

From Taxonomies to Institutional Design

As we have seen in the previous lecture, corporate governance taxonomies categorise systems based on a number of key features:

- **How they finance growth** (market-based vs. bank-based),
- **Who controls firms** (insider vs. outsider systems),
- **Their legal origins** (common law vs. civil law),
- **Their political roots** (liberal vs. coordinated markets).

This gives us the opportunity to synthesise them into two overarching models that dominate real-world practice: the *Anglo-Saxon* and *Rhineland* models.

	Anglo-Saxon Model	Rhineland Model
Finance System	Market-based (U.S./U.K.)	Bank-based (Germany and some other continental European countries)
Ownership	Outsider-dominated (dispersed)	Insider-dominated (families/banks)
Legal Family	Common law (investor protection)	Civil law (stakeholder rights)
Political Economy	Liberal Market Economy (LME)	Coordinated Market Economy (CME)

Other key Differences between Anglo-Saxon and Rhineland Models:

	Anglo-Saxon (U.S./U.K.)	Rhineland (Germany/Netherlands)
Primary Focus	Shareholder value	Stakeholder welfare
Board Structure	Unitary board	Two-tier board (Management + Supervisory)
Capital Markets	Equity-financed, short-term	Bank-financed, long-term
Labour Relations	Market-driven, flexible	Co-determination (worker reps)

The Anglo-Saxon Model — Shareholder Primacy & Market Capitalism

Introduction

The Anglo-Saxon model of governance is characterised by widespread shareholding of equity and a stress on financial objectives by the companies. A typical company is one that is represented by a large number of shareholders at arm’s length (hence the model is sometimes referred to as the “outsider model”). The objective of the governance system is to establish rules and guidelines that enable board members and executives to work towards maximising shareholder wealth. Shareholders are viewed as the “risk takers” of the company.

Revisiting the agency problem

Shleifer and Vishny (1997) ¹ provide a concise explanation of the rise of the agency problem and the difficulties in creating the perfect contract:

The Agency Problem: Ownership vs. Control

The agency problem arises when the people who manage a business (managers) are not the same as those who provide the funding (owners or investors). A manager might raise money from investors to start a new project or to sell their own stake in the company. Investors rely on the manager's expertise to make a profit, while the manager depends on the investors' money, either because they don't have enough funds themselves or because they want to cash out.

However, once investors hand over their money, how can they be sure the manager won't misuse it or invest in bad projects? This is the core of the agency problem: ensuring that managers don't waste or steal the funds they've been entrusted with.

Contracts and Control Rights

To address this, investors and managers create contracts that outline how the funds will be utilised and how profits will be distributed. Ideally, these contracts would cover every possible situation, but in reality, it's impossible to predict every future scenario. Even if the manager wants to cooperate, writing a "perfect" contract isn't feasible.

Because of this uncertainty, contracts must include **residual control rights**—rules that specify who has the authority to make decisions when unexpected issues arise. One might think investors should keep all control, but this doesn't work because they lack the expertise to make day-to-day business decisions (which is why they hired the manager in the first place). As a result, managers typically retain significant control over how funds are allocated.

While contracts and corporate governance systems can place limits on a manager's power, the reality is that managers often hold the majority of residual control rights. This imbalance is a key challenge in corporate finance and governance.

Market-driven governance

Bertrand and Mullainathan (2003) ² suggest that a small managerial ownership can create moral hazard for managers. This is because managers bear little financial costs if they pursue their own goals rather than maximise shareholder wealth.

Moral Hazard is a situation in which a party is incentivised to risk causing harm because another party is obligated to remedy the consequences of the harm caused.

Incentive contracts (revisited) — aligning Manager and Investor Interests

A key way to reduce conflicts between managers and investors is to **tie the manager's pay to long-term performance** from the start. By designing compensation contracts that reward managers only when the company succeeds, their interests become more aligned with those of shareholders.

Of course, there may be rare cases where a manager values personal perks or power more than their performance-based pay. However, if the incentives are substantial enough, these situations should be rare. Well-structured contracts can motivate managers to act in investors' best interests, without encouraging manipulation or hold-up tactics.

