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Employee ownership, board representation, and corporate financial policies☆

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ABSTRACT

French law mandates that employees of publicly listed companies can elect two types of directors to represent employees. Privatized companies must reserve board seats for directors elected by employees by right of employment, while employee-shareholders can elect a director whenever they hold at least 3% of outstanding shares. Using a comprehensive sample of firms in the Société des Bourses Françaises (SBF) 120 Index from 1998 to 2008, we examine the impact of employee-directors on corporate valuation, payout policy, and internal board organization and performance. We find that directors elected by employee shareholders increase firm valuation and profitability, but do not significantly impact corporate payout policy. Directors elected by employees by right significantly reduce payout ratios, but do not impact firm value or profitability. Employee representation on corporate boards thus appears to be at least value-neutral, and perhaps value-enhancing in the case of directors elected by employee shareholders.

1. Introduction

Should employees be allocated control rights in the companies for which they work? This question has long been debated, but has picked up impetus recently as societies have struggled to balance worker rights with effective corporate governance