitu Gulati et. al., *When A Workers' Cooperative Works: The Case of Kerala Dinesh Beedi*, 49 UCLA L. REV. 1417, 1422 (2002) ("Worker cooperatives are appealing in many ways, but they are rare."); Levinson, *supra* note 35, at 323 ("Yet despite the promise they hold, worker cooperatives are relatively rare in the United States.");

[38] Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 546-47 (2003).

[39] *See, e.g.*, JOSEPH BLASI, DOUGLAS KRUSE & AARON BERNSTEIN, IN THE COMPANY OF OWNERS: IN DEFENSE OF STOCK OPTIONS (2003).

[40] *Id.* at 81 (noting that employees own "a much smaller amount" of actual stock than their stock options).

[41] The problem of lack of diversification is an endemic problem to employee ownership. *See* Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159, 207

workers at Enron, many of whom had their 401(k) plans deeply invested in Enron stock, illustrate the dangers of employee holdings of employer shares.[42]

Although putting one's own pension in employer stock is dangerous business, retirement funds are invested in a variety of mutual funds, index funds, and other financial vehicles representing trillions of dollars.[43] When these funds are managed by unions, they can exert a strong presence on corporate governance issues. Labor pension funds, especially large public-sector funds run by CalPERS and AFSCME, have led the way in efforts to strengthen shareholder voting rights, rein in the power of the CEO, and fight fraud and abuse by insiders.[44] However, they have made no play for a direct role in governance through board representation. In examining the behavior of these funds as shareholders, researchers have found not "a socialist or proletarian plot," but rather "a model for any large institutional investor attempting to maximize return on capital."[45] Actual directors' seats are not on the agenda, at least in the near term.

Despite their relative absence from the economic scene, worker directors are now very much in the policy spotlight. Both Senator Tammy Baldwin and Senator Elizabeth Warren have introduced bills that would provide for worker representation on boards. Senator Warren's Accountable Capitalism Act would provide for 40% employee board representation for companies that have more than $1 billion in gross receipts;[46] Senator Baldwin's bill would provide for a

(1991) ("Risk diversification is thus in both theory and practice the most serious problem with employee ownership as now practiced in the United States.").

42 Susan J. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305, 313 (2007) (noting that "the publicity associated with the disaster befalling participants in the 401(k) plans of companies like Enron and Global Crossing have not resulted in a significant decline in the amount of assets invested in employer securities").

43 DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON at xii (2018) (putting the valuation of worker pension funds at $3-6 trillion).

44 *Id.* at 45-78, 111-51, 172.

45 Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1019-20 (1998).

46 Accountable Capitalism Act, S. 3348, 115th Cong. § 6 (2018). *See also* Matthew Ygelsias, *Elizabeth Warren Has a Plan to Save Capitalism*, VOX.COM (Aug. 15, 2018), https://www.vox.com/2018/8/15/17683022/elizabeth-warren-accountable-capitalism-corporations.

third of the board to worker representation for all publicly-listed companies.[47] These bills reflect public sentiment supportive of employee participation in corporate governance.[48] Worker protest movements such as Google have included board representation on their list of demands.[49] And at a recent presidential debate, Senator Bernie Sanders defended his proposal for worker representation against claims of "communism."[50] Such proposals remain, at present, only proposals. But the absolute control that shareholders have over corporate governance is falling into contestation.

B. German Codetermination

Many European countries give employees some degree of access to corporate boards.[51] But the German system of codetermination offers the most robust protection of employee representation. German codetermination has also been in place for decades as part of a large, modern economy, making it the obvious exemplar of such a system.[52]

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[47] Reward Work Act, S. 2605, 115th Cong. § 3(c)(2) (2018); H.R. 6096, 115th Cong. § 3(c)(2) (2018) (same); *see also* McGaughey, *supra* note 11, at 698-99.

[48] Dylan Matthews, *Workers don't have much say in corporations. Why not give them seats on the board?*, VOX.COM (Apr. 6, 2018), https://www.vox.com/2018/4/6/17086720/poll-corporate-board-democracy-worker-council-codetermination-union-labor ("A poll of more than 3,300 American likely voters by Civis Analytics finds that a majority (53 percent) would support allowing employees at large companies to elect representatives to those companies' boards of directors, thus giving employees a direct, democratic say in how the company is run.").

[49] Noam Scheiber, *Google Workers Reject Silicon Valley Individualism in Walkout*, N.Y. TIMES (Nov. 6, 2018), https://www.nytimes.com/2018/11/06/business/google-employee-walkout-labor.html.

[50] *Full Transcript: Ninth Democratic debate in full*, NBCNEWS.COM (Feb. 19, 2020), https://www.nbcnews.com/politics/2020-election/full-transcript-ninth-democratic-debate-las-vegas-n1139546 (reporting that Sen. Sanders said, "I want workers to be able to sit on corporate boards, as well, so they can have some say over what happens to their lives," and that Mayor Bloomberg called the proposal "ridiculous" and "communism").

[51] For a recent list of countries, see Ewan McGaughey, *Votes at Work in Britain: Shareholder Monopolisation and the "Single Channel*,*"* 47 INDUS. L.J. 76, 79-80, 79 n.17, & 80 fig.1 (2018).

[52] See Robert Scholz & Sigurt Vitols, *Board-level Codetermination: A Driving Force for Corporate Social Responsibility in German Companies?,* 25 EUR. J. IND. REL. 233, 233-34 (2019).

The term "codetermination" has been used to describe two different features of German economic life.[53] "Social codetermination" involves employee representation on shop-level works councils at all companies with at least five employees.[54] The works councils have a broad range of rights in the workplace, ranging from the right to receive economic and financial information to the right of consultation on matters relating to the organization and structure of jobs to the power to negotiate work agreements.[55] "Supervisory codetermination," on the other hand, describes employee representation at the level of the corporate board,[56] and is of greater interest here.

Supervisory codetermination laws dictate the composition of the boards of directors for large German companies.[57] Unlike the United States, Germany uses a two-tiered corporate board structure.[58] The supervisory board provides more general oversight of the company and appoints the members of the management board.[59] The management board runs the company, directing resources and making the day-to-day business decisions.[60] Management boards of larger companies also have a personnel director responsible for all matters relating to

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[53] Here we are using the terminology from Otto Sandrock & Jean J. du Plessis, *The German System of Supervisory Codetermination by Employees*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 167, 169 (Jean J. du Plessis *et al.* eds., 3d ed. 2017).
[54] *See id.* at 169-71.
[55] *See* JOHN T. ADDISON, THE ECONOMICS OF CODETERMINATION: LESSONS FROM THE GERMAN EXPERIENCE 16-19 (2009).
[56] *See* Sandrock & du Plessis, *supra* note 53, at 169.
[57] *See id.* at 172-78.
[58] *See* Jean J. du Plessis *et al.*, *An Overview of German Business or Enterprise Law and the One-Tier and Two-Tier Board Systems Contrasted*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at 1, 8-13.
[59] *See* Jean J. du Plessis & Otto Saenger, *The Supervisory Board as Company Organ*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at 105, 133-53; Jean J. du Plessis & Otto Saenger, *The General Meeting and the Management Board as Company Organs*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at 63, 73 [hereinafter du Plessis & Saenger, *General Meeting*].
[60] Generally speaking, the two-tiered boards are probably better at supervising top employees because there are fewer of the conflicts of interest that occur when managers are on the corporate board; without those managers, though, information may flow to the supervisory board more sluggishly.

labor relations.[61] The supervisory board is thus more analogous to the American board of directors, while the officers in U.S. corporations share many of the responsibilities of the management board.[62]

The degree of supervisory codetermination on German corporate boards depends on the type of industry, the number of employees, and a few other factors.[63] Corporations with fewer than 500 employees have supervisory board members elected solely by shareholders. However, corporations with 500 to 2000 employees typically have one-third of their board members elected by employees (called, unsurprisingly, one-third board parity), and companies with more than 2000 employees have one-half of their supervisory board members elected by employees.[64] In most of these large companies with one-half codetermination, employees enjoy "quasi-parity" because shareholders elect the chair (and potential tiebreaker vote). In the coal, iron, and steel industries, however, there is a neutral chair (and tiebreaker), giving the employees "full parity," or a truly shared system of governance.[65]

Volkswagen workers have a unique arrangement, one that takes codetermination to the next level. Originally a project of the German government during the Nazi era, the company was transferred into private hands in 1960. As part of the transfer, the government passed a special "Volkswagen law" that gave seats on the supervisory board the local government of Lower

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[61] Depending on the level of codetermination (discussed below) the personnel director has the support of the employee representatives of the supervisory board. For full-parity codetermination governed by the 1952 law, employee representatives have veto power over the appointment of the personnel director; for companies with quasi-parity codetermination, personnel directors are usually not appointed unless they enjoy the support of the employee representatives. *See* Otto Sandrock, *German and International Perspectives of the German Model of Codetermination*, 26 EUR. BUS. L. REV. 129, 131-32 (2015).

