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Codetermination as a (Partial) Substitute for Mandatory Disclosure?

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Abstract
Employee board representation can serve information dissemination purposes. This comment argues that in Germany, which (still) has a bank-oriented financial system, transparency may be better served by using codetermination (under which up to half of the supervisory board is composed of employees) as an information channel, rather than by importing the mandatory disclosure requirements that are typical of Anglo-Saxon jurisdictions. There are two reasons for this. One is that the evidence about the efficiency of mandatory disclosure requirements is mixed. The other is that mandatory disclosure is an intrinsic component of market-oriented financial systems such as the US financial system.

Transplanting a market-oriented component into a bank-oriented financial system brings the risk of inconsistencies, as it affects the complementarities that exist among the intrinsic components of a bank-oriented system. This comment thus concludes that before suggesting ways to transplant further mandatory disclosure requirements into the German financial system, or improve existing ones, one should consider how to use or improve the use of codetermination as an information dissemination channel.

Keywords: codetermination, creditor protection, mandatory disclosure.

The debate about the benefits of corporate disclosure requirements has been going on for decades. Critics have argued that, from an information supply perspective,

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disclosure mandates inflict excessive costs on smaller firms and are inadequate for larger firms, whereas from an information demand perspective creditors and investors alike are better served by market mechanisms.

The empirical evidence, however, remains scarce and mixed.[1] For their part, securities regulators around the world have imposed disclosure requirements upon listed firms.[2] The primary objective is to protect public shareholders, but other stakeholders obviously also benefit from securities regulation. In addition, various corporate laws, in particular in Europe, protect creditors by mandating the disclosure of legal capital or financial account information.[3]

In recent years, mandating or fostering disclosure has been on the increase in Europe. The European Commission, Member States (especially through corporate governance codes) and even the European Court of Justice have become proponents of disclosure mechanisms.[4] This evolution is related to the ongoing transformation of the bank-oriented continental European financial systems into market-oriented systems.

1. Bank-oriented and market-oriented financial systems

Firms in bank-oriented systems have so-called “insider” governance regimes under which a few players (essentially lenders and controlling shareholders) have high incentives to gather information and not much data is made publicly available. Firms in market-oriented financial systems have so-called “outsider” governance regimes where large amounts of information are disseminated publicly and incentives to gather additional information are low due to free-rider problems.

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[1] Compare recently P.G. Mahoney and J. Mei, *Mandatory vs. Contractual Disclosure in Securities Markets: Evidence form the 1930s*, Working Paper (2006), available at: <http:// www.ssrn.com> (securities laws did not add measurably to the content and credibility of the NYSE’s existing disclosure requirements); M. Greenstone, P. Oyer, and A. Vissing-Jørgensen, ‘Mandated Disclosure, Stock Returns, and the 1964 Securities Act Amendments’, 121 *Q. J. Econ.* (2006) p. 399 (results suggest that mandatory disclosure causes managers to more narrowly focus on the maximization of shareholder value); A. Ferrell, *The Case for Mandated Disclosure in Securities Regulation Around the World*, Working Paper (2005), available at: <http://www.law.harvard.edu> (mandatory disclosure enhances competition and reduces agency costs).

[2] See G. Hertig, R. Kraakman, and E. Rock, ‘Issuers and Investor Protection’, in R. Kraakman, et al., *The Anatomy of Corporate Law, A Comparative and Functional Approach* (Oxford, Oxford University Press 2004) p. 197.

[3] G. Hertig and H. Kanda, ‘Creditor Protection’, in Kraakman, et al., op. cit. n. 2, at pp. 79-83.

[4] See H. Merkt, ‘Creditor Protection through Mandatory Disclosure’, in this issue, at s. 3.

When capital markets start playing a more important role in jurisdictions that traditionally had a bank-oriented financial systems, trade-off issues arise.[5] In particular, one has to balance the needs of new players, such as institutional investors, for better disclosure against the private information needs of (still important) traditional players, such as controlling shareholders.

