IUC WORKING PAPER SERIES

Reference Number: 2021/003/BSR/LEPG/PPS

Board-Level Codetermination in Germany - The Importance and Economic Impact of Fiduciary Duties

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Domain: Behavioural studies, Society and Religion; Law, Economics, Politics and Governance; Philosophy and Philosophy of Science

IUC course: The "Betrieb" (Organization, Firm, Establishment…) as Corporate Actor – A Theoretical and Empirical Challenge, 2021

Date of publication: 17 May 2021

DOI: https://doi.org/10.53099/ntkd4304

ISSN: 2787-5717

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Board-Level Codetermination in Germany

The Importance and Economic Impact of Fiduciary Duties[1]

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Abstract

The empirical accounts of the costs and benefits of quasi-parity codetermined supervisory boards, a very special German institution, have long been inconclusive. A valid economic analysis of a particular legal regulation must take the legal specificities seriously, otherwise it will be easily lost in economic fictions of functional equivalence. At its core the corporate actor "supervisory board" has no a priori objective function to be maximised – the corner stone of the theory of the firm – but its objective function will only be brought about a posteriori – should negotiations result in an agreement (E. Fraenkel). With this understanding, the paper presents six recent quasi-experimental studies on the economic (dis) advantageousness of the German codetermination laws that try to follow the rules of causal inference despite the lack of random variation. By and large they refute the hold-up model of codetermination by showing positive or nonnegative effects even on shareholder wealth – and a far-reaching improvement of the well-being of the core workforce. In conclusion, indications are offered that the shareholder primacy movement has only weakened, but not dissolved the "Deutschland AG".

Key words: shareholder vs. stakeholder theories of the firm; quasi-experimental studies of codetermined supervisory boards in Germany; socio-economic analysis of corporate law

[1] Thanks to the participants of Conference "The 'Betrieb' (organization, firm, establishment,…) as corporate actor – a theoretical and empirical challenge", HSU HH, April 2021. Thanks also for helpful comments to Oscar Gabriel, Kerstin Pull and Philipp Sadowski.

Contents

1. To whom do board members owe fiduciary duties?

Although stock corporations everywhere have boards, the dual board structure and in particular the mandatory quasi-parity codetermination distinguish German public companies with more than 2000 employees from the rest of the corporate world. It is not easy to evaluate a singular institution as in a strict sense there is nothing to compare to. No wonder, therefore, that empirical accounts of the costs and benefits of this peculiar institution have long been inconclusive.

The following paper rests on the methodological assumption that the legal shape of German boards should not be dismissed by rashly claiming "functional equivalence" between all sorts of monitoring and advisory bodies. A valid economic analysis of a particular legal regulation must take the legal specificities seriously, otherwise it will be easily lost in economic fictions. The first part of the paper will present both the general legal characteristics of corporations as opposed to other legal forms of enterprises and the particular powers and duties of board members in larger German corporations. The second part takes distance from a key notion of straightforward economic thinking, namely that there is an ex-ante objective function to be maximized.[2] Instead, the paper argues that as the German codetermination laws constitute a pluralist body where each of the members has connections, and perhaps obligations or duties, towards different "constituencies", the logic of a pluralist formation of will is to be expected. The political scientist Ernst Fraenkel showed long ago that pluralist decision-making cannot resort to the fiction of an *a priori* objective function, but, if successful, will only produce a shared judgement *a posteriori*. The third part of the paper will present recent quasi-experimental studies on the economic (dis-)advantageousness of the German codetermination laws that try to follow the rules of causal inference. In conclusion, I ask whether the shareholder primacy movement has not only weakened or dissolved the "Deutschland AG", but also the pluralist constitution of public corporations in Germany, as some sociological narratives of "financial managerialism" would make us believe.

Before starting, it may be useful at least to quote the most important current economic concepts of understanding firms/enterprises/companies/corporations. In keywords: incomplete contracts, relationship contracting, firm-specific investments, the pooling of resources, constitutional theories of the firm. (Cf. Sadowski (2002, 149-152) for a summary of these ideas and main contributors.) If competitive advantage essentially rests on firm-specific resources the concrete character of which is hard to anticipate and to lay down in a contract – be it investments of the employer, specific human capital investments of the employees, or co-specialized investments

[2] For lawyers that seems to be obvious: "a common goal perspective of all supervisory board members is not evident" ("eine gemeinsame Zielperspektive aller Aufsichtsratsmitglieder ist nicht ersichtlich" (Velten 2010, 23).

of both – the problem arises of how to credibly incentivize them. This is difficult if there are no market prices and therefore no credible exit threats ex-post to enforce any ex-ante promises of rewarding those firm-specific investments. "If committing not to renegotiate the contract is impossible, then contracting has no value, i.e., the parties cannot do better than to abandon contracting altogether in favour of ex-post negotiations." (Che/Hausch 1999, 125). If co-specific investments not only concern one employer and one employee, but the pooling of investments or resources between many financial and human capital investors, it is appropriate not to remain with contractual theories of firm, but to turn to constitutional theories of the firm.

There is ample evidence that these ideas have certainly reached the Anglo-Saxon legal thinking about the nature of the firm (cf. Blair 1999, Deakin 2012b). Meanwhile, the concept of "a corporate constitution" ("Unternehmensverfassung") is well established in the German legal literature. German economists also use it when they elaborate "Corporate Governance als Verfassungsvertrag" (Schmidt, Weiß 2009, 172, a lucid exposition of shareholder vs. stakeholder approaches using the above-mentioned key arguments).