[62] Thilo Kuntz, *German Corporate Law in the 20th Century*, *in* RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW 205 (Harwell Wells ed., 2018) (discussing how supervisory directors had traditionally been part-time positions somewhat removed from day-to-day governance, but have recently stepped up their oversight roles).

[63] *See* Sandrock & du Plessis, *supra* note 53, at 182-83.

[64] *See* Jean J. du Plessis & Ingo Saenger, *An Overview of the Corporate Governance Debate in Germany*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at 17, 48-49; Sandrock & du Plessis, *supra* note 53, at 173-78; ADDISON, *supra* note 55, at 103; Sandrock, *supra* note 61, at 131-32.

[65] *See* Sandrock & du Plessis, *supra* note 53, at 173-76. This is true of companies in these sectors at a lower threshold—1000 instead of 2000 employees.

Saxony.[66] Because the government directors tended to side with the employees, Volkswagen has a de facto worker majority.[67]

Over the last thirty years, Germany has followed certain international trends in corporate governance: directors on supervisory boards have become more professionalized and less insular; banks and insurance companies do not quite have the same dominant shareholdings that they once had; and legislation has required heightened auditing standards and shareholder rights.[68] But the movement—predicted by some—towards a shareholder primacy model has not materialized. Rather, the 2008 financial crisis slowed, or even reversed, efforts to bring Germany closer to the Anglo-American system.[69] Germany's particular style of codetermination remains solidly entrenched within the German economic system, as well the European and international political economy.

III. CODETERMINATION IN THEORY

So what have American corporate law scholars made of this alternative version of corporate governance, one that actually exists in the form of flesh and blood German supervisory boards? For decades, codetermination has received

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[66] Law of 21 July 1960 on the privatisation of equity in the Volkswagenwerk limited company (Gesetz über die Überführung der Anteilsrechte an der Volkswagenwerk Gesellschaft mit beschränkter Haftung in private Hand, BGBl. 1960 I, p. 585, and BGBl. 1960 III, p. 641-1-1.

[67] In addition, individual Volkswagen shareholders were limited to a maximum of 20% of the voting rights. In 2007, this limitation was overturned by the European Union Court of Justice as a violation of the free movement of capital within the E.U. *See* Case C-112/2005, dated 23 October 2007, Commission v. Federal Republic of Germany "Volkswagen." In response, Volkswagen changed its charter in 2009 to give directors certain veto powers over plant closures and layoffs. For additional discussion of Volkswagen's unique governance, see JACK EWING, FASTER, HIGHER, FARTHER: THE VOLKSWAGEN SCANDAL 57 (2017); Nicola Faith Sharpe, *Volkswagen's Bad Decisions & Harmful Emissions: How Poor Process Corrupted Codetermination in Germany's Dual Board Structure*, 7 MICH. BUS. & ENTREPRENEURIAL L. REV. 49, 62 (2017); Peer Zumbansen & Daniel Saam, *The ECJ, Volkswagen and European Corporate Law: Reshaping the European Varieties of Capitalism*, 8 GERMAN L.J. 1027 (2007).

[68] Kuntz, *supra* note 62, at 233.

[69] *See* Andreas Rühmkorf, Felix Spindler & Navajyoti Samanta, *Evolution of German corporate governance (1995-2014): an empirical analysis*, 19 CORP. GOV. 1042 (2019).

little more than passing attention from corporate governance scholars.[70] It is rarely given the kind of in-depth treatment that a fully functioning, alternative model of corporate governance would seem to demand.[71] Instead, corporate law scholars in American have spent much of the last fifty years focused on shareholder primacy.

A. The Hegemony of Shareholder Primacy

Shareholder primacy has been the dominant corporate governance model in the United States for decades. The basic corporate structure—where shareholders elect the directors, who in turn select the officers to run the corporation—replicates itself in corporations from every state. While there are some variations in governance structures, both among actual corporations and in the guise of potential reforms, this corporate form has remained relatively stable over the last century. Its critical governance feature—who gets to vote, about what, and under what circumstances—has also been fixed: the corporate franchise belongs to shareholders and shareholders alone. And shareholder governance is not limited to board elections. Shareholders have voting rights to amend the corporation's charter as well as its bylaws,[72] and transformative corporate decisions—such as mergers, certain acquisitions, and dissolution (the end of the corporation)—also require shareholder approval.[73] From start to finish, shareholders call the shots in American corporate law.

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[70] *See, e.g.*, CORPORATE LAW AND ECONOMIC ANALYSIS 295-96 (Lucian Arye Bebchuck ed., 1990) (one passing reference to codetermination); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 69 (1991) (again, one passing reference to codetermination); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 110-112 (1996) (a few pages); STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 47-49 (2008) (a few pages, though he wrote a couple of earlier articles on what he called "participatory management"); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 230 (2008) (some passing references to the German system).

[71] One refreshing exception is EMPLOYEES AND CORPORATE GOVERNANCE 163-235 (Margaret M. Blair & Mark J. Roe eds., 1999).

[72] Generally, the board of directors must first propose an amendment to the charter, and then the shareholders must approve the amendment. *See, e.g.*, MODEL BUS. CORP. ACT § 10.03 (2016). In Delaware, the amendment must be approved by a majority of all shares outstanding, rather than just a majority of shares voting. DEL. CODE ANN. tit. 8, § 242(b)(1) (2019).

[73] WILLIAM A. KLEIN, ET AL., BUSINESS ORGANIZATION AND FINANCE 222-25 (11th ed. 2010) (describing different types of mergers and acquisitions).

Over time, scholars have developed an intellectual framework in support of this central role that shareholders play in corporate governance. As they developed the framework, the role of shareholders within the corporation evolved from that of absentee landlords to the focus of the entire enterprise. The resulting theory of shareholder primacy redesigned the purpose and function of the corporation to revolve around shareholder wealth maximization.[74] And the shareholder primacy norm, a familiar notion even to nonlawyers, now has wide acceptance in both theory and practice.

The main scholarly justifications for the central control feature of shareholder primacy—the exclusive shareholder franchise—were generated in the latter part of the twentieth century. One model describes the corporation as a nexus of freely bargained contracts among all corporate constituents, and therefore presumptively the most efficient way to structure firm governance.[75] Another argument is that shareholders are owners of the corporate residual, and they have the appropriate incentives to make good firm decisions.[76] Rights to the residual provide shareholders with a common interest in maximizing corporate profits, which reduces their tendency to squabble about firm decisions and thus promotes efficiency. This homogeneous interest in profits also eliminates the possibility of destructive voting cycles, à la Arrow's theorem.[77]

We have routinely questioned these traditional arguments for the shareholder franchise. The nexus of contracts model of the corporation is an entirely fictitious account of the corporation and its constituents, and tells us

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[74] Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 977 (2006) ("This [shareholder primacy] norm is much more than a descriptive account of shareholders' rights; it is instead a normative judgment on the most socially efficient way of organizing the economy.").

[75] *See* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9 (2002) ("The dominant model of the corporation in legal scholarship is the so-called nexus of contracts theory."); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.").

[76] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67-68 (1991) (justifying the corporate franchise based on shareholders' interests in the residual).