⚠ Caution

However, these contracts aren't perfect. If the benefits of control (such as status or private perks) are extremely valuable to the manager, or if their pay cannot fall below a certain minimum (even in bad times), incentive contracts can become costly to implement.

For these contracts to be effective, two things are usually needed:

1. **Measurable Performance:** There must be a clear, objective way to track performance—something that can even hold up in court if disputed.
2. **Credible Enforcement:** Sometimes, even informal signals (like observable but unverifiable metrics) can work if investors have a credible way to punish or reward the manager based on results.

Incentives can take many forms, such as:

- **Stock ownership** (giving the manager a direct stake in the company's success),
- **Stock options** (rewarding them if share prices rise), or
- **The threat of firing** if performance is consistently poor.

Using a 15-year panel data set of CEOs in the largest, publicly traded US companies, **Hall & Liebman (1998)**³ show that the elasticity of salary and bonus with respect to changes in firm value is 0.16, meaning that a one-unit change in performance is related to only a 0.16-unit change in salary and bonus. This suggests that the salary component of compensation has a weak link to performance. However, the paper finds a rising sensitivity since the early 1980s. The most important finding is this: the pay-to-performance sensitivity from direct compensation is tiny in comparison to the sensitivity generated by holdings of stock and stock options. The 0.22 elasticity of salary and bonus (adding the coefficients on contemporaneous and lagged performance) implies that a 10 per cent increase in firm performance will increase salary and bonus by 2.2 per cent or about \$23,400 (evaluated at the median CEO salary and bonus in 1994). In contrast, this same 10 per cent increase in firm value increases the value of the median CEO's stock and stock options by about \$1.25 million, which is 53 times larger.

How about the performance effect on total compensation? The paper divides sample firms into nine deciles based on performance. It reports that, "assuming a tenth percentile performance, the average CEO in the sample loses \$2.4 million in the value of stock option holdings and nearly \$15 million in the value of their stock holdings. These losses swamp the amount of direct compensation gains to the CEO, so that on net CEOs lose an average of about \$14 million when their firms perform this poorly. These losses contrast with net gains of \$7.6 million for a median performance and an astounding \$35 million gain for a ninetieth percentile performance."

There is further evidence that both the pay-for-performance sensitivity increases from 1980 to 1994:

TABLE VIII
CHANGE IN FOUR PAY TO PERFORMANCE MEASURES OVER TIME MEASURES ARE
BASED ON CHANGES IN THE VALUE OF HOLDINGS OF STOCK
AND STOCK OPTIONS ONLY

Year	Median elasticity (1)	Median change in CEO wealth per \$1000 change in firm value (2)	Median 10th to 90th dollar change (millions of dollars) (3)	Median 50th to 70th dollar change (millions of dollars) (4)
1980	1.17	2.51	1.396	0.281
1981	1.40	2.70	1.631	0.323
1982	1.50	2.86	1.676	0.334
1983	1.71	3.35	2.097	0.415
1984	2.02	3.21	2.671	0.523
1985	1.91	3.46	2.881	0.569
1986	2.26	3.84	3.318	0.654
1987	2.42	3.97	3.885	0.761
1988	2.33	3.63	3.931	0.770
1989	2.81	4.11	4.517	0.887
1990	3.10	3.64	5.297	1.034
1991	2.68	4.22	4.424	0.873
1992	3.61	4.63	6.773	1.333
1993	3.99	5.30	7.929	1.560
1994	3.94	5.29	9.237	1.823

Columns (3) and (4) are in 1994 dollars. Pay to performance measures are calculated using actual CEO compensation arrangements for each year, under various assumptions about firm performance. The elasticity in column (1) is the percent change in CEO compensation divided by the percent change in market value from moving between a 50th and a 70th percentile performance.

In summary, we can say that:

- The Anglo-Saxon model prioritises **shareholder value maximisation**, so executive pay is structured to reward behaviours that boost stock prices and dividends.
- Incentives like **stock options** tie compensation directly to market performance, encouraging rapid responses to market signals.
- Contracts are designed to be **results-driven**, reflecting market expectations.