Getting the right balance is not merely a smoothening of the transition question. Two more fundamental determinants have to be taken into account. First, one cannot assume convergence towards a "pure" market-oriented system. Even in the United States, the prototypical market-oriented jurisdiction, banks do play an important role. Conversely, in the prototypical bank-oriented jurisdiction, Germany, banks will continue to play a major role for the foreseeable future. In other words, we can expect financial systems to evolve towards variable combinations of markets and intermediaries.[6] Second, financial systems comprise sets of complementary elements.[7] It follows that transplanting "capital market" components into a transitioning but still bank-oriented financial system may lead to inconsistencies that could ultimately lead to financial crisis.[8]

Thus, as pointed out by Hanno Merkt,[9] the case for creditor protection through mandatory disclosure is far from unambiguous. But this is not necessarily because the disclosure requirements that have been developed for market-oriented systems are overly costly, do not meet market needs or must be reformed with respect to comprehensibility, timeliness and enforcement. To be sure, disclosure requirements may well deserve improvements. However, it is also critical to consider the possibility of making better use of information pools and information channels that are typical of bank-oriented systems as an alternative to mandatory disclosure. For example, given the importance of lending in bank-oriented systems, it could be more efficient to give banks incentives to make their internal ratings of their borrowers available to the public. Or, to take another example, given the established governance role of employees in many bank-oriented systems, it could be more efficient to channel at least some information through the corporate

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5 See F. Allen and D. Gale, *Comparing Financial Systems* (Cambridge, MIT Press 2000) pp. 19-21.

6 See also Allen and Gale, op. cit. n. 5, at pp. 21 and 470.

7 See already P. Milgrom and J. Roberts, 'Complementarities and Systems: Understanding Japanese Economic Organization', 1 *Estudios Economicos* (1994) p. 3 et seq.

8 See R.H. Schmidt and M. Tyrell, 'What Constitutes a Financial System in General and the German Financial System in Particular?', in J.P. Krahnen and R.H. Schmidt, eds., *The German Financial System* (Oxford, Oxford University Press 2004) pp. 19, 53-7 and 62 (emphasizing the complementary nature of a bank-dominated financial sector, stakeholder-oriented corporate governance and risk management through lending-based inter-temporal risk sharing).

9 See Merkt, loc. cit. n. 4, at s. 6.

bodies on which employees are represented, such as boards or works councils, than to disclose it directly to the public.

Whether it could prove efficient to provide information to creditors and other stakeholders by fostering the disclosure of internal ratings is an issue that will be dealt with in an article that is forthcoming in this review.[10] This comment will focus on the comparative advantages of using corporate bodies that comprise human capital representatives, in particular codetermined boards, to inform one specific class of creditors, i.e., employees.

2. EMPLOYEE DIRECTORS AS INFORMATION CHANNELS

There seems to be no fundamental reason to require managers to be better informed in a market-oriented than in a bank-oriented system. In a given industry, the relative costs and benefits of information gathering and processing are likely to be similar in both systems. On the other hand, the costs and benefits of *disclosing* information held by managers are likely to vary among financial systems.

More specifically, public disclosure requirements are likely to prove less beneficial or costlier for firms in bank-oriented systems than for firms in market-oriented systems. In bank-oriented systems, information generation depends on its remaining internal to a limited number of recipients, whereas in market-oriented systems information is externalized through stock prices.[11] Hence, public disclosure is less likely to be beneficial in terms of access to external finance for firms in bank-oriented systems, as it would reduce lenders' informational advantage and make them less attractive to depositors – leading to loans becoming more expensive without certainty about corresponding decreases in the cost of bonds or equity.[12] Conversely, public disclosure is less likely to be costly for investors in market-oriented systems than for controlling shareholders in bank-oriented systems – the latter generally requiring the benefit of private information as remuneration for their more demanding monitoring role.

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[10] G. Hertig, 'Using Basel II to Facilitate Access to Finance: The Disclosure of Internal Credit Ratings', *EBOR* (forthcoming).

[11] For a comparison of internal (in bank-oriented systems) and external (in market-oriented systems) information distribution, see R.H. Schmidt and M. Tyrell, 'Information Theory and the Role of Intermediaries', in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, eds., *Corporate Governance in Context, Corporations, States, and Markets in Europe, Japan, and the US* (Oxford, Oxford University Press 2005) p. 479 et seq.

[12] See, however, R. Elsas and J.P. Krahnen, 'Universal Banks and Relationship with Firms', in Krahnen and Schmidt, op. cit. n. 8, at pp. 197, 207 (studies on the ability of German banks to mitigate financial constraints of large listed firms yield mixed results).

There are, on the other hand, at least partial substitutes to public disclosure for firms in bank-oriented systems. In such systems, management is monitored through stakeholder voice (i.e., shareholder and employee monitoring or decision making) rather than through investor entry and exit (i.e., stock price variation and hostile takeovers). It follows that it should prove less costly or more profitable to provide at least some information through channels such as direct encounters with management, board meetings or other stakeholder gatherings than through public channels.