[77] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983) (discussing KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963)).

very little about the choices that actual shareholders and other corporate constituents would make in the absence of various constraints.[78] The argument based on the residual is undercut by the growing realization that shareholders do not have a common interest in wealth maximization, but instead have interests that diverge along a number of dimensions.[79] As a result, scholars are losing trust in shareholders with significant power,[80] and there is even support for nonvoting shares and passive shareholding.[81] Those who support strengthened shareholder power are even accused of supporting special interests and shadow

[78] See Grant M. Hayden & Matthew T. Bodie, *Shareholder Voting and the Symbolic Politics of Corporation as Contract*, 53 WAKE FOREST L. REV. 511 (2018).

[79] *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 791 (2017) (describing "several sources of conflict among shareholders, including differing investment horizons and needs for cash payouts, empty voting, and competing outside interests"); Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 477-98 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 574-92 (2006).

[80] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1258 (2008) ("[A]ctivist shareholders are using their growing influence not to improve overall firm performance, as has generally been assumed, but to profit at other shareholders' expense."); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1750 (2006) ("[S]hareholder voting is properly understood not as a primary component of the corporate decisionmaking structure, but rather as an accountability device of last resort, to be used sparingly, at most.").

[81] Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 697-98 (2019); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 497 (2018) (arguing that passive funds should not have voting rights).

agendas.[82] And the argument based on Arrow's theorem, with its prediction of firm-destroying voting cycles, was nonsensical from the very beginning.[83]

So while it may seem an ideal time to examine alternatives to the traditional model, competing corporate law theories have not filled this gap. Board primacy theories may do a better job describing the actual relationship between shareholders and the board of directors,[84] or better take into account the many participants in the life of a corporation,[85] but they fall back upon the traditional arguments to support the retention of the exclusive shareholder franchise.[86] Stakeholder theories propose that corporate governance should take all stakeholder into account,[87] but they lack a model for allocating governance

[82] *See, e.g.*, Bainbridge, *supra* note 80, at 1754 (claiming that Lucian Bebchuk's argument for shareholder empowerment would help "precisely the institutions most likely to use their position to self-deal—that is, to take a non-pro rata share of the firm's assets and earnings—or otherwise to reap private benefits not shared with other investors"); Hon. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014) ("Bebchuk is the sincere champion of one group of 'agents' wielding power and authority over others' money—the money managers who control most of the investments belonging ultimately to ordinary Americans who are saving to pay for their retirements and for their children's education—against another group of 'agents' that he believes is somehow more conflicted--the agents who actually manage corporations that make real products and deliver useful services (i.e. 'productive corporations').").

[83] *See* Grant Hayden & Matthew Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1219 (2009).

[84] *See generally* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008).

[85] *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[86] For an overview and critical evaluation of the various forms of board primacy theory, see Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, 51 WM. & MARY L. REV. 2071 (2010).

[87] *See* David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW 1, 11-12 (Lawrence E. Mitchell ed., 1995) (discussing efforts to provide protections to nonshareholder constituencies); Blair & Stout, *supra* note 85, at 293-94 (arguing that directors owe a duty to the corporation and that the corporation consists of all of the stakeholders who are responsible for the business of the enterprise).

rights and responsibilities among the participants.[88] Shareholder primacy still reigns supreme in corporate governance theory.

The triumph of shareholder primacy seemed so complete that it prompted Henry Hansmann and Reinier Kraakman to declare the end of corporate law history. "There is no longer any serious competitor," they claimed, "to the view that corporate law should principally strive to increase long-term shareholder value."[89] And, to this day, shareholder primacy remains the dominant model of corporate governance in the United States, and certainly retains a hammerlock on corporate legal scholarship. It remains an unspoken, seemingly self-evident truth about corporations.

B. Codetermination in American Legal Scholarship

The deep commitment that American legal scholars have for shareholder primacy has obvious implications for their views of codetermination. Arguments in favor of the exclusive shareholder franchise are necessarily arguments against any system of shared governance. So, in a sense, the scholarly community's assessment of German codetermination lurks beneath the surface of these broader commitments. And given the stranglehold that shareholder primacy has over American legal scholarship, that assessment, though rarely explored at any length, is largely a negative one.

With very few exceptions, corporate law scholars tend to focus on one particular aspect of the German system of codetermination: the fact that it is mandated by law. That, coupled with the absence of corporate boards with employee representatives in the United States, is viewed by the scholars as proof positive that their theoretical arguments for shareholder primacy—and, more specifically, for the exclusive shareholder franchise—are on the money.

Their argument here is a variant of the contractarian argument for the exclusive shareholder franchise. This version is as follows: if codetermination is so great, then firms would voluntarily adopt it. But American firms have not

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[88] *See* Eric W. Orts & Alan Strudler, *Putting a Stake in Stakeholder Theory*, 88 J. BUS. ETHICS 605, 611 (2009) (arguing that stakeholder theory fails to provide a system of mechanisms for governance, other than "balancing" stakeholder concerns); Joseph Heath, *Business Ethics Without Stakeholders*, 16 BUS. ETHICS Q. 533, 543 (2006) (arguing that stakeholder theory creates "extraordinary agency risks" because of the potential for conflicts).

[89] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

done so. Codetermination, therefore, is not that great and, in fact, is less efficient than the method of governance chosen in the United States, with corporate boards elected by shareholders alone. In fact, the only way a firm would end up with employee representation on its board is if you mandate it, as Germany does by law. In short, nobody freely chooses codetermination, thus it is less efficient than having shareholders run the show.

A wide range of legal scholars have made versions of this argument that codetermination must be inefficient because it has not been voluntarily adopted by firms.[90] Stephen Bainbridge, for example, has made a number of arguments against shared governance.[91] Those more general arguments—which largely spring from his views about the corporation as a nexus of contracts, his application of Kenneth Arrow's distinction between consensus and authority decisionmaking, and his reasons for advancing board primacy—have been critiqued elsewhere.[92] More specifically, though, Bainbridge notes that voluntary adoption of codetermination is "very rare."[93] Instead, shared governance is usually adopted by national legislation. The German system, for example, was created by "sweeping statutory mandates."[94] For Bainbridge, this lack of voluntary adoption reinforces his other arguments against shared governance, for "[in] the absence of any documented market failure, it is fair to infer from this evidence that codetermination is less efficient than the Anglo-American tradition of excluding workers from board representation."[95]

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[90] This argument in broader theoretical context is also discussed in ADDISON, *supra* note 55, at 104-08.

[91] See, e.g., Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1054-55 (1998) [hereinafter Bainbridge, *Privately Ordered Participatory Management*]; Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657 (1996).

[92] *See, e.g.*, Grant M. Hayden & Matthew T. Bodie, *Shareholder Voting and the Symbolic Politics of Corporation as Contract*, 53 WAKE FOREST L. REV. 511, 530-46 (2018) (critiquing the nexus of contracts view of corporations); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 143 (2009) (critiquing his applications of Arrow's views on consensus and authority in decisionmaking); Hayden & Bodie, *supra* note 86 (critiquing the relationship between the arguments for board primacy and those for the exclusive shareholder franchise).

[93] Bainbridge, *Privately Ordered Participatory Management*, *supra* note 91, at 1054.

[94] Id.

[95] *Id.* at 1054-55.

George Dent makes a similar argument with respect to the broader concept of stakeholder representation (though he mostly focuses on employees).[96] As he explains, "Apart from economic theory, there is another and perhaps more telling problem with the stakeholder concept: If stakeholder governance can produce a bigger pie, and a larger piece for each constituency, why has it not happened through private arrangements?"[97] He likens the absence of shared governance systems to "the dog that did not bark" in the *Silver Blaze*, a story in which Sherlock Holmes solves a crime by noting that a dog's silence shows than the intruder was an insider. For Dent, there are few voluntarily adopted systems of codetermination—the dogs are not barking—and that tells us something important about the purported benefits of such a system.