The corporate-control market

Theoretical foundation

Henry Manne (1965)⁴ constitutes an introduction to a study of the market for corporate control, emphasising that the control of corporations constitutes a valuable asset independent of economies of scale or monopoly profits.

When a company is poorly managed - meaning it's not generating as much profit for shareholders as it potentially could under better leadership - we see its stock price drop compared to competitors in the same industry or the overall stock market. This price decline matters significantly for what we call the "market for corporate control" (how companies are bought, sold, or taken over) for an important reason:

 **Important**

When a company's stock price falls below its potential value (due to poor management), it becomes a more appealing target for investors who think they can run the business better. This creates a strong incentive for takeovers, as the financial rewards for successfully improving an underperforming company can be extremely large.

Manne argues that the stock market serves as the only reliable measure of how well a company is managed. In reality, the threat of takeovers is what truly keeps corporate managers efficient and protects regular shareholders. While government agencies like the SEC (Securities and Exchange Commission) and FCA (Financial Conduct Authority) and lawsuits do offer some shareholder protections, these pale in comparison to the power of the takeover market. Although this system requires unhappy shareholders to sell their shares (often at a loss) to work, without this competitive market for corporate control, shareholders could face even bigger losses from continued poor management.

Evidence (1): Bertrand and Mullainathan (2003)

Bertrand and Mullainathan (2003) investigate the effect of takeovers on performance using the passage of antitakeover laws to measure changes in corporate governance. **These laws, passed by many states at different points in time, restricted hostile takeovers of firms incorporated in the legislating states.** The reduced fear of hostile takeover means that an important disciplining device—market for corporate control—has become less effective, and that corporate governance overall has been reduced.

The analysis of the laws focuses on two types of outcomes: firm-level and plant-level.

- Firm-level analysis: To infer the laws' effect for firm-level outcomes, the paper compares changes in outcomes around the time of a law for firms affected by the law to changes for firms unaffected by the law.
- Plant-level analysis: When a state passes an antitakeover law, all firms incorporated in that state are affected, regardless of their state of location. Since many of the corporations in the sample (roughly three-quarters) have plants located in different states, this feature allows the authors to completely control for shocks specific to a state of location and year.

Note

What does this mean?

These laws apply to firms *incorporated* in the state, **not** just firms *physically located* there

Consider two plants located in New York, one of which belongs to a Delaware-incorporated firm and the other to a California-incorporated firm. When Delaware passes its law in 1988, researchers can compare the changes in outcomes in the Delaware-incorporated plant with the changes in the California-incorporated plant. Since both are located in New York, they will be affected by roughly similar economic and political shocks; however, only the plant belonging to the Delaware firm will be impacted by the change in corporate law.

Firm	Incorporation State	Plant Locations	Affected by DE Antitakeover Law?
A	Delaware (DE)	DE, Ohio, Texas, NY	Yes (all plants)
B	California (CA)	DE, California, NY	No (even DE plant is unaffected)

Why does this matter?

Rules out alternative explanations (e.g., "Maybe firms in Delaware declined because of a local recession"). Since many firms operate (have plants) in **multiple states**, their *locations* are exposed to different local economic shocks. But their *incorporation state's laws* affect them uniformly, regardless of where they operate.

In this way, researchers can control for any political economy or business cycle factors that may have coincided with or led to the passage of the antitakeover law, **isolating the effect of antitakeover laws** from other state-specific factors (e.g., local labour markets, taxes).

Findings:

- The paper finds that production workers' wages rise by about 1% in the protected plants and white-collar wages rise by about 4%.
- Both the rate of plant destruction and the rate of plant creation fall.
- **The total factor productivity declines following the enactment of anti-takeover legislation.**
- Return on capital falls by nearly 1%.
- **These findings support the idea that better governance improves economic performance and does not involve only a transfer of rents to shareholders.**

Evidence (2): Cain et al. (2017)

Instead of using individual takeover laws, **Cain et al. (2017)**⁵ examine the long-term effect of the full array of takeover laws on firm performance. The paper utilises a dataset of 17 different takeover laws and court decisions from 1965 to 2014 to measure the variation in takeover laws and their long-term impact on hostile activity.