As a matter of fact, it is well known that in bank-oriented systems managers provide their lenders and controlling shareholders with significant private information, and there is a rich body of academic research dealing with these information channels. Corporate governance literature has paid less attention to information flows between managers and employees and their impact in terms of mandatory disclosure.[13] This could simply be because it is perceived that employees have no relevant governance function. Such a conclusion, however, would ignore the large place given to employee board participation across Europe. Employees have the right to have representatives on the board of state-owned firms in Ireland, Spain and Greece, whereas larger French firms are required to let two non-voting worker representatives attend board meetings.[14] Scandinavian countries, for their part, require boards to include three employee directors, whereas boards in Austria, Germany and Luxembourg have even larger employee representation.[15]

Another explanation for the relative lack of interest in information flows between managers and employees may be that employee board representation has no governance significance, either because employees are not interested in getting or providing information or because they are prevented from doing so by the other governance players. The informational significance of employee board participation is ultimately an empirical question that cannot be resolved here. From a theoretical perspective, however, there are reasons to believe that employee directors can play an important information role. On the one hand, their board participation may reduce information asymmetries between executives and other employees, thus reducing bargaining costs as well as the risk of strikes.[16] On the other hand, the presence of employee directors can provide the board with a

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13 See, however, M.M. Blair and M.J. Roe, eds., *Employees and Corporate Governance* (Washington D.C., Brookings Institution Press 1999).

14 See H. Hansmann and R. Kraakman, 'The Basic Governance Structure', in Kraakman, et al., op. cit. n. 2, at p. 62.

15 Ibid.

16 See J. Kennan and R. Wilson, 'Bargaining with Incomplete Information', 31 *J. Econ. Lit.* (1993) p. 45 et seq.

well-informed source of information, which in turn makes the board less dependent on (mandated or voluntary) managerial information.[17]

There is thus both statutory and theoretical support for using employee board participation as an information channel in (still) bank-oriented continental Europe. What remains to be tackled is whether the benefits of this potential substitute to public disclosure exceed its costs. Here again, this is ultimately an empirical question.[18] However, the German codetermination experience allows for preliminary conclusions.

3. German codetermination as an efficient information channel

German law provides for the most extensive employee corporate governance participation in Europe. Employees enjoy extensive information, consultation and participation rights through works councils, which represent employees at the shop floor level (so-called *betriebliche Mitbestimmung*). In addition, the 1976 Codetermination Statute (*Gesetz über die Mitbestimmung der Arbeitnehmer*) subjects larger firms, and thus those firms that fall within the scope of securities regulation, to quasi-parity[19] employee supervisory board representation requirements (*Unternehmensmitbestimmung*).

Works councils were institutionalized by nineteenth century legislation, whereas employee participation beyond the shop floor was introduced at the beginning of the twentieth century, with board representation institutionalized in the 1950s.[20] In spite – or because – of this employee participation tradition, the 1976 Codetermination Act was strongly opposed before and after its enactment.

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[17] See M. Osterloh and B. Frey, *Shareholders Should Welcome Employees as Directors*, Working Paper (2005), available at: <http://www.ssrn.com>; A.J. Hilman and Th. Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives', 28 *Academy Management Rev*. (2003) p. 383 et seq.

[18] The fact that employee board participation is rare in the absence of legal compulsion may be caused by the same factors that require disclosure to be mandated to be effective, and is therefore not necessarily evidence that such an information distribution channel has costs that exceeds its benefits. Compare Hansmann and Kraakman, loc. cit. n. 14, at p. 64; C. Windbichler, 'Cheers and Boos for Employee Involvement: Co-Determination as Corporate Governance Conundrum', 6 *EBOR* (2005) p. 507 et seq.

[19] There is "quasi-parity" in the sense that while the supervisory board must comprise an equal number of shareholder and employee representatives, the chairman is elected by the shareholder bench and has the decisive vote when there is a tie.

[20] For a concise description of the evolution of employee participation in Germany, see K. Pistor, 'Codetermination: A Sociopolitical Model with Governance Externalities', in Blair and Roe, op. cit. n. 13, at pp. 165-175.

The public debate lost steam after Germany's Constitutional Court upheld the law in 1979, and public controversies had practically disappeared by the 1990s.[21]

This lack of public debate could reflect the limited practical impact of codetermination. However, empirical studies on the economic effects of codetermination are rather scarce and inconclusive.[22] This is likely to mean that codetermination is either ineffective or has costs that balance its benefits.

It is quite obvious that codetermination has its disadvantages.[23] Unions may capture the employee bench and pursue policies that are detrimental to the company. Employee participation may increase transaction costs by requiring more cumbersome board preparation meetings. Employee representatives may not have the required financial and strategic knowledge. They may also have diverging interests among themselves or be prone to managerial capture. In addition, business secrets may be leaked when it is in the private interest of employee representatives. Conversely, managers may withhold information from the supervisory board under the pretense that confidentiality is critical. Finally, employee participation can increase board size to a point where group dynamics make it difficult to challenge the firm's executives.