Roberto Romano approaches the issue in a similar fashion, though expands her list of silent dogs to include state governments.[98] "It is questionable," she says, "whether such worker representation provisions enhance shareholder value. If they did, one would expect U.S. states and firms to opt for such arrangements . . . ."[99] In other words, market forces would lead both corporations and state governments to adopt shared governance were it perceived to increase share value. And to top it off, she adds that though the German codetermination model is available in France, almost no French firms have adopted it.[100]

Henry Hansmann and Renier Kraakman make a similar point.[101] After discussing a range of potential advantages to employee representation, they (along with coauthors Luca Enriques and Mariana Pargendler) nevertheless end with these questions: "if large efficiencies result from codetermination, why do the parties fail to contract for labor directors voluntarily and divide the surplus? Why do we seldom see labor directors where they are not mandated by law?"[102]

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[96] *See* George W. Dent, Jr., *Stakeholder Governance: A Bad Idea Getting Worse*, 58 CASE W. RES. L. REV. 1107, 1115-16 (2008).
[97] *Id.* at 1115. This particular argument elides the possibility that codetermination might produce a bigger overall pie without producing a larger piece for every constituency.
[98] *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 129-30 (1993).
[99] *Id.* at 130.
[100] See id.
[101] *See* Luca Enriques, Henry Hansmann, Renier Kraakman & Mariana Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 79, 106 (John Armour *et al*. eds., 3d ed. 2017); *see also* Hansmann & Kraakman, *supra* note 89, at 445.
[102] Enriques *et al*., *supra* note 101, at 106.

While there may be cultural explanations, the authors note that "a competing explanation is that the costs of labor representation exceed its benefits, or at least are feared to do so."[103] Elsewhere, Hansmann and Kraakman note, "The growing view today is that meaningful direct worker voting participation in corporate affairs tends to produce inefficient decisions, paralysis, or weak boards, and that these costs are likely to exceed any potential benefits that worker participation might bring."[104]

So this argument has been made by Bainbridge, Dent, Romano, Hansmann, and Kraakman in the 1990s through the early 2000s. But it may have been first (and in any case, most forcefully) made by Michael Jensen and William Meckling in the late 1970s.[105] "Without fiat," they flatly claimed, "codetermination would be virtually nonexistent."[106] They then backed up this argument with a prediction: German codetermination would soon devolve into a system in which either shareholders or employees had complete control.[107] If the former, then codetermination would just go away, and be replaced by the shareholder control that dominates the landscape in the United States.[108] If, however, employees succeed in controlling firms, then the Germany economy would grind to a halt like Tito's Yugoslavia, with "fairly complete, if not total, state ownership of the productive assets in the economy."[109]

Some forty years later, Jensen and Meckling's prediction looks laughable. German codetermination remains in place and, as we shall soon see, is an important aspect of its robust economy. More recently Jens Dammann and Horst Eidenmüller have taken a different tack: they argue that while codetermination might work in Germany, it is a "poor fit" with the United States.[110] They argue that certain aspects of the German economy—such as robust unions, protections against unjust terminations, and a slower market for corporate control—make codetermination work better there than it would in America. Thus, even

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[103] *Id.*
[104] Hansmann & Kraakman, *supra* note 89, at 445.
[105] See Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 473-75, 503-04 (1979).
[106] *Id.* at 473.
[107] *See id.* at 503.
[108] *See id.*
[109] *Id.* at 504.
[110] Jens Dammann and Horst Eidenmüller, Codetermination: A Poor Fit for U.S. Corporations, Working Paper, April 9, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3565955.

conceding that "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."[111]

C. Shortcomings in Codetermination Scholarship

There are a number of shortcomings in the way in which American corporate law scholars use German codetermination to make their case for shareholder voting. Initially, their arguments are based on a flawed understanding of how German codetermination actually came into existence. In addition, they largely overlook the many possible reasons individual firms might not voluntarily adopt a system of employee representation despite the fact that it may lead to overall welfare gains (and perhaps even gains to shareholders themselves). Finally, U.S. scholars have yet to engage in the real debate over codetermination: the question of shareholder versus employee power.

1. The Origins of German Codetermination

The theoretical arguments for the exclusive shareholder franchise have always been vulnerable to a factual rebuttal. This is especially true because many of the arguments trade on the disasters that would allegedly befall firms that deviate from the model of shareholder control. One solid counterexample of a firm that involved shared governance—and held its own, or even thrived, in the marketplace—should be enough to undercut even the most elaborate theoretical justification. The recent performance of the German economy (indeed, its continued existence) not only makes mockery of Jensen and Meckling's specific prediction, but more generally undermines the arguments for the exclusive shareholder franchise. And for that reason, we will look at the empirical research evaluating German codetermination in Part IV.

Here, though, we focus on the more specific claim that codetermination must be inefficient because nobody voluntarily agrees to such a system of corporate governance; it must, instead, be mandated. But it turns out that this position, too, may be subject to empirical rebuttal. And, in fact, a key assumption underlying the claim—that codetermination can only arise through fiat, not voluntary agreement—has itself been revealed to be false.

Ewan McGaughey, a U.K. legal historian and economist, recently showed that German codetermination first arose through collective agreements and only

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[111] *Id.* at 49.

later was enacted into law.[112] Codetermination arrived at the end of World War I, "not as a law, not as a regulation, but as an agreement."[113] Only afterward did supervisory codetermination get codified into legislation.[114] Codetermination was then abolished by the Nazi Regime with a 1934 statute,[115] only to be recreated—again though agreement—at the conclusion of World War II.[116]

The basic sequence was that codetermination arose through consensual agreement, developed into social consensus, and later became embodied in the law.[117] This history shows that the law and economics scholars are not just wrong on this point, but may have the picture completely upside down: codetermination was created by agreement not once but twice, while the law was sometimes used to quash it.[118] So if codetermination arose through voluntary agreement in Germany, why didn't the same bargain get struck everywhere else? What was so special about Germany? McGaughey identifies two, relatively rare "Goldilocks" conditions that existed in postwar Germany: first, employers and employees had relatively equal bargaining power, and, second, the labor movement was unified around a common objective of securing meaningful representation at work.[119] These two conditions made the codetermination bargain possible.

Now, it might be argued that the historical rarity of these Goldilocks conditions makes the German example unique, ingermane to the more typical bargains struck by labor and capital. But a closer look at those conditions shows that, if anything, the opposite is true. Remember, the contractarian argument draws its normative force from the assumption that freely bargained for agreements better reflect the preferences of the parties.[120] All things being equal, they reflect the most efficient outcome. But in order for this to work, the parties must actually be free to bargain. That freedom may be limited if the parties are in unequal bargaining positions (making it less likely that the weaker party is

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[112] *See* Ewan McGaughey, *The Codetermination Bargains: The History of German Corporate and Labor Law*, 23 COLUM. J. EUR. L. 135 (2016).
[113] *Id.* at 155.
[114] *See id.* at 157.
[115] *See id.* at 162.
[116] *See id.* at 163-67.
[117] *See id.* at 174.
[118] *See id.* at 170.
[119] *See id.* at 136-37, 155-56, 168.
[120] *See* Grant M. Hayden & Matthew T. Bodie, *Shareholder Voting and the Symbolic Politics of Corporation as Contract*, 53 WAKE FOREST L. REV. 511, 531, 533, 541-42 (2018).

really getting what it wants), one group of constituents has coordination problems (again, reducing their bargaining power), or there are legal or logistical roadblocks to certain kinds of agreements. The contractarian argument for the exclusive shareholder franchise fails to account for all three of these issues: employees have never had equal bargaining power; U.S. labor unions have never represented more than one-third of private-sector employees, and currently represent less than 7 percent; and both legal and logistical roadblocks make it difficult for American unions to participate in corporate governance.[121]

The Goldilocks conditions, in other words, do not reflect the conditions that surround the formation of U.S. corporations, but they *do* reflect the kind of rare situation that gets the contractarian arguments up and running and gives them their normative force. Corporate constituents in the presence of those conditions do not, however, hand over all governance authority to shareholders. They instead put both shareholder and employee representatives on the board. Like the argument from Arrow's theorem—where we learned that the presence of an oppositional electorate actually *decreases* the chance of a voting cycle[122]—the contractarian argument, if anything, ends up militating in favor of employee representation. When corporate stakeholders have relatively equal bargaining power and are free of internal coordination problems, they bargain for codetermination.