The set of takeover laws and court decisions includes:

1. The Williams Act in 1968
2. The first generation takeover laws and their repeal
3. Business combination laws
4. Fair price provisions
5. Control share acquisition statutes
6. Control share cash-out statutes
7. Poison pill cases and statutes
8. Mandatory classified board laws
9. Expanded constituency laws
10. Disgorgement provisions
11. Anti-greenmail laws
12. Golden parachute restrictions
13. Tin and silver parachute blessings
14. Assumption of labour contract laws
15. The Revlon standards of review (based on Revlon Inc. v. MacAndrews & Forbes Holdings)
16. The Unocal standards of review (based on Unocal v. Mesa Petroleum)
17. The Blasius standards of review (based on Blasius Industries v. Atlas Corp.)

A takeover index is then constructed, which shows the probability of a hostile takeover. The higher the index coefficient, the more susceptible to takeover:

Scaled Takeover index	Mean	Standard Deviation	25th percentile	Median	75th percentile
1965-1979	1.449	0.881	0.736	1.290	2.117
1980-1989	1.389	1.216	0.486	1.064	2.012
1990-1999	1.083	0.957	0.383	0.769	1.493
2000-2014	1.172	0.917	0.473	0.966	1.586

Source: Table 8.

Varying trend

The scaled Takeover Index shown above has the highest mean in the 1960s, 1970s, and 1980s, when firms were most susceptible prior to the passage of the fair price laws. The 1990s and 2000s are lower, reflecting more state-level protection and lower rates of hostility in the market for corporate control.

The paper finds that the general susceptibility to a hostile takeover peaked in 1973 (likely due to lax regulations, weak defences, or favourable economic conditions) and has varied substantially since then. As a proportion of total M&A equal-weighted volume, hostile activity peaked in 1967 at 40%⁶ immediately prior to the enactment of the Williams Act and declined to about 8.6% in 2014, showing hostile takeovers became far rarer relative to friendly deals.

Tip

[Student activity]

1. What does the Williams Act require?
2. What are poison pills and staggered boards, and their effect on hostile takeovers?

Statistical relation between takeover susceptibility and firm value

The paper then proceeds to examine the correlation between firms' takeover susceptibility and firm value, with the Takeover Index serving as a proxy for firms' susceptibility to hostile takeovers.

Coefficient	All Years (1)	1965-1979 (2)	1980-1989 (3)	1990-1999 (4)	2000-2014 (5)
Takeover index	0.022**	0.091*	0.006	0.051***	0.040***

Source: Table 9. ***, ** and * represent statistical significance at the 1%, 5%, and 10% level, respectively.

Column 1 reports a strong and economically significant positive correlation between takeover susceptibility and firm value, indicating that firm value is increasing in its susceptibility to hostile takeover. Columns (2) through (5) indicate that the positive coefficient on the Takeover Index is consistent across all time periods and significantly different from zero in all but one period. The results are consistent with studies that show legal environments in which managers are insulated from takeovers have a negative impact on shareholder value. The results also highlight the effect of takeover laws on the disciplinary market for corporate control and, ultimately, the trade-off between bargaining power and entrenchment with the resulting impact on firm valuation.

Statistical relation between takeover susceptibility and takeover premium

The paper then examines the correlation between firms' takeover susceptibility and takeover premium, which is the cumulative abnormal return over the period 63 trading days prior to the announcement until 126 days after the announcement or deal completion, whichever comes first⁷.

Coefficient	All Years (1)	1970-1979 (2)	1980-1989 (3)	1990-1999 (4)	2000-2014 (5)
Takeover index	-0.041**	-0.010	-0.005	-0.042***	-0.064**

Source: Table 11. ***, ** and * represent statistical significance at the 1%, 5%, and 10% level, respectively.