Given these disadvantages and the inconclusive empirical evidence, codetermination must also have significant advantages. Labor peace and strike avoidance are certainly among them. But these social benefits cannot occur without codetermination also reducing information asymmetries within firms. In other words,

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[21] See also O. Riekers and G. Spindler, 'Corporate Governance: Legal Aspects', in Krahnen and Schmidt, op. cit. n. 8, at pp. 350, 361.

[22] For a review, see M. Becht, P. Bolton, and A. Röell, 'Corporate Governance and Control', in G.M. Constantinides, M. Harris, and R.M. Stulz, *Handbook of the Economics of Finance, Vol. 1A: Corporate Finance* (Amsterdam, North-Holland 2002) at s. 7.6.2. See also T. Baums and B. Frick, 'The Market Value of the Codetermined Firm', in Blair and Roe, op. cit. n. 13, at p. 207 et seq. (finding that codetermination does not influence stock prices); F.A. Schmid and F. Seger, 'Arbeitnehmermitbestimmung, Allokation von Entscheidungsrechten und Shareholder Value', 5 *Zeitschrift für Betriebswirtschaft* (1998) at p. 453 et seq. (codetermination is costly for shareholders); S.N. Kaplan, 'Top Executives, Turnover, and Firm Performance in Germany', 10 *J. Law Econ. Org.* (1994) p. 142 et seq. (German firms are not comparatively slow in removing poorly performing managers); F.R. FitzRoy and K. Kraft, 'Economic Effects of Codetermination', 95 *Scandinavian J. Econ.* (1993) p. 365 et seq. (suggesting overall social gains from codetermination, but decreased firm-level profitability); G. Benelli, C. Loderer, and T. Lys, 'Labor Participation in Corporate Policy Decision Making: West Germany's Experience with Codetermination', 60 *J. Bus.* (1987) p. 533 et seq. (codetermination has no significant effect); J. Svejnar, 'Codetermination and Productivity: Evidence from the Federal Republic of Germany', 63 *Rev. Econ. Stat.* (1981) p. 188 et seq. (codetermination has no significant effect).

[23] For a discussion and specific examples, see Pistor, loc. cit. n. 20, at pp. 188-191; M.J. Roe, *Political Determinants of Corporate Governance* (Oxford, Oxford University Press 2003) at pp. 73-76; K.J. Hopt, 'Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe', 14 *Int. Rev. Law. Econ*. (1994) pp. 203, 205-212.

it cannot be denied that German codetermination has an information channel function.

What remains open is its role in a changing environment. The recent revival of the public debate about the value of codetermination shows that its costs and benefits may be affected by employees having more valuable firm-specific knowledge in an information society and by ongoing changes in German ownership structures, financial systems, product competition and corporate ethics.

German executives have recently expressed concerns about the rising costs of codetermination in a more market-oriented environment. Their complaints have been balanced by reports about the increasing benefits of codetermination. Hence, it is said that, these days, employee representatives sent from the works councils bring beneficial operational knowledge to the board. Moreover, employee representatives (including those designated by the unions) are allegedly more open to restructurings and less inclined to favor social benefits over the corporation's interest. In short, it is argued that "codetermination practices are becoming more micro-focused and insider-oriented."[24] Finally, and most importantly, it is argued that being a member of the supervisory board nowadays gives broad access to any relevant firm information.[25]

It thus appears that codetermination could well prove a better information channel in the current environment than in the past. The significance of this channel and the question whether its contribution could be improved by amending existing codetermination rules deserves further analysis. What cannot be disputed, however, is that codetermination has informational advantages while being an intrinsic component of the (still) predominantly bank-oriented German financial system. Conversely, it cannot be disputed that the evidence about the efficiency of mandatory disclosure requirement is mixed, and that it is an intrinsic component of market-oriented financial systems. It follows that before suggesting ways to transplant mandatory disclosure requirements into a bank-oriented system, one should consider how to use or improve information channels inherent to bank-oriented systems – including codetermination.

In sum, while Hanno Merkt makes an important point about the need to establish whether and how mandatory disclosure is beneficial to creditors, one should also consider whether and how codetermination and related mechanisms could be used as information channels between the firm and one important category of creditors: employees.

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24 See G. Jackson, M. Höpner, and A. Kurdelbusch, *Corporate Governance and Employees in Germany: Changing Linkages, Complementarities, and Tensions*, Working Paper (2005), available at: <http://www.ssrn.com>.

25 See C. Leuz and J. Wüstemann, 'The Role of Accounting in the German Financial System', in Krahnen and Schmidt, op. cit. n. 8, at pp. 450, 464.