2. The Limitations of Private Ordering

The primary theoretical argument against adoption of codetermination within the United States has been its failure to naturally catch on at individual companies. Under U.S. market settings, there are a number of reasons why codetermination may not be voluntarily introduced even if it increases overall

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[121] For discussions of the legal impediments to systems of worker participation, see Matthew T. Bodie, *Holacracy and the Law*, 42 DEL. J. CORP. L. 619, 662-71 (2018); Jeffrey M. Hirsch, *Labor Law Obstacles to the Collective Negotiation and Implementation of Employee Stock Ownership Plans: A Response to Henry Hansmann and Other "Survivalists,"* 67 FORDHAM L. REV. 957 (1998). Dammann and Eidenmüller argue that the low rate of unionization within the U.S. is actually a reason not to adopt codetermination, because employees will not be in as good a position to take advantage of the board seats. Dammann and Eidenmüller, *supra* note 110, at 23-24.

[122] *See* Hayden & Bodie, *supra* note 83, at 1238.

utility. First, allocation and distribution are not separated.[123] Employees with governance rights may engage in rent-seeking in ways that reduce profits; even if codetermination increases overall welfare, shareholders may not go for it because it wouldn't advance their own interests.[124] This, of course, would happen whether or not shareholders would actually lose out under a system of shared governance—so long as they believe they'll lose out, they won't agree to such a system.

Second, there may be information asymmetries that prevent a company from voluntarily introducing codetermination.[125] The introduction of a new system of shared governance might, for example, send a false signal to the market that there's some problem with the firm's labor-management relations that needs fixing. That signal could affect the company's ability to raise funds, putting them at a unique disadvantage.[126]

Third, collective action problems may prevent individual firms from adopting a system of shared governance. David Levine and Laura Tyson have argued that codetermination needs to be adopted on a broad scale because individual firms find themselves in a prisoners' dilemma with regard to their existing entitlements and constituents.[127] Unilateral adoption of codetermination may lead to wage compression (resulting in the loss of managerial and executive employees) and dismissal protections (resulting in the retention of poorly performing employees), disadvantaging the adopting firm in relation to its competitors for capital and sales.[128]

Finally, there are additional reasons to think that the bargain for employee representation may not be struck by individual corporations—namely, the path-dependency and network effects of the widespread adoption of a particular system of governance. Current systems of both corporate law and ownership structures are embedded in existing businesses and may prove resistant to

[123] *See* Simon Renaud, *Dynamic Efficiency of Supervisory Board Codetermination in Germany*, 21 LABOUR 689, 691 (2007).
[124] *See id.*
[125] *See id.*
[126] *See id.* at 691-92.
[127] *See* David I. Levine & Laura D. Tyson, *Participation, Productivity, and the Firm's Environment*, *in* PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE 183 (Alan S. Blinder, ed. 1990).
[128] *See id.* at 214-19.

change.[129] Moreover, participants in the system grow accustomed to particular methods and models and must absorb transaction costs if these change.[130] The depth and consistency of Delaware corporate law as developed over time has been cited as a factor in the small state's success on the corporate law market, making it costly to incorporate elsewhere.[131] The state's solicitude towards managers and shareholders doesn't hurt, either.[132]

Without some kind of industry-wide (or economy-wide) agreement, these information asymmetries and collective action problems mean that the boards of individual firms—which are at that point still governed solely by shareholders—will rationally fail to adopt the approach that would have the greater utility overall.[133] The industry-wide bargaining that took place in post-war Germany

[129] *See* Lucian Ayre Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 129 (1999) (describing how "initial ownership structures" can affect both "subsequent ownership structures" ("structure-driven path dependence") and "subsequent structures through their effect on the legal rules governing corporations" ("rule-driven path dependence")); Eric Engle & Tetiana Danyliuk, *Emulating the German Two-Tier Board and Worker Participation in U.S. Law: A Stakeholder Theory of the Firm*, 45 GOLDEN GATE U. L. REV. 69, 110 (2015) (noting the role of path dependence).

[130] *Cf.* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1567 (1989) (discussing the externalities introduced by the use of non-standard corporate forms). *But cf.* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990) (developing the "triviality hypothesis" that, "appearances notwithstanding, state corporate law is trivial: it does not prevent companies—managers and investors together—from establishing any set of governance rules they want").

[131] *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 723 (1997) ("Most broadly, the use of generally accepted accounting principles as a baseline convention for bond covenants and the choice of Delaware as a state of incorporation facilitate obtaining high quality accounting and legal advice, respectively."); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 683 (2005) (" . . . Delaware chancellors and supreme court justices devote a considerable amount of time to fashioning sensible, fair corporate law decisions in a timely way.").

[132] *See* Strine, *supra* note 131, at 680 (". . . [C]orporation law in Delaware is influenced by only the two constituencies whose views are most important in determining where entities incorporate: managers and stockholders.").

[133] *See id.* at 214. Under the prisoner's dilemma framework, individual players make less-than-optimal choices because of the interdependency of outcomes and the inability to trust their partner/opponent.

involved exactly the kind of cooperation needed to lift corporate players out of these situations. But it's unlikely that such conditions will naturally arise in the American economy any time soon.

3. The Battle for Corporate Power

Because American corporate law scholarship has not really taken codetermination seriously, it has not joined the true conflict at the heart of the debate: the struggle between shareholders and employees—between capital and labor—for power. The U.S. system is premised on the idea that total shareholder control will keep labor in check and spur management to get the highest returns possible for equity holders. By labeling employees with all other stakeholders as "fixed" claimants, shareholder primacy can categorize an increase in shareholder returns as an overall increase in efficiency, rather than a claim to a large share of the pie. But as corporate profits and share prices have ratcheted upwards, and workers' wages have remained stagnant, the effects of shareholder primacy can be keenly felt. Shareholders run the game, and they use their power to increase their gains.

Codetermination breaks this shareholder vise-grip on corporate control. It empowers employees by giving them a voice and a role within the governance of the firm. As a result, shareholders are likely to see their power within the corporation diminish. But this is a feature, not a bug. There are larger empirical questions about which system works best that can be measured in different ways: equity prices, wages, Tobin's Q, gross domestic product, environmental harm, or return to creditors. As we will discuss in Part IV, codetermination has scored solidly under these measures, and has held up even more strongly in the wake of recent crises. But the ideological questions of shareholder and worker power are a critical part of the debate—and one that law and economics research has largely ignored.

In their recent working paper, Dammann and Eidenmüller work within the traditional law and economics framework in arguing against the adoption of codetermination on U.S. soil.[134] But rather than a mounting a full-throated defense of shareholder primacy, they characterize codetermination as a fine proposition for Germans but unavailing here. They do not, for example, outright argue that having worker representatives on the board will distract from shareholder wealth maximization; instead, the problem is having two conflicting

[134] Dammann and Eidenmüller, *supra* note 110.

sets of goals that will confuse matters.[135] At times, their arguments seem self-defeating. For example, they minimize codetermination's usefulness to workers by pointing out the ways in which U.S. workers are comparatively powerless; as such, they would not be able to use board representation as effectively as German workers can.[136] The relative powerlessness of workers, on this view, becomes reason to retain the core feature of the governance structure that disempowers them to begin with. Elsewhere, they downplay the non-pecuniary benefits of codetermination, such as providing dignity to workers and strengthening economic democracy, by maintaining that the main concern of employees "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."[137] It doesn't even seem to register that there might be a relationship between these two concerns.[138]

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[135] *Id.* at 26-28. Dammann and Eidenmüller admit that there's quite a bit of evidence that more diverse boards improve corporate decision-making, but then assert—without evidence—that this is true only when boards members have the same goals. *Id*. at 26. Of course, board members are diverse precisely because they do not entirely agree with each other, even with respect to corporate goals, and shareholders themselves do not have homogeneous preferences with regard to corporate goals. *See* Grant M. Hayden & Matthew T. Bodie, *The False Promise of One Share, One Vote*, 30 CARDOZO L. REV. 445 (2008). And as we will see in the next section, German supervisory board members are required by law to put the interest of the corporation above those of their constituents, and there is quite a bit of evidence that supervisory board meetings are marked by a great degree of cooperation between shareholder and employee representatives. *See infra* Part IV. The authors completely overlook this evidence, and instead emphasize the importance of board collegiality by trying to analogize the situation to the corporate boards that might be produced by cumulative voting, which, according to one 1955 article, detrimentally affected collegiality (despite the fact that majority and minority shareholders supposedly shared a common goal of maximizing shareholder wealth). *See* Damman & Eidenmüller, *supra* note 110, at 27-28.