Over the entire sample period, the paper finds a negative relationship between takeover premiums and takeover susceptibility, consistent with the bargaining power hypothesis, which posits that takeover protections offer target firms a stronger negotiating position.

In summary, we can say that:

- Anglo-Saxon firms rely on **capital markets** to hold managers accountable.
- Poor performance leads to falling share prices or hostile takeovers—forcing managers to perform or face replacement.

[Student activity]

1. What are the proponents and critics of hostile takeovers? Check Jensen (1986) and Lipton (2002) ⁸.
2. What are the main arguments in chapters 2 and 3 from *The Shareholder Value Myth* (Lynn Stout, 2012), which criticise the legal foundation and economic assumptions of shareholder primacy?

The Rhineland Model (German Focus) — Stakeholder Capitalism & Co-Determination

Introduction

The Rhineland model is characterised by significant holding by a parent company, and outside shareholders represent a smaller portion of the equity. This model is based more on a “socially correct” market economy. In fact, individual companies within a particular company group can be viewed as an “internal market”, both in terms of financial and other resources such as labour and intellectual properties. Hence, cooperation is stressed. Shareholders in this system are generally stable partners and relatively long-term investors compared to the Anglo-Saxon model. Shareholders are viewed as “partners” of the company.

The Rhineland model also presents a difference in the structure of the board of directors. German companies, for instance, are comprised of a dual board system: a supervisory board responsible for strategic decision-making, and a management board responsible for executing day-to-day strategies (a broadly similar system is also present in the Japanese corporate system).

Large German firms take several different legal forms:

	Aktiengesellschaft (AG)	Kommanditgesellschaft auf Aktien (KGaA)	Gesellschaft mit beschränkter Haftung (GmbH)
English equivalent	A stock corporation	A partnership partly limited by shares	A limited liability company
Function	Public limited company	Has elements of both a public limited company and a partnership	/
Legal evidence of ownership	Shares	Shares	/
Eligible to be listed?	Yes	Yes	No
Supervisory board?	Compulsory	Compulsory	Compulsory when the no. of employees exceeds 500
Can the supervisory board dismiss/appoint the management board?	Yes	Yes	No

The role of banks

In Germany, most company shares are unregistered bearer shares, meaning they don't list the owner's name. For safety and convenience, shareholders often deposit these shares with banks. When shares are deposited, **banks may gain the right to vote them at shareholder meetings**. Shareholders can grant banks a 15-month proxy to vote on their behalf.

However, banks must follow specific rules when using these voting rights. Before each meeting, the bank must tell shareholders how it plans to vote and ask for their instructions. If shareholders don't provide directions, the bank can generally vote as it originally proposed – though in practice, banks sometimes have flexibility to vote differently.

Banks are often elected to the supervisory boards of companies as shareholder representatives, and sometimes chair supervisory boards. This allows banks to **monitor** the management of companies, particularly when a bank chairs the supervisory board, since the chairman is usually consulted monthly by the management, while the full supervisory board may only meet twice a year.

German banks can influence corporate governance through proxy voting and supervisory board positions, but this power has limits. Their proxy voting rights only apply to stock corporations (AGs) and partnership limited by shares (KGaAs) - companies that represent just a small portion of Germany's economy. Unlike the UK, where public companies dominate, most German business activity comes from private firms like GmbHs (limited liability companies), partnerships, and sole proprietorships that can't issue public shares.

The supervisory board system also has restrictions. These boards are legally mandatory only for **AGs, KGaAs, and large GmbHs**. Consequently, **banks can only place representatives on supervisory boards for these specific types of companies**. Their influence doesn't extend to Germany's many smaller or privately-held businesses.

Ownership concentration

Some facts

Shareholder representatives on the supervisory board are elected at the shareholders' general meeting by a simple majority vote of shareholder representatives. Certain other decisions are made by vote at the shareholders' general meeting, rather than by the management board, requiring a 75% majority. These decisions include changes in the company's statutes, changes in equity capital, and mergers and liquidations. Therefore, a shareholder with over 25% of the voting equity can block these decisions.