Economic and legal thinking has to come together to understand and foster "… the conditions under which legal and other normative structures can contribute to the sustainability of corporate enterprise" (Deakin 2012b, 376). A word of all-clear: Although legally the supervisory board („Aufsichtsrat") is part of the corporate structure and not located in the plant or the establishment ("Betrieb"), as a matter of fact there are often close relationships and overlapping memberships between supervisory board and works councils that are essential for their working.[3]

2. The legal nature of a stock corporation ("Aktiengesellschaft")

There are several legal forms among which investors may choose to organize their interests in an enterprise. The key features of the corporate form are independent of their legal origin, i.e., they are essentially the same in common law and civil law countries. Quoting Blair (2013, 7 - 11):

Corporations have a legal personality. Each of the various participants in the corporation is thus allowed "…to contract with the corporation itself, rather than having to create separate contracts

[3] In a large survey, Gerum (2007, 237) found that 97% of employee representatives in supervisory boards are works council members, that one fourth of vice chairpersons chair the group works council (ibid., 241), and one third of vice-chairpersons are external union delegates (ibid., 239).

with each of the other participants. … Creditors of the business cannot seize personal assets of the participants to satisfy corporate debts, and individual participants may not pledge corporate assets to secure personal loans." (ibid., 8)

When a corporation is formed, the default rule holds "... that the corporation exists until it is formally dissolved" (ibid., 10), that is the going-concern assumption. The assumed indefinite existence facilitates the accumulation of assets, whereby none of the participants "…can compel the corporation to buy back the shares or even to pay dividends" (ibid., 10). None of the participants have property rights over those assets.

The separate entity status of the corporation implies limited liability for the participants. "Shareholders, creditors, employees, and suppliers can all lose what they have invested in a corporation if the business fails. But if such a loss occurs, none of them can go after the personal assets of any of the others to make themselves whole." (ibid., 8).[4]

Corporate shareholders have the right to sell their equity shares to other parties, but the corporation does not have to buy out a shareholder. "The ability to lock-in the capital makes it possible for a corporation to invest in assets and build businesses that have a very long-term horizon… Shares are bought and sold… without having any necessary impact on what is happening inside the corporation…" (ibid., 9).

Corporations are required by statute to have a Board of Directors to manage the enterprise. In German law, the dual board version provides for Executive board ("Vorstand") and Supervisory board („Aufsichtsrat"). Legally, "…corporate directors are not agents of shareholders – shareholders may not dictate to directors what they are to do. Legally, directors are more like trustees for the corporation as a whole." (ibid., 9). In the US, courts in general follow a doctrine, the so-called "business judgment rule", "… by which the court refuses to second-guess the business judgment of the board, unless a plaintiff can show that board members had engaged in fraud, or illegal behavior, or had a significant conflict of interest" (ibid., 12). "… the statutes (and case law) say that directors must act in good faith and in the belief that their actions are in the best interests of the corporation" (ibid., 10).

This characterization stands in stark contrast to the "shareholder primacy" view of corporations that has gained dominance among legal scholars and economists as well as financial investors only since the early 1980s. Then the shareholders' role as residual claimants became reason enough to declare them "the principal" whose wealth was to be maximized by all the other "agents", be it management or the employees.

[4] In two situations US courts have interpreted the fiduciary duties of boards towards the shareholders as maximizing the share price: (1) in cases of mergers or leveraged buyouts in which holders of common shares are going to be eliminated, (2) situations when controlling shareholders engages in actions that prevent a minority shareholder from sharing in the benefits of his investment, cf. Blair (2015, 5). The UK law also forbids poison pills. (Deakin 2012a,124ff.)

German corporate law essentially shares the traditional view of *Aktiengesellschaften***.** It stresses the legally conferred corporate privileges of legal personality, limited liability, indefinite existence and independence of individual shareholders and also stipulates that the members of the *Supervisory board* act as trustees or stewards of foreign interests. German corporate law works on the assumption that shareholders' interests are not necessarily homogenous; that already "defined benefit pension claims" make employees sort of financial shareholders; and that beside shareholder interests there are other interests equally worth to be protected *("in vergleichbarer Weise schutzwürdig anerkannt*": Kübler 1999, 164): the public interest as well as the interest of employees. Employees have particular high-stakes in a corporation, the risk of which they cannot diversify. Even though German corporate law no longer refers to the concept of 'the company per se', it still protects the interests of shareholders and stakeholders via mandatory rules, in order to ensure the functioning of corporations *('Schutz von Interessen und der Funktionsfähigkeit der Institution Aktiengesellschaft',* Kübler 1999, 165). The tax liability of corporations alone can justify the public interest in their functioning (Semler 2010, 1395). There is no doubt that „…the firm is a resource which is subject to multiple, overlapping and sometimes conflicting claims on its use" (Deakin 2012b, 373). Pistor adds that German legal scholars, judges and politicians continue to see that the enterprise beyond the corporate shell "… is a unit with its own right. … In this enterprise, the major antagonism is the one between labor and capital, not between owners and agents." (Pistor 1999, 177).

Some law scholars fervently point out that the shareholder primacy view contradicts US statutory and case law even in Delaware. Bruner (2013, 37) calls shareholders in the US "spectators": "The defining attributes of U.S. corporate law are the shareholders' marginal role and very weak governance powers;…" (ibid., 37). He stresses that in the US boards do have fiduciary duties towards the company as a whole, while in the UK shareholder primacy indeed reigns (Bruner 2013, 37). Deakin (2012b, 359), however, takes a different view. It is not up to us to decide this controversy, neither is it necessary, because we want to analyse the functioning of the German legal institution supervisory board („Aufsichtsrat").

It is true that economists love the working hypothesis of the functional equivalence of institutions, here supervisory boards, to enable or ease international comparisons of institutions. But too much acontextuality by disregarding a major difference or even an idiosyncrasy for the sake of comparability will be misleading not only for comparative law scholars, but also for a sensible economic analysis of a particular institution. (cf. Bruner 2013, 14-27)[5]

[5] Kluge (2005, 170) presents the distribution and different forms of employee board level representation in the EU-25.