[136] *Id.* at 20-23.

[137] *Id*. at 24.

[138] And as for strengthening economic democracy, the authors maintain that democracy is already strong enough in the United States, a fact they find support for in the sheer number of elected offices, including even judges. With such proliferation of elections, they argue, Americans don't really need any more opportunities to cast a ballot. *See id*. at 25. But the strength of an economic democracy isn't measured by the number of elective offices or the number of votes cast, but by whether citizens meaningfully participate in a way that provides "social constraints over the use of capital." *Id*. at 23 (quoting Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE, *supra* note 9, at 167).

In terms of the downsides of codetermination, Dammann and Eidenmüller focus on the role of employees in confronting corporate risk. Based on the different incentives between shareholders and workers, they argue, companies run by diversified capitalists have been and should remain more willing to take risks than companies with significant labor involvement. Codetermination discourages risk-taking, and "extreme risk-taking" is an American specialty.[139] This argument, of course, assumes that there's an optimal level of risk-taking; that the United States happens to be at that optimal point; and that shareholders are in the best position to assess the potential downsides of risky corporate behavior with respect to all corporate constituents. These are all dubious propositions. They present the fact that American firms are significantly more likely to undergo bankruptcy than their German counterparts somehow as a positive development.[140] Dammann and Eidenmüller also believe that the U.S. bankruptcy system will interact poorly with codetermination.[141] Unlike the German system—where an insolvency administrator does most of the work—the U.S. generally relies on creditor governance with the debtor-in-possession running the show. Greater levels of employee input might slow down this system, since the debtor's decision-making process on the restructuring plan "would be fraught with difficult discussions between shareholder and employee representatives."[142] This concern, if truly problematic, could be resolved through changes to the bankruptcy law—a possibility Dammann and Eidenmüller overlook.

We do not pretend to claim that there are not economic arguments in favor of the current U.S. system. But the academic debate about the superiority of shareholder primacy versus codetermination has not really been joined. The strategy of law and economics scholars to this point has been primarily to ignore, belittle, or sequester codetermination as a practice that does not deserve real

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One of the principal criticisms of our system of democracy is that politicians are beholden to corporate interests, and corporations are not looking out for their employees.

[139] Damman & Eidenmüller, *supra* note 110, at 41-44.

[140] *Id.* at 43 ("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.").

[141] *See id*. at 31-32.

[142] *Id*. at 32.

examination. We believe differently and hope that this treatment will inspire American academics to take another, deeper look.

IV. CODETERMINATION IN PRACTICE

So how well has codetermination worked in Germany? Much of the scholarship evaluating the system has centered on its role in promoting broader goals such as social cohesion and fairness.[143] The bottom-line, economic effects of codetermination (which we'll turn to shortly) are either seen as secondary or as necessarily following from the achievement of these societal goals.[144] That is, codetermination is viewed less in terms of an economic system than as one designed to promote a well-functioning democracy and help prevent social division—in particular, the division between labor and capital. And, on this broad level, it is thought to be quite successful.

The success of codetermination on the social level has carried over to the boardroom, where the relationship between labor and capital is relatively harmonious.[145] Shareholder and employee representatives typically meet separately with the managing board before coming together at the supervisory board meetings.[146] These pre-meetings allow representatives to focus on the interests of their constituents and raise concerns with the management boards.[147] Recent studies have revealed that the supervisory meetings themselves are marked by a great deal of cooperation between shareholder and employee representatives.[148] This cooperation may be fostered in part by the legal requirement that shareholder and employee representatives must, at that point, put the interest of the corporation over those of their respective constituents.[149] While the relationships at the supervisory board level are not perfect, they are a far cry from the law-and-economics predictions of firm-destroying voting cycles and other visions of inter-board squabbling and dysfunction.

A. Codetermination and Economic Performance

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[143] *See* ADDISON, *supra* note 55, at 2.
[144] *See id*.
[145] *See* Sandrock, *supra* note 61, at 131.
[146] *See* du Plessis & Saenger, *supra* note 64, at 49.
[147] *See id*.
[148] *See* Sandrock & du Plessis, *supra* note 53, at 186.
[149] *See id.* at 184; du Plessis & Saenger, *General Meeting*, *supra* note 59, at 66.

There are a limited number of studies that evaluate the actual effects of codetermination on firm behavior and economic success. And most of those studies focus on a relatively narrow set of outcomes associated with shareholder interests. Robert Scholz and Sigurt Vitols recently cataloged the 37 extant studies on the relationship between codetermination and firm performance and found that 14 of them focused on stock market performance and 13 on profitability.[150] Seven studies analyzed codetermination's impact on productivity, which would be of interest to both shareholders and employees (and, more broadly, society).[151] Very few studies analyzed issues that would seem to be most important to employees, such as wages, employment levels, and job security.[152]

This evaluative approach is odd and continues to infect most discussions of codetermination. One would expect that, all things being equal, a shift from full shareholder control to partial shareholder control would decrease the gains allocated to shareholders. Employees can, in various ways, allocate a greater proportion of the returns to joint production to themselves if they have governance power. These distributional shifts would leave shareholders with less of the pie, even if overall the firm had the same or greater gains.

In any case, we should not be misled into thinking that the effect of codetermination on shareholders alone tells us its effect on the firm, broadly construed to include all corporate constituents. This lack of identity between shareholder interests and firm interests seems obvious, and raises the question of why so many studies appear to assume they are one and the same thing. Prominent academics have critiqued this focus on shareholder wealth maximization even in the context of U.S. companies.[153] A comprehensive

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[150] *See* Scholz & Vitols, *supra* note 52, at 235 tbl.1. The overall numbers add up to more than 37 because some studies had multiple subjects, but the overall skew toward shareholder interests is still clear, with only 5 studies involving wages and not a single study analyzing the effect of codetermination on any measures of corporate social responsibility.
[151] *See id*.
[152] *See id.* at 235.
[153] Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 639-40 (2006) ("Indeed, most studies do not expressly consider the implications of using shareholder wealth as a measure of firm value, despite the fact that they purport to be conducting a general efficiency analysis in which the primary goal should be maximizing the size of the corporate surplus, while considerations of the appropriate division of the corporate surplus should be secondary."). *See also* Oliver Hart & Luigi Zingales, *Companies Should Maximize*

assessment of codetermination must include its impact on all corporate constituents.

What this means is that many studies we're about to discuss necessarily render an incomplete picture of codetermination, one that largely focuses on the success of the firm as measured by stock price or profits. This puts us in a curious position when trying to make a broader assessment. If these studies show that shareholders come out behind, we still need to ask whether their losses are counterbalanced or even outweighed by gains to other constituents. If, on the other hand, shareholders fortunes are unaffected by codetermination, or they even come out ahead, then we can be pretty confident that the German system of shared governance delivers across the board.[154]

A number of studies have assessed the economic effects of codetermination, with a consensus that has shifted back and forth over the last four decades.[155] Some early studies from the 1980s found that codetermination had very little impact on corporate performance.[156] Those studies, however, were criticized on

Shareholder Welfare Not Market Value, 2 J.L. FIN. & ACCT. 247, 248 (2017) (discussing the difference between shareholder utility maximization and shareholder wealth maximization).

[154] Making a similar point on the range of possibilities, John Addison explains, "Worker representation on company boards arouses strong feelings. At one extreme it is viewed as tantamount to wealth confiscation with palpably adverse consequences for firm performance. At another, it is viewed as helping guarantee cooperative labor relations, with long term gains in terms of productivity and improved worker morale. Intermediate positions would recognize the joint occurrence of allocative and distributive effects, permitting either increases of decrease in overall welfare . . . ." ADDISON, *supra* note 55, at 119. On this question of economic performance, we take the intermediate position.

[155] For the best summary of the literature through 2008 and a discussion of the three initial phases of research detailed below, see ADDISON, *supra* note 55, at 108-121; *see also* Uwe Jirjahn, *Ökonomische Wirkungen der Mitbestimmung in Deutschland: Ein Update*, ARBEITSPAPIER 186, Düsseldorf: Hans-Böckler-Stiftung (Feb. 2010).