The concentration of ownership in large German firms is much greater than in UK firms. **Franks and Mayer (1995)**⁹ found that, in 1990, nearly 85% of the 170 largest listed German companies had a single shareholder with an ownership stake of at least 25% of the share capital; the corresponding figure for the 170 largest listed UK companies was 16%. In a more recent study, **Rojahn and Zechser (2021)**¹⁰, using data of companies listed on the German Prime Standard from 2007 to 2017, reveal that the median holding of the largest shareholder is 25.33% of all shares outstanding, indicating substantial ownership concentration in German issuers. In 249 firm-year observations, the largest shareholder holds more than 25% of all shares. The paper reports that the median holdings of the second and third largest shareholders are considerably lower (5.33% and 3.39%, respectively).

The benefit of concentrated ownership

In Germany's corporate landscape, most large companies avoid the classic conflict between scattered shareholders and powerful, unaccountable managers. This is because German firms typically have at least one major shareholder who owns a significant portion of the company. When an investor holds a substantial stake, they have both the incentive and the ability to oversee management effectively.

These block shareholders personally benefit from keeping managers in check, which reduces executives' ability to pursue self-interested goals at shareholders' expense. More importantly, with their controlling position, major shareholders can actively shape company leadership—either by installing their preferred management team or even taking the top executive role themselves.



Tip

[Student activity]

While the existence of block shareholders can reduce the conflict of interest between managers and shareholders, does it create any conflict of interest itself?

Possible explanations

Goergen and Renneboog (2003)¹¹ investigate the reasons for the differences in control between Germany and the UK. The paper answers two questions: (1) the legal and regulatory explanation of the discrepancy in the level of control concentration, and (2) corporate factors that trigger changes in control.



Tip

[Student activity]

Formal assessment 1: essay

Assess how divergent shareholder protection explains variations in ownership structure between Anglo-Saxon and Rhineland corporate governance models. Explain the pros and cons of concentrated and dispersed ownership.

2500 words

In the essay, you should:

- 1. Critically discuss to what extent the varying degrees of shareholder protection can explain the differences in ownership structure between the two major corporate governance models mentioned.**
- 2. Illustrate the theories that support and criticise the concentrated and dispersed ownership structures.**

To complete this assessment, you may use the following points as guidance:

- Revisit La Porta et al. (1998)¹² (see lecture notes of Part 2.1 - Taxonomies of Corporate Governance).
- Study Goergen and Renneboog (2003) and look for evidence of regulatory explanations of investor protection variation.

Codetermination

As opposed to the Anglo-Saxon shareholder system, in stakeholder system countries—e.g., Germany, Japan, and France—a broader view of corporate governance is often taken; the interests of a firm's other stakeholders, including creditors, employees, customers, suppliers, and government, are also considered. While in stakeholder systems the existence of various agency conflicts is acknowledged, the success of the firm is ultimately regarded as in the best interest of all parties.

Basic features

The supervisory board comprises both shareholder and worker representatives. In firms with over 2,000 employees, there is an equal number of shareholder and worker representatives; in small firms, the proportion of worker representatives is one-third. In the former case, the chairman of the supervisory board, always a shareholder representative, can cast a second vote to break ties in supervisory board decisions.

Given the government policy known as the *Mitbestimmungsrecht* (Right of Codetermination), German firms extend decision-making rights to employees. Beginning with the *Montanmitbestimmungsgesetz* of 1951, Germany requires that mining, coal, and steel workers enjoy 50% representation on their company's boards, with the remaining 50% allocated to shareholders. The *Mitbestimmungsgesetz* of 1976 extends this right to all firms with more than 2,000 employees. For public corporations with 500–2,000 employees, the *Betriebsverfassungsgesetz* of 1952 requires that labour receive one-third of the board seats, meaning that there are twice as many representatives of labour as of shareholders.

German public companies, known as *Aktiengesellschaft* (AG), employ a unique **two-tier system**. The first board, known as the *Aufsichtsrat* (**supervisory board**), functions similarly to boards of directors in the US or UK. This group oversees major company decisions, including long-term strategy, CEO selection, and financial performance reviews.