3. The role and mode of operation of the supervisory board („Aufsichtsrat“)

The main duty of the supervisory board in the German two-tier corporate governance system is to select and appoint the executive board (“Vorstand”), to supervise it and if necessary to dismiss its members. The supervisory board also decides the remuneration of the executive board members. Certain transactions of the executive board may be subject to the supervisory board's explicit approval. The supervisory board also has a word on which recommendations of the German Corporate Governance Codex the company should follow – “comply or explain”.

In corporations with more than 500 employees one-third of the supervisory board members represent the employees (Works Constitution Law - Betriebsverfassungsgesetz). For corporations with more than 2000 employees - which are our main focus - the Employee Codetermination Act (Mitbestimmungsgesetz) of 1976 prescribes a varying size of the supervisory board (12, 16 or 20 members) depending on the number of the corporation’s employees. The composition is a quasi-parity representation of shareholders and employees - "quasi" because in the case of a tie, the chairman of the supervisory board, who is always a shareholder representative, has the casting vote. The employee side or “bench” must include at least one blue- and one white-collar worker, one managerial employee and two trade unionists. The exact size of each group depends on the composition of the whole corporation (§ 7 and § 15 Codetermination Law). The employee representatives receive their mandate from the workforce. Shareholder representatives are elected at the general meeting of shareholders (§ 101 Company Law). This Law requires at least four supervisory board meetings per year, and usually there are no more than this.

The s*upervisory board* has not only supervisory duties and an advisory role, but co-decides strategic decisions together with the executive board. Lieder (2018, 524f.) suggests that preventive controlling might have become even more important than monitoring the past. In other words, the members of the supervisory board perform an entrepreneurial role, although the Executive Board sits ‘in the driving seat’ (Hopt 2019, 519). The supervisory board has to co-operate from a critical distance with the *executive board* (Hommelhoff, zit. bei Hopt 2019, 519). "Each body may and must determine and interpret this [corporate] interest". (“Jedes Organ darf und muss dieses [Unternehmens-]Interesse selbst ermitteln und auslegen” (Semler 2010, 1398)). The various bodies are independent and autonomous. That includes the duty to form their own risk assessment. As membership in a supervisory board is a part-time activity, members’ main professional basis – such as banks or trade unions or the focus company in which employee representatives are employed – might lead to conflicts of interest. Here the letter of the German law is clear: "When participating in a corporate decision, a board member typically performs his/her role as part of the supervisory board (and not an activity outside the board). In this respect, the unrestricted priority of the company's interests over the special interests of the individual supervisory board member remains.” (Original: „Denn bei der Mitwirkung an einer unternehmerischen Entscheidung nimmt das Mitglied typischerweise sein

Organfunktion im Aufsichtsrat (und keine organfremde Tätigkeit) wahr. Insofern bleibt es bei einem uneingeschränkten Vorrang des Unternehmensinteresses gegenüber Sonderinteressen des einzelnen Aufsichtsratsmitgliedes.“ (Lieder 2018, 571)). All members of the Supervisory board are under the obligation to cooperate effectively and trustfully (cf. Seibt 2010, 1371).

The interest of the company – “das Wohl der Gesellschaft”, a traditional legal figure (‘eine hergebrachte Rechtsfigur’ according to Lieder 2018, 576) – implies securing the long-term earning capacity and the competitiveness of the company and its products. "The organ members only act outside the company's best interests if they act in a grossly negligent manner or simply take irresponsible (entrepreneurial) risks." (“Die Organmitglieder bewegen sich erst dann außerhalb des Unternehmenswohls, wenn sie grob sorgfaltswidrig handeln oder schlichtweg unverantwortliche (unternehmerische) Risiken eingehen.“ (Lieder 2018, 578).

The judgment whether a decision complied with the business interest has to be based on the context in which it was taken, not on ex-post considerations. This corresponds with the business judgment rule in US-American law (Hopt 2019, 523ff.).

The executive board first of all has to find common ground among often conflicting interests between majority and minority stockholders, between shareholders and executive board, and within the supervisory board. The interest of the corporation is meant to come into being through negotiation and cooperation, not through litigation. (cf. Pistor 2009, 235).

Empirically, the capital bench is not homogeneous. Block holders and minority shareholders might pursue different investment strategies. Furthermore, in 2004 Gerum (2007) examined all German stock companies who were part of the DAX (N=29), the MDAX (N=46) and the TechDAX (N=25) or subject to the Employee Codetermination Act (N=347). He found that 57% of the shareholder bench were not legitimized through own shares, but were former members of the executive board, consultants or – in large companies – representatives of the public (ibid., 228f.).

The employee bench is not homogeneous either. Both trade union delegates and workforce representatives may adhere to different unions or different election lists or be managerial employees (“Leitende Angestellte”). This raises the question how works councillors or trade unionists will act in situations where a partial closing down of a plant or the partial relocation into a foreign country will hit only parts of the workforce. Even if there are no competing interests among employees: If unions call a strike, should the respective union board members be banned from voting in the board in strike affairs because of a conflict of interest?[6]

[6] Gerum (2007, 287-338) identifies many process deficits based on extensive document analyses. Jansen (2013) reports and interprets interviews with several representatives of both benches in each of 26 corporations. Jürgens, Lippert, Gaeth (2008) provide a detailed view of employee board members on the internal working of boards.

In business groups and corporations, there is a tendency to centralize the operation of establishment works councils, central works councils ("Gesamtbetriebsräte"), and group works councils ("Konzernbetriebsräte"), a process assisted by unions, but without foregoing independency (cf. Behrens 2019)[7]. Supervisory board and works council share a strong interest in strategic issues like major investments, reorganization or the sale of business units. Even if there are transactions that require consent by the supervisory board, the works council might have a better understanding of the consequences, given its information rights in the "business committee" ("Wirtschaftsausschuss"). Faust, Bahnmüller, Fisecker (2011, 360) found that controversial issues are more likely to be put on the agenda of works councils and that the employee representatives in supervisory boards only reject executive board submissions when they are convinced of shopfloor support (ibid., 362). Personnel managers, in turn, use a consenting vote of the employee representatives in the supervisory board to legitimize their actions and establishments, should they deem it helpful (ibid., 357).