[156] *See, e.g.*, Jan Svejnar, *Relative Wage Effects of Unions, Dictatorship, and Co-determination: Econometric Evidence from Germany*, 63 REV. ECON. & STATS. 188 (1981) (finding codetermination associated with higher earnings in the iron and steel industry but not in the coal mining industry); Guiseppe Benelli *et al.*, *Labor Participation in Corporate Policy-Making Decisions: West Germany's Experience with Codetermination*, 60 J. BUS. 553 (1987) (finding no real differences between firms with codetermination and without codetermination across a variety of measures of performance); Michael A. Gurdon & Anoop Rai, *Codetermination and Enterprise Performance: Empirical Evidence from West Germany*, 42 J. ECON. & BUS. 289 (1990) (finding codetermination led to higher profitability but lower productivity).

a number of methodological grounds,[157] and several more sophisticated evaluations in the 1990s and early 2000s gave a more pessimistic account, finding that codetermination was associated with, among other things, lower productivity and lower profits.[158] That consensus, though, soon gave way to a third phase in the literature, one that both reversed the principal findings of the second-phase studies (finding them to be artifacts of a particular method of assessment)[159] and found that codetermination was also modestly associated with greater innovation.[160] These more optimistic assessments were bolstered by a couple of modern financial studies on the market value of the firm, which found that "prudent" levels of employee representation led to better board decisionmaking by improving monitoring and thus reducing agency costs.[161] "Armed with better information," Larry Fauver and Michael Fuerst explain, "the supervisory board may more easily recognize and thwart investments and strategies that represent private control benefits to large shareholders or management through asset stripping, pyramiding, dilution of small investors, crony capitalism, and simple perquisites."[162] A similar finding was made by

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[157] *See* ADDISON, *supra* note 55, at 109. Those early studies were criticized for reasons that included "sample size, data frequency (in the case of stock returns), lack of controls for other relevant economic or organizational variables, focus on a single event, and narrow reach." *Id.*

[158] *See, e.g.*, Felix FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 SCAND. J. ECON. 365 (1993) (finding that the shift to quasi-parity codetermination in 1976 had negative effect on productivity); Theodor Baums & Bernd Frick, *Co-determination in Germany: The Impact of Court Decisions on the Market Value of Firms*, 1 ECON. ANALYSIS 143 (1998) (finding that court rulings that expanded or restricted codetermination had no real effect on share price); Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of Codetermination*, 2 J. EURO. ECON. ASS'N 863 (2004) (finding that moving from one-third to quasi-parity codetermination negatively affected shareholder wealth).

[159] *See, e.g.*, Felix FitzRoy & Kornelius Kraft, *Co-determination, Efficiency, and Productivity*, 43 BRIT. J. IND. REL. 233 (2005); *see also* ADDISON, *supra* note 55, at 115-16, 120. The negative findings in the second phase of studies may have been artefacts of the cross-section estimation they used, which (by definition) did not control for firm heterogeneity or firm-specific effects. *Id*. at 115, 120.

[160] *See, e.g.*, Kornelius Kraft *et al*., *Codetermination and Innovation*, 35 CAMBRIDGE J. ECON. 145 (2011); *see also* ADDISON, *supra* note 55, at 116.

[161] *See* Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673 (2006); see also Renaud, *supra* note 120.

[162] *See* Fauver & Fuerst, *supra* note 164, at 703.

Kornelius Kraft and Marija Ugarković, who found that the 1976 strengthening of codetermination positively affected returns on equity.[163] Uwe Jirjahn, summing up the studies in early 2010, reported that codetermination was connected to higher productivity, and that more recent studies (unlike earlier ones) had found that codetermination also had a positive effect on profitability and capital market valuation.[164] This third, rather optimistic phase of assessment brought us right up to one of the most profound tests of all systems of corporate governance: the global financial crisis of 2008.

The financial crisis did not spare any of the world's major economies, but some recovered more quickly than others. Germany, in particular, recovered more quickly and more thoroughly than many other countries, and did so, at least in part, because of its corporate governance model.[165] Economic downturns are always difficult for companies and their employees. But codetermination allows the management of many companies "to more easily seek the consent of its workforce for carrying out more or less drastic measures."[166] These measures include a system (*Kurzarbeit*) that temporarily reduces the working hours (and salaries) of many of the employees.[167] This avoids painful layoffs and allows companies to retain their core workforces, which in turn allowed the economy as a whole to avoid the worst of the economic slump.[168] This led one group of scholars to conclude: "Particular to Germany was the social partners' willingness to work together during this specific economic hardship. . . . it cannot be denied that the *quality* of industrial relations was a factor in overcoming the crisis."[169]

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[163] *See* Kornelius Kraft & Marija Ugarković, *Gesetzliche Mitbestimmung und Kapitalrendite*, 226 JAHRBÜCHER FUR NATIONALÖKONOMIE UND STATISTIK 588 (2006).
[164] *See* Jirjahn, *supra* note 158, at 52.
[165] *See* Jean J. du Plessis *et al.*, *Preface* to GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at vii; Sandrock, *supra* note 61, at 136. For some brief comparisons of the German recovery to that of other countries, see Michael Burda & Jennifer Hunt, *What Explains the German Labor Market Miracle in the Great Recession?*, 2011 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 273-75.
[166] *See* Sandrock, *supra* note 61, at 134.
[167] *See id.*; Sandrock & du Plessis, *supra* note 53, at 188-89, 193.
[168] *See* Lutz Bellman *et al.*, *The German Labour Market Puzzle in the Great Recession*, *in* PRODUCTIVITY PUZZLES ACROSS EUROPE 187, 187-88 (Philippe Askenazy *et al.* eds., 2016); Sandrock, *supra* note 61, at 134; Sandrock & du Plessis, *supra* note 53, at 188-89, 193.
[169] Bellman *et al.*, *supra* note 171, at 229.

There are, of course, some caveats to this story. The labor stockpiling that smoothed over the effects of the recession was tailor-made for the particular economic woes that hit Germany: a short-term demand shock that primarily affected the manufacturing sector.[170] More typically, German employment follows GDP, sometimes with a slight delay.[171] But the system worked surprisingly well this time around, and the resulting difference between Germany and the United States was apparent in the early part of the recovery period.[172]

A number of new studies came out during the period of recovery that were consistent with the third phase of the literature, showing that codetermination generally had positive economic effects. One of the stronger results came from a 2019 study by Simon Jager, Benjamin Schoefer, and Jörg Heining, which showed that shared governance was "associated with an *increase* in capital formation and a shift towards more capital intensive production," probably because it facilitated cooperation between firms and their employees.[173] Shareholders, on this account, may be better off investing in firms where employees have a stronger governance role. Other studies were more circumspect. One model by Kornelius Kraft found that codetermination did not significantly affect productivity in either direction.[174] And a note of caution was introduced by an event study by Stefan Petry, who showed that the expansion of codetermination in 1976 was correlated with a decrease in share price at the time.[175]

Overall, however, we think it's fair to say that the emerging consensus of the studies of the effects of codetermination on firm performance is quite positive. A number of studies have shown that employee representation is accompanied by higher productivity, profitability, and capital investment. And it's clear that codetermination contributed to Germany's ability to recover from

[170] *See id.* at 187.
[171] *Id.*
[172] Indeed, by the end of 2009, Paul Krugman had already devoted an entire column to "Germany's jobs miracle." Paul Krugman, *Free to Lose*, N.Y. TIMES, Nov. 13, 2009, at A31.
[173] *See* Simon Jager, Benjamin Schoefer & Jörg Heining, Labor in the Boardroom 28-29, (unpublished manuscript), *available at* http://economics.mit.edu/files/17273 (emphasis added).
[174] Kornelius Kraft, *Productivity and Distribution Effects of Codetermination in an Efficient Bargaining Model*, 59 INT'L J. IND. ORG. 458 (2018).
[175] Stefan Petry, *Mandatory Worker Representation on the Board and Its Effect on Shareholder Wealth*, 47 FIN. MGMT. 24 (2018).

the global financial crisis much more quickly than other countries without strong systems of employee representation. Shareholders have fared pretty well. But how does codetermination affect the fortunes of other corporate constituents?

B. The Effect of Codetermination on Other Stakeholders

A number of recent studies have demonstrated the effects of codetermination on a range of corporate constituents. We start here with the obvious constituents—employees. One would expect that employees would lead the pack of constituents expected to gain from more direct board representation. And, in fact, employees do appear to be better off under codetermination, at least by their own measures. But, as foretold by the story of German employment during the global financial crisis, those employees may measure success in ways that aren't limited to the size of their paychecks.

As described above, Germany's bounce back from the financial crisis was largely a result of the ability of firms to keep employment levels relatively stable. Those employment levels, however, did not come costlessly: they were maintained at the price of the number of hours worked, bonuses (or the lack of them), and resulting lower wages and salaries. But this is exactly the kind of deal that employees bargained for under the *Kurzarbeit* system.

A recent study by E. Han Kim, Ernst Maug, and Christoph Scheider confirmed that employees at full-parity codetermined firms are better protected against layoffs during industry downturns.[176] This job security, however, comes at the price of significantly lower wages. Employees at codetermined firms pay a premium equal to 3.3 percent of their wages for this employment insurance.[177] Importantly, this swap of wages for job security has no effect on shareholders one way or the other.[178] This is similar to the finding by Jager, Schofer, and Heining, who concluded that "we did not find that installing worker representatives in German supervisory boards increased wages in these firms, nor did it lead to more rent sharing."[179] This suggests, then, that this feature of

[176] E. Han Kim, Ernst Maug & Christoph Scheider, *Labor Representation in Governance as an Insurance Mechanism*, 2018 REV. FIN. 1251, 1286.

[177] *Id.* at 1279, 1286. The benefit of this employment insurance was really only experienced by white collar and skilled blue collar employees; unskilled blue collar workers do not receive much in the way of job security protections. *Id.* at 1286. The authors of the study attribute this finding to the lack of real representation of unskilled workers on supervisory boards. *Id.*

[178] *Id.* at 1286.

[179] Jager *et al.*, *supra* note 176, at 28.

employment insurance at codetermined firms was not a result of employee entrenchment in the form of employee-manager collusion, and it did not come at the expense of other corporate constituents.[180] Kornelius Kraft, however, found that while codetermination did not affect productivity, it did lead to a significant increase in employee bargaining power and affected the distribution of rents.[181]

That's not to say, however, that codetermination does not affect other corporate constituents. Employee representation, for example, turns out to be good for creditors. Employees have interests that align with those of creditors along a couple of dimensions. As Chen Lin, Thomas Schmid, and Yuhai Xuan explained in a 2018 study, "Employee representatives who aim to protect the interests of the firm's employees can (unintentionally) also help to protect the interests of banks as both stakeholders are interested in the long-term survival and stability of the firm."[182] For that reason, employee representation and bank ownership can act as "substitutes" for one another.[183]

The result of this interest alignment redounds to the benefit of both the firm and the banks. The study found that codetermination was associated with favorable financing conditions, lower costs of debt, longer debt maturities, and fewer covenants.[184] Codetermined firms were also found to have entered into fewer and better merger and acquisition deals, had more stable cash flows, and were exposed to less idiosyncratic risk.[185] The authors of the study concluded that "a direct voice of employees in firms' governance structure can be a powerful mechanism to reduce agency conflicts between debt providers and firms and to improve their financing opportunities and conditions."[186]

Creditors aren't the only other constituents that might benefit from employee representation. Scholz and Vitols recently evaluated the impact of codetermination on a firm's commitment to substantive corporate social responsibility (CSR) measures.[187] The study was novel in several respects. Unlike earlier work, which assumed that worker influence was the same at all

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[180] *See* Kim *et al.*, *supra* note 179, at 1286.
[181] *See* Kraft, *supra* note 177.
[182] Chen Lin, Thomas Schmid & Yuhai Xuan, *Employee Representation and Financial Leverage*, 127 J. FIN. ECON. 303, 321 (2018).
[183] *Id*.
[184] *See id*.
[185] *See id.*
[186] *See id.* at 322.
[187] *See* Scholz & Vitols, *supra* note 52.

codetermined firms, the authors developed measure of the strength of codetermination based on a number of factors, including obvious ones such as the level of codetermination (one-third, quasi, or full) and less obvious ones such as the extent of worker representation on board committees and the importance of the supervisory board in firm governance.[188] The study was also the first to look at the effect of codetermination on CSR outcomes.[189]

The authors found that the strength of codetermination was positively related to substantive CSR policies, including setting concrete goals on emission reductions, the publication of a separate CSR report (or section in its annual report), and the presence of a job security (no-layoff) policy.[190] These were deemed "substantive" CSR measures because they required an expenditure or investment in company resources.[191] There was not a corresponding relationship to merely symbolic measures, indicating that employee representatives have little interest in measures that do not result in direct improvements for workers.[192]

The recent performance of the German economy has begun to change the way people view codetermination. By 2016, its popularity among the German people rose to an all-time high.[193] The German business community looks at it in a more positive light,[194] and foreign businesspeople—long baffled by the complex codetermination laws—have come to see some of its advantages.[195] In sum, this new economic research suggests that employee representation on corporate boards benefits employees, creditors, and the broader community through the pursuit of meaningful CSR measures. Employees are often able to secure greater job security (though at some expense to their wages) in a way that avoids hold-up issues. Their representation also seems to help other corporate constituents through a variety of mechanisms including the promotion of greater information flow within the firm and the fact that other constituents often have interests that align with those of employees (such as a concern for the long-term health and stability of the firm). In any case, the results of these recent studies

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[188] *See id.* at 34-37.
[189] *See id.* at 39-44.
[190] *See id.* at 43-44.
[191] *See id*.
[192] *See id*.
[193] *See* Sandrock & du Plessis, *supra* note 53, at 188.
[194] *See id.* at 237; Otto Sandrock, *The Impact of European Developments on German Codetermination and German Corporate* Law, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT, *supra* note 53, at 243, 320.
[195] *See* Sandrock & du Plessis, *supra* note 53, at 168.

are quite clear: codetermination benefits a wide range of corporate constituents at little or no cost to shareholders.

V. CONCLUSION

As the dogma of shareholder primacy is reevaluated, the structure and experience of the codetermination model deserves examination. The success of the German system serves as an empirical rejoinder to the hypothetical arguments used by law and economics scholars to justify the exclusive shareholder franchise. Codetermination was born of consensual agreement at a time when labor and capital had roughly equal bargaining power, and only later became enshrined in law. As a result, they developed a system that is dramatically more employee-oriented than Anglo-American corporate law. The standard thinking in U.S. corporate circles would predict—and has predicted—the failure of this deviant system. But German firms have not been paralyzed by more heterogeneous board electorates. And they have not been destroyed by voting cycles. Rather, they have in many important ways outperformed their United States counterparts. The arguments against employee representation were already in trouble on their own theoretical terms. The presence of a significant, well-functioning counterexample to shareholder primacy should be further cause to question.

Does this mean that German-style codetermination is without faults? Of course not.[196] The system has been criticized for its large, two-tiered board structures.[197] It makes use of an (arguably) unnecessarily baroque version of an electoral college to elect employee representatives.[198] And the recent success of the German system also doesn't mean that it would directly translate to corporations in the United States. Perhaps supervisory codetermination can only flourish in conjunction with the strong union presence and works councils found in Germany. (Or perhaps it's the other way around.)

Nevertheless, German codetermination is working well enough that it helps confirm many of the arguments made in favor of a shared approach to corporate governance. We hope that this review of codetermination spurs American

[196] *See id.* at 196-233; Sandrock, *supra* note 61, at 137-45.
[197] *See* du Plessis *et al*., *supra* note 58, at 8-13.
[198] In a process that may cost companies hundreds of thousands of Euros, individual employees elect members of an electoral college, who, in turn, elect the employee representatives to the supervisory board. *See* Sandrock & du Plessis, *supra* note 53, at 205; Sandrock, *supra* note 61, at 138.

scholars to consider the German model and reimagine the possibilities for a more efficient and more just framework for corporate law.