The second board, known as the *Vorstand* (**management board**), oversees day-to-day operations. Importantly, the supervisory board has the power to hire and fire management board members and determines their compensation. **The management board must regularly report to and answer to the supervisory board.**

The codetermination laws also specify the size of the board and the procedures for board elections. The supervisory board typically has between 3 and 21 board members, depending on the statutory capital, number of employees, and the applicable codetermination statute.

Hypothesis

Fauver and Fuerst (2006)¹³ formally examine **whether more comprehensive stakeholder involvement in the governance of a firm can increase firm value**. Specifically, the authors ask “whether employee representatives—while seeking to govern the firm in a manner that protects their own interests—indirectly protect the interests of minority shareholders and thereby increase firm value.”

Employee representation on corporate boards may offer several key benefits:

1. Having workers involved at the highest decision-making level provides management with **valuable on-the-ground operational insights**, leading to better-informed business decisions.
2. Companies in sectors where **teamwork and information flow** are especially crucial - like manufacturing or technology - stand to gain the most from this arrangement.
3. Worker representatives can serve as an important **check on executive power**. They help monitor and limit excessive managerial perks, unjustified salaries, and special privileges for large shareholders, similar to how bank representatives function on boards.
4. This system creates a **two-way communication** channel: employees gain reliable information about company strategy and financial health, while management better understands worker concerns. This mutual understanding helps **prevent costly labour disputes and work stoppages**.

Potential downside of employee representation:

While the prudent use of labour in corporate governance may be value-enhancing, the excessive influence of labour can create a firm that is a “country club” for workers.

Excessive labour representation can reintroduce some of the agency problems that labour representation is meant to cure: The improved assessment of project feasibility may give way to the selection of technologies that maximise payroll rather than minimise the cost of production. That is, given excessive labour representation, project choice may be based in part on labour, rather than management, perquisites.

How do we know this?

Some experts (Roe, 1998)¹⁴ argue that strong worker representation rules might actually weaken German supervisory boards. When companies face extensive employee participation requirements, they may try to work around employee representatives' influence. One common strategy involves shifting important decisions away from formal board meetings. Instead, management frequently meets privately with major shareholders to make key choices, effectively bypassing the official governance process.

Tip

[Student activity]

If you are asked to show the relation between the percentage of labour representation and firm value using a two-dimensional graph with firm value on the vertical axis and labour representation on the horizontal axis, what is the shape of the relation?

Analysis & evidence

Test sample

Fauver and Fuerst (2006) use a sample of all publicly traded German corporations as of 2003 (**786 firms in total**), including firms with varying degrees of labour representation (from zero to more than one-half) and firms for which labour representation is both optional and mandatory. The paper uses Tobin's Q as a proxy of firm value. This research approach lets the authors examine two key questions: First, does having any employee representation help compared to having none at all? Second, by studying a broader range of cases, the authors can gain a deeper understanding of both the potential advantages of worker participation and determine the optimal level of representation.

Preliminary evidence - simple comparison

By dividing the sample into a subsample with employee representation on their supervisory boards (400 out of 786) and one without, the paper finds that firms with employee representation have a significantly higher median value for Tobin's Q than do firms without employee representation (1.126 vs 1.038). This suggests that employee representation may have a positive impact on firm performance.

ER vs no-ER - competition analysis

There may be an interaction between product market competition and the effect of employee representation on firm value.

- **When the level of market competition is high**, board membership should provide a credible means to convey information such as the vulnerability of the firm's competitive position and profits.
- **When the level of market competition is low**, management may be disincentivised to perform, leading to operational inefficiency. Employee representatives equipped with detailed operations-level information should be vehicles for the communication of any operational inefficiency to the board, thereby adding value to firms in concentrated industries.