4. The political nature of the supervisory board

Despite the seemingly unambiguous commitment of all members to the company interest, the composition of the supervisory board is meant to guarantee a diversity of viewpoints and interests to a degree that some companies and employer associations filed a constitutional complaint at the Federal Constitutional Court (*Bundesverfassungsgericht*) to claim a violation of the fundamental right of property. They lost their case. Later attempts to cut back on the quasi-parity supervisory board remained unsuccessful, and for the time being touching this institution is considered taboo among German law makers.

Without long reflections it is easy to imagine conflicting interests within the supervisory board between some or all members of the supervisory board and the executive board, and between both bodies and (groups) of shareholders.

A trade union representative might want to support a strike of his union against the focus corporation;

The executive board and employee representatives might try to increase their remuneration at the shareholders' expense;

[7] There are works councils where unions are kept at bay, cf. Röbenack, Artus, Kraetsch (2019).

in view of a hostile takeover attempt, the executive board and employee representatives might combine in defence, but it is also conceivable that employees form a coalition with shareholders to get rid of the incumbent management or to tighten up transparency requirements;

the likelihood of such constellations depends on the shareholder composition: block-holding shareholders have options different from shareholders of widely held stock; institutional investors may not act like family owners.

A closer look at the reality of the codetermination complicates the picture:

The company employees in the supervisory board often are the chairpersons of the central works council and the group works council (Gesamtbetriebsrats- und Konzernbetriebsratsvorsitzende) and as such cannot be assumed to leave their core vantage point.

The obligation to maintain confidentiality in the supervisory board might put those members in peril in front of their constituency.

The WpÜG – *Wertpapiererwerbs- und Übernahmegesetz* from 2001 - gives the say on defensive actions to the supervisory board (Hopt 2019, 513).

In view of all these tensions and ambiguities, Jansen (2014) declares the double obligation of worker representatives to be at the same time constructive power and countervailing power a double-bind. His sociological (system-theoretic) analysis and some illustrative cases lead him to call the corporate codetermination in Germany an insoluble dilemma that necessarily results in "institutionalised failure" ("institutionalisiertes Scheitern" (Jansen 2014, 93)).

It is striking to read another sociological account that not only downplays this alleged fundamental dilemma, but states: "In practice, codetermination goes far beyond its legal foundations, interfering in and legitimizing company policy not only in social and personnel issues, but in economic issues also." (Höpner 2001, 32) Furthermore: "… Evidence is growing that the role of labor law is decreasing, while the importance of negotiated codetermination rules is increasing" (ibid.). A view culminating in: 'shareholder orientation and codetermination might be a precondition for economic success, because that combination can secure worker confidence' (ibid., 35).[8]

In 2005 and 2006, Raabe (2010) conducted 89 semi-structured, anonymous interviews with supervisory board members of DAX-companies to learn more about work and decision procedures within supervisory boards. He summarizes that 'with few exceptions the employee

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[8] "Disclosure conflicts are conflicts over managerial control in which both shareholders and employees oppose managers. Trade unions and works councils welcome the change in accounting practices toward internationally accepted standards and are calling for a European directive that would abolish German commercial code (HGB) accounting. Transparency, trade unionists argue, is a condition for effective codetermination." (Höpner 2005, 348)

representatives have said goodbye to the countervailing power model' (Raabe 2010, 139). "In most cases, ...there is a strict focus on consensus." ("In den meisten Fällen wird …strikt auf Konsens gesetzt." (ibid., 140)) The notable exceptions mostly occur in times of heavy restructuring. In such situations, the chairperson usually exercises his/her casting vote (ibid., 140). As to the process of negotiations, it is worth noting that usually the shareholder bench and the employee bench meet separately before a session to clarify their respective positions, so that each bench comes up with a common position (ibid., 191ff.). In that phase, the chair person is usually the only shareholder representative who has direct contact with the employee bench (ibid., 142). During the session it is not unusual that only the vice chairperson presents the employee bench's view. According to Raabe's results, the internal employee representatives in general welcome the trade union delegates because they appreciate their knowledge in financial and accounting affairs, but also their capacity to help to overcome internal strife (multiple unions or works council lists) on the employee bench (ibid., 160). But that does by no means imply the dominance of the external trade union members (ibid., 160).

The ‚consent principle' is said to hold even when appointing members to the executive board, be it for the first or a repeat appointment (ibid., 272, 277). In rare cases where the employee bench resists an appointment, the candidate is usually withdrawn (ibid., 257). Likewise, remuneration decisions are preferably taken on the basis of a unanimous vote by the whole supervisory board (ibid., 280).