To measure the level of competition, the paper uses the Herfindhal index value of the firm's business segment.

$$\begin{aligned} \text{Tobin's } Q &= \alpha + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_n X_n \\ &+ \beta_a ER + \beta_b \text{Industrial Concentration} + \beta_c (ER * \text{Industrial Concentration}) \end{aligned}$$

The paper finds that although industry concentration has little effect on firm value, **there is a positive and significant effect when employee representatives are present**. The authors suggest that the benefit of employee representation stems from the increased quality of the information available to the board: employee representatives reduce the costs of incomplete information by providing credible advice as to the feasibility of proposed projects and expenditures. In this way, the board as a whole may more easily identify potential agency costs.

ER vs no-ER - coordination analysis

Firms in industries that demand intense coordination or involve specially skilled and knowledgeable workers should benefit most from employee representation. Strategic management, operations management, and management science literature indicate that coordination and complex information flow are critical issues in industries that require supply chain management. Moreover, a major component of supply chain management is transportation and logistics management and bidirectional flow of information.

To identify these firms, the paper assigns industries according to SIC (Standard Industry Classification) groupings for which complex serial processing is a central component of the industry's operations.

$$\begin{aligned} \text{Tobin's } Q &= \alpha + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_n X_n \\ &+ \beta_a ER + \beta_b \text{Trade Industry} + \beta_c \text{Transportation Industry} + \beta_d \text{Manufacturing Trade Industry} \\ &+ \beta_e (ER * \text{Trade Industry}) + \beta_f (ER * \text{Transportation Industry}) + \beta_g (ER * \text{Manufacturing Trade Industry}) \end{aligned}$$

The paper finds that being in the trade, transportation and manufacturing industries consistently and significantly negatively affect firm value. However, the presence of employee representatives on the board alleviates these negative effects.

Optimal ER

The paper examines three variables:

- *Employee Representation 0– 33* assumes a value of one if employee representation strictly exceeds zero but is less than one-third, and zero otherwise.
- *Employee Representation 33– 50* assumes a value of one if employee representation weakly exceeds one-third but is less than one-half.
- *Employee Representation 50+* assumes a value of one if employee representation weakly exceeds one-half, and zero otherwise.

$$\begin{aligned} \text{Tobin's } Q = & \alpha + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_n X_n \\ & + \beta_a ER_{0-33} + \beta_b ER_{33-50} + \beta_c ER_{50+} \\ & + \beta_d (ER_{0-33} * \text{Trade Industry}) + \beta_e (ER_{33-50} * \text{Transportation Industry}) + \beta_f (ER_{50+} * \text{Manufacturing Trade Industry}) \\ & + \beta_g (ER_{0-33} * \text{Trade Industry}) + \beta_h (ER_{33-50} * \text{Transportation Industry}) + \beta_i (ER_{50+} * \text{Manufacturing Trade Industry}) \\ & + \beta_j (ER_{0-33} * \text{Trade Industry}) + \beta_k (ER_{33-50} * \text{Transportation Industry}) + \beta_l (ER_{50+} * \text{Manufacturing Trade Industry}) \end{aligned}$$

The analysis reveals an important pattern:

- ✓ Only when employee representatives hold between 33-50% of board seats in trade, transportation, and manufacturing companies do we see a statistically significant positive impact on shareholder value. This suggests that simply having workers on the board isn't enough - what matters is having the right balance (roughly one-third to one-half of seats occupied by employee representatives).
- ✓ These findings support our earlier hypothesis that moderate labour representation is most effective. When employee representation falls below one-third or exceeds one-half of the board, the effect on company value becomes negligible (while still generally positive, it's not statistically significant).

Final thought

Jensen and Meckling (1979) say, "If co-determination is beneficial to both stockholders and labour, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily. The fact that stockholders must be forced by laws to accept co-determination is the best evidence we have that they are adversely affected by it."

However, Fauver and Fuerst (2006) show the value-enhancing effect of co-determination.

Tip

[Student activity]

Are Jensen and Meckling wrong? What is the underlying assumption of Jensen and Meckling (1979)? Why is it difficult for the market to recognise the benefit of co-determination?

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 6. 40% of all mergers/acquisitions by *number of deals* were hostile. [↗](#)
 7. A more reader-friendly definition of the takeover premium is the additional amount an acquirer pays over the market value of a target company's shares or assets during a merger or acquisition. [↗](#)

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