The triangle of executive board, employees and shareholders allows different coalitions. 'Managerial capitalism' was characterized by a coalition of employees and executive board against the interests of shareholders. 'Financial capitalism' with its emphasis on shareholder value relatively weakened employee interests. A closer look would distinguish majority and minority shareholders or employees in German or foreign subsidiaries. Suffice it here to say that such coalitions are not stable, but change with issues. If shareholders demand greater transparency, employees will support them, as they often perceive a lack of information by the executive board (cf. note 8). In case of a tied vote, the executive board may buy the consent of employees through concessions in aeras where the employees have no legal say. The field of forces that determine 'the interest of the corporation' cannot reasonably be organized by contracts, but will evolve through instable coalitions or more broadly: through a political process. "Compared to bargains, coalitions are less stable, less enforceable, and less predictable." (Coffee 1989, 1496) This is why I am sceptical of the descriptive value of the agency theory of the firm with its aim to solve all problems through incentive contracts. There is no given, well defined objective function representing the firm as if it were of a representative principal. Blair (1995,79) states bluntly: "One of the most important problems impairing the function of boards is the lack of consensus not only about their goals, but also about whose interests they should serve." That is why I would like to borrow an insight from the political theory of pluralism. Ernst Fraenkel (1898-1972, who experienced the failure of the Weimar republic and the terror of the Nazi-regime) put forward the idea that in a pluralist democracy it does not make sense to hypothesize a common objective function *a priori*, but that "the common interest" gets substantial meaning only *a posteriori*, i.e., after the process of deliberation and negotiation has come to a – perhaps temporary – agreement.[9]

Not to draw misleading analogies, I pretend neither that business interests as such are equivalent to the *bonum commune* nor that public companies should be organized as democracies or for that matter as cooperatives. But I adopt Fraenkel's idea: 'Common good is not a social reality, but a regulative idea.' ("Gemeinwohl ist keine soziale Realität, sondern eine regulative Idee." Fraenkel 1960, 61; zit. nach Buchstein 2002, 223).

„"The 'common good' is [...] understood to be a regulative idea, based in its details on a code of values postulated as generally valid, which is subject to the constantly changing socio-economic considerations of expediency, and which has the vocation and suitability to serve as a model in the shaping of politically non-controversial matters and as a binding guideline in the balancing regulation of politically controversial matters." ("Unter dem 'Gemeinwohl' wird […] eine in ihrem auf einen als allgemein gültig postulierten Wertkodex basierende, in ihren Einzelheiten den sich ständig wandelnden ökonomisch-sozialen Zweckmäßigkeitserwägungen tragende regulative Idee verstanden, die berufen und geeignet ist, bei der Gestaltung politisch nicht kontroverser Angelegenheiten als Modell und bei der ausgleichenden Regelung politisch kontroverser Angelegenheiten als bindende Richtschnur zu dienen." (Fraenkel 1963, 339; zit. nach Buchstein 2002, 227)).

„"The function of reflected consensus, apart from integrating divergent wills, is above all to legitimise agreements reached." ("Die Funktion des reflektierten consensus besteht neben der Integration der divergierenden Willen vor allem in der Legitimation getroffener Vereinbarungen." (Buchstein 2002, 229))

Fraenkel demands from each particular group not to overstate their interests – this corresponds in a way to the faithful co-operation that the Company Law demands from each member of the supervisory board. The Company Law even requires to disregard individual interests – in the eyes of economists a condition that can only be understood and accepted as a moral admonition to self-restriction, but not to self-sacrifice. Mind you, the Company Law does not confer equal voting power to each party involved.

While in Fraenkel's democracy the public good only comes into being through a public process of negotiations, discussions and compromises, the Company Law stipulates the confidentiality

[9] Thanks to Oscar Gabriel who drew my attention to Fraenkel's theory. This view appears to be more plausible to lawyers than to economists: „The effectiveness of corporate co-determination is conceived as a process in which people from different areas and with different forms of legitimacy help to shape the corporate policy of the public limited company as a pluralistic value-creation event." ("Die Wirkkraft der Unternehmensmitbestimmung ist prozesshaftgedacht, indem Personen aus unterschiedlichen Bereichen und unterschiedlich gestalteter Legitimation die Unternehmenspolitik der Aktiengesellschaft als interessenpluralistischer Wertschöpfungsveranstaltung mit gestalten." (Windbichler 2009, 813))

of the negotiations in the supervisory board. This lack of transparency is again intended to overcome special interests; public discussions could limit each member's room for manoeuvring and thus complicate compromises.

Fraenkel's theory of the public good in pluralist democracies is highly controversial among political scientists because of its implied, but not elaborated natural law underpinnings. But I think it can serve well as a perspective on the working of co-determined supervisory boards – and finally on their economic effects.

Faust, Bahnmüller, Fisecke (2011, 387f.) take the view that both benches in the supervisory board share a common interest in the competitiveness of their corporation and therefore are willing to compromise – including a tendency towards externalizing negative effects on secondary or foreign workers and thus presumably turning a coalition into collusion. But what statistical insights do we have into causal effects of codetermined supervisory boards?

5. The economic impact of codetermined supervisory boards – quasi-experimental studies

There is no lack of bold statements on the allegedly devastating economic impact of the German codetermination laws (cf. exemplary Peltzer 2009, 710, passim). I refrain from repeating them here. I also see no point in once again recapitulating the many empirical studies of the economic impact of codetermined boards in Germany (cf. Lopatta et al. 2020, 58f.; Wolff, Rapp 2019, 13-17). They vary with regard to the dependent variables considered, sample size and time span, estimation methods used - and also in their results. In fact, reported results are often contradictory (cf. e.g., Bermig/Frick 2011 or Gordon, Schmid 2004, Zugehör 2003 or Petry 2018).[10] Instead, I shall base my arguments exclusively on *quasi-experimental studies* of the economic effects of co-determined supervisory boards in Germany, because the identification strategies of these studies allow for causal inference – despite the lack of random assignment.[11] By focusing on one country (Germany), a common institutional background is guaranteed, as

[10] I skip international comparisons in the vein of the functional equivalence hypothesis. Hansch (2012), for instance, realized a case study to compare the (employer borne) agency costs of corporate governance in Germany and the United States for the year 2006. Her study investigated German companies with subsidiaries in the US who had to comply with US standards. In her accounting study, Hansch states that in one of her two cases the costs of the corporate governance in Germany are *lower* than in the US. Including the costs of works council codetermination resulted in a slight advantage in favour of the US regulation in one of the two corporations (Hansch 2012, 251).

[11] More traditional regression techniques capture the intensity of co-determination through continuous (e.g., Scholz, Vitols 2018; Balsmeier/Bermig/Dilger 2013) or categorical (e.g., Gerum, Mölls, Shen 2018) indices and estimate a variety of correlations.

advocated by the context-matters hypothesis. In total, I selected six quasi-experimental studies on the economic effects of German co-determination. All the studies include in their theory of corporations the possibility that the agency model, i.e., the hold-up model of codetermined supervisory boards, might not be adequate to grasp the political nature of the inner working of corporations and, by implication, of their bodies.

While two studies compare companies that are subject to the so-called *one-third codetermination*, the four others focus on quasi-parity codetermination. As employees in both situations have a minority status, I will report on these together.

All of the six studies use the legal threshold of the headcount that determines the applicability of the respective co-determination law to assign the treatment condition: i.e., 500 employees in case of the One-Third Codetermination Act and 2,000 employees in case of the Parity Codetermination Act. Assuming that companies just a little smaller than the threshold are essentially identical to those just a little bigger, the first may be viewed as control group or counterfactual for the experimental treatment "installing a codetermined supervisory board" that the law imposes for the companies with a headcount over and above the threshold. One may compare treatment and control group directly with regard to different outcomes. Alternatively, one may take the date of the legal intervention to see whether this treatment changed parallel trends between otherwise comparable companies. The estimation techniques used are regression discontinuity designs and difference-in-differences designs respectively.

5.1 Investment incentives not weakened

In 1994, an amendment of the German Company Law abolished the election of employee representatives in German supervisory boards of newly founded stock corporations with less than 500 employees, while maintaining the minimum requirement of one third of employee representatives in supervisory boards for already existing stock corporations – a requirement that was enacted in 1952 for all stock corporations irrespective of their size. Other (non-stock) corporations, like limited liability companies, with less than 500 employees remained exempt from codetermined boards. Jaeger, Schoefer, Heining (2021) use this clear cut, first, to compare stock corporations incorporated before or after the cut-off date to otherwise comparable limited liability companies for which the rules were not changed and which were also incorporated before or after the cut-off date. They look at the time interval 1992 to 1996 and base their examination of the "treatment effect" of the 1994 legal change on a rich set of combined data: firm-level panel data on balance sheets and income statements that includes information on incorporations and exits; matched employer-employee data to measure effects on wages, employment, worker turnover, as well as skill and occupational structure; and a complete list of German corporations that contains information on the composition of boards with regard to employee and shareholder representatives.

To identify the effects of the legal change the authors compare, first, "old" or incumbent stock corporations (incorporated up to two years before the cut-off date of the amendment) to "young" ones (incorporated up to two years after the cut-off date), and, second, they compare the development of limited liability companies which were always exempted from employee representation in their supervisory boards. This difference-in-difference comparison does not assume that stock corporations and limited liability companies are not different from one another, but that trends are parallel, "…that is, the with-in-legal-form difference between slightly older versus younger firms would stay constant, were it not for the 1994 reform changing the codetermination mandate in young stock operations (but leaving these rules unchanged for the three other groups)". (Jaeger, Schoefer, Heining 2021, 698, note 27). [12]

Here are some of the key results from the study by Jaeger, Schoefer, Heining (2021) on the economic impact of one-third codetermination in supervisory boards:

Jaeger, Schoefer, Heining (2021) reject the canonical hold-up prediction of agency theory that increasing labor's power reduces owners' investment incentives. On the contrary, they find a considerably higher value-added per employee and no increases in wages, but even small positive effects on the capital share under shared governance – albeit with wide confidence intervals. These results can explain the absence of disinvestment effects (ibid., 673, 711-716).

There seems to be a complementarity between workplace codetermination via works councils and board-level codetermination in terms of wage effects.

The authors find no evidence for reductions in revenue or employment.

They can rule out that stock corporations seek to avoid codetermination by remaining small.

With board-level codetermination the share of sales produced in-house increases.

Jaeger, Schoefer, Heining (2021) conclude their thorough analysis by firmly rejecting the agency model of the corporation, without being able to determine the mechanisms through which the stated results are achieved: Are the investment horizons of employees longer than those of shareholders and management? Are institutionalized communication channels and repeated interactions the main drivers, e.g.?

[12] In an exemplary manner, the authors handle threats to the identification assumption for their difference and difference-in-differences regressions, such as strategic delays of incorporation, a changed composition of new firms by legal form, selective attrition of firms, and they provide checks of placebo reforms in 1996 and 1997.

5.2 Higher financial leverage and cash flow, lower working capital

There are two quasi-experimental studies of the impact of codetermination on financial performance indicators; both focus on parity codetermination. Lin, Schmid, Xuan (2017) examine the impact of the 1976 Law on the financial leverage of firms (= long-term debt ./. total capital, book values). Lopatta, Böttcher, Jaeschke (2018) analyse the consequences of overstepping the 2000-threshold on the short-term financial performance, which they measure by the net working capital and the operating cash flow. (The net working capital is the amount by which current assets exceed current liabilities, it is one indicator of the liquidity of a company; operating cash flow is the amount of cash generated by the regular operating activities of a business within a specific time period.)

Lin, Schmid, Xuan (2017) take two different approaches. First, they compare corporations with slightly less than 2,000 employees with those slightly above the threshold for the new law to apply (regression discontinuity design), then by comparing companies over time that were affected by the law with those that were not affected (diff-in-diff estimation).

Both approaches give the same qualitative result: Being affected by quasi-parity codetermination increases the financial leverage. After disregarding external influences, such as lobbying activities by banks, the findings support the view that there is an interest alignment of employee representatives and banks: "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." (ibid., 322) Further analyses reveal that firms with quasi-parity codetermination enjoy more favourable financing conditions, lower costs of debt, no debt maturities, and fewer covenants, they conduct fewer and better M&A deals, they also have more stable cash flows and profits. (ibid.).

Also interested in financial consequences, Lopatta, Böttcher, Jaeschke (2018) compare a sample of listed and non-listed firms that crossed the threshold of 2000 employees and had to change to quasi-parity codetermination during the years 1987 – 2014 with two control groups: one subject to one third codetermination throughout, the other one with permanent quasi-parity codetermination. The comparability of treatment and control groups is strengthened by using nearest neighbour matching, the identification again uses diff-in-diff estimations.

The authors observe that the switch to quasi-codetermination goes hand in hand with lower working capital and higher operating cash flows, in other words, a more efficient short-term financial management. The authors vaguely relate these effects to improved monitoring and better motivated employees. "Thus, parity codetermination may awaken workers interest in corporate governance issues and may be associated with financial policies that consider the interests of bankers, competitors, customers, creditors, and politicians." (ibid., 9).

Taken together, both studies highlight a positive effect of quasi-parity codetermination on the overall financial performance of codetermined corporations, again the opposite of the hold-up-hypotheses of agency theory. The next three studies show further consequences of codetermination using regression discontinuity designs, and they also shed some light on mechanisms presumably at work.

5.3 Employment stability, but varying wage effects

Gleason et al. (2020) use the threshold of 500 employees to find out whether in the period 2009 – 2015 employee representatives on corporate boards lead to an improved monitoring of financial reporting or whether employee representatives prioritize payroll maximization at the expense of monitoring. The authors hypothesize and confirm that employee representation on corporate boards is associated with a better monitoring of financial reporting – if monitoring responsibilities and payroll maximization incentives are aligned. Their quantile regression shows that employee representatives reduce real earnings management that would otherwise result in wage cuts or job losses, but that they do not constrain real earnings management that increases payroll or job security. The authors observe that employee representatives are associated with increasing stock production for firms in the lower tale of the real earnings management distribution, but not with a decrease in overproduction in the upper tail of the distribution, thus securing total wages and job security at least in the short run, *but foregoing cost-efficient adaptations*. The authors also examine the resistance of codetermined boards against offshoring which the authors interpret as exploiting tax advantages. Gleason et al. (2020) find that in firms where wage and job security would be at risk in case of offshoring, employee representatives in co-determined boards opt against offshoring, *disregarding the tax gains*. Ceteris paribus these results indicate that codetermination "…can help to reduce agency costs in general. However, when they are required to monitor transactions that impact payroll and job security, workers appear to prioritize worker concerns." (ibid., 27)

The suspicion of employee-backed management decisions at the expense of share-holders, a conceivable collusion, are also the subject of two further studies.

Lin, Schmid, Sun (2019) aim at identifying the role of codetermined supervisory boards for the level of executive compensation. First, they use the Codetermination Act from 1976, then the Act on the Appropriateness of Executive Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung - VorstAG) from 2009 which strengthened the role of the employee representatives on the supervisory board in setting executive compensation. The law mandated that executive pay may no longer be determined by the 'compensation committee' – where employee representatives were underrepresented in two-third of the cases considered (compared to their overall share in the supervisory board) – but must be decided by the supervisory board as a whole. In both cases, the exogenous threshold clearly separates treatment and control group. The authors also combine the two approaches to compare the change in executive compensation among similar firms just above and just below the threshold of 2,000 employees in a "discontinuity in difference" approach.

All three analyses result in similar findings. Firms with just above 2,000 employees before the passage of the respective law increase their compensation per manager by 40% more than firms just below the threshold (ibid., 5). Rejecting the idea that the increase might reflect a higher risk premium, the authors put forward a worker-manager-alliance hypothesis to explain this perhaps surprising result. They show that workers are better off in codetermined firms as they enjoy better job security in the form of a lower employment-performance sensitivity (ibid., 24). It is plausible that employee representatives honour a higher employment protection through conceding a higher management remuneration. Shareholders should object to such collusion, if it reduces the part of the corporate value-added that accrues to them. But the question of whether codetermination changes worker productivity, value-added and the distribution of the value-added are left aside in the three papers just mentioned. It is, however, tackled by Kim, Maug, Schneider (2018).

Kim, Maug, and Schneider (2018) ask who bears the costs of a preferential treatment of corporate stakeholders. They, too, find that employment in firms with quasi-co-determined supervisory boards is less volatile. They then proceed to show that employees pay an insurance premium for employment stability via reduced wages. Empirically this implies that co-determined firms dampen the effects of demand shocks on the employment level, and that employment protection occurs in conjunction with which wage reductions. Such an implicit insurance contract relies on a commitment device. Kim, Maug, Schneider (2018) view the employee representatives in the supervisory board as a guarantor of such an implicit contract. The period they consider ranges from 1990 to 2008, only listed companies were included, and the accounting data were matched with establishment level data on employment and wages from the IAB. The majority of non-parity firms in the sample have one-third employee board-level representation. An employment shock was defined as an industrywide decrease of at least 5% in employment (given a three-digit NACE-code) in non-sample firms.

The empirical findings confirm their hypotheses. Quasi-parity-codetermined firms retain about 8% more employees in comparison to non-parity firms in response to a negative industry shock. If there were no wage reduction, the authors would suspect a worker-management collusion, making shareholders pay for the insurance of employees. But their point estimate "… indicates employees of parity-co-determined firms receive on average about 3.3% lower wages, consistent with… implicit contract theory." (ibid., 1279). Thus wages become fixed costs rather than variable costs, the operating leverage deteriorates, i.e., firms must cover a larger amount of fixed costs per period regardless of whether they sell any units of product. The authors' estimations of the return on assets (ROA) "… suggest that parity codetermination more than doubles the negative impact of shocks on profitability and valuation relative to non-parity firms" (ibid., 1284). In the end, however, the wage reductions leave the interests of shareholders untouched.

Kim, Maug, Schneider (2018) cannot rule out other explanations for the relative wage disadvantage observed in firms with parity co-determined supervisory boards, nor do they know whether the wage reduction amounts to a fair insurance premium. They see an indirect encouragement for their insurance-premium interpretation in the observation that low-qualified employees do not experience lower wages, as they are not protected against employment shocks and as they are typically not represented in supervisory boards (according to Kim, Maug, Schneider 2018, 1281 and 1286).

Overall, the state-of-the-art quasi-experimental studies on the economic effects of codetermined supervisory boards by and large show positive or nonnegative effects even on shareholder wealth – and a far-reaching improvement of the well-being of the core workforce. As to the theory of codetermination, these contributions overwhelmingly refute the hold-up model of codetermination in favour of a view that treats the supervisory board as a pluralist and political body that generates the corporate objective function, "the business interest", only *a posteriori*. The results reported are in stark contrast to Bebchuk and Tallarita's (2020) reasoning on "the illusory promise of stakeholder governance" – at least as far worker codetermination in German corporations is concerned.

Collectively, the evidence on the effects of codetermined supervisory boards point to different mechanisms, i.e., deals and coalitions within the supervisory board and across the two boards:

a limited coalition between worker, bank and shareholder representatives with regard to monitoring to make life more difficult for the executive board,

a conditional alignment of interests between worker representatives and members of the executive board to ensure employment stability for core workers and a pay premium for the executive board at the perhaps short-term expenses of shareholders or

a deal between core worker representatives and the executive costs to ensure employment stability with the employees paying for it themselves through wage reductions.

6. Does 'financial market capitalism' make the results obsolete?

While past studies on the economic impact of corporate codetermination remained often inconclusive, these more recent papers essentially "document" that co-determined supervisory boards in many regards served both shareholder and employee interests. As the time periods covered lie between 1974 and 2015, the question arises, whether the results still hold. Although the legal regulation of codetermined boards did not change, the end of the Deutschland AG (withdrawal of banks from industrial investments, end of deposit voting rights, and disappearance of the house bank principle) and the much-vaunted rise of financial or shareholder capitalism have brought about new control strategies in public corporations.

This is not the room to scrutinize the various grand narratives of the new dominance of Financial Market Capitalism "…. that insinuates that powerful institutional investors, guided by a single and unambiguous definition of interest and accordingly an unambiguous logic of action, are authorized and capable to impose their will onto all of the actors in and around the enterprise" (Faust, Kädtler 2019, 291). Instead, I shall sum up the account of the current shareholder composition in German corporations as provided by Faust, Thamm (2015), condensed in Faust 2017).

Unfortunately, the importance of high-frequency traders, index funds and exchange-traded funds – that is shareholders 'with investment strategies without a connection to the real economy reference object' – is unclear in Germany, but their rise in particular among institutional investors is uncontested. (In 2016 for instance 36% of Deutsche Bank shares and 25% of Daimler shares were held by index funds, Handelsblatt 3.8.2018, cit. according to Faust 2017, 6). These shareholders 'act' without stating their motives, thus exercising no direct influence on the governance of the affected company (cf. Faust 2017, 7).

Another shareholder type makes its investment decisions dependent on the real behaviour and plans of companies, focusing for example on 'green' investments, or on event-oriented trading; activist hedge funds are a one example of that type of investor. While the importance of activist hedge funds is hard to assess quantitatively, "the structural hurdle for hedge fund activism continues to be very high in Germany. As of 2014, 58.1% of all 160 DAX companies still had a de jure investor with more than 25% of the voting rights according to share ownership" (Faust 2017, 13), i.e., at least a blocking minority. Taking into account the low attendance of shareholder meetings in 2014, for instance, the proportion of companies with a de facto block holder amounted to 71.3% (Faust, 2017, 14).

Concentrated ownership has historically been characteristic of the German stock market. Owner families may hold shares over generations and thus are held to have interest "in maintaining and growing the functional and social coherence of the company … rather than the short-term and optimistic exploitation of returns" (ibid., 16). According to the 'cautious' estimations of Faust/Thamm (2015, 18): In 2014 in Germany "…58.1% of listed companies have an anchor investor defined by a blocking minority of 25%, 33.1% have a majority shareholder (more than 50% of votes) and 8.1% have a super majority (75% of voting rights)". As a consequence, hostile takeovers are much harder to achieve then than under widely held stock.[13]

[13] Gerum, Mölls, Shen (2018) also reject the image of capital market-oriented firms as capturing the essential conditions in Germany, based on an empirical analysis of their financial behaviour.

Faust (2017, 24f.) rejects the self-image of funds as being the successors to Deutschland AG on the grounds that they do not exert the role of insiders to a similar extent. He regards the block holders “much more of a functional equivalent to Deutschland AG” (ibid., 25). Sharing this view, an American observer strikes a surprising conclusion: Despite pervasive rhetoric about shareholder primacy in the US, corporate governance there provides relatively little explicit or implicit shareholder influence, whereas in Germany “… the prevailing concentrated ownership structure creates a considerable degree of explicit shareholder influence” (Gelter 2009, 176) – in contrast to the law in the books.

Quasi-parity codetermination cannot balance the bargaining power between block holders and employees, neither does it lead to “deliberative corporate governance” (Ferraro 2019), but the recent empirical research summarized here indicates that, given the actual power relationships and a common will among the corporate actors to succeed in a competitive environment, codetermined boards do serve the role German corporate law envisages for them. Whether this justifies calling the law "a stroke of genius of modern social order" (“einen Geniestreich moderner Sozialordnung” (Lutter (1982, 571), zit. according to Gietzen 2013, 268 – without Lutter’s irony, however) is up to the reader to decide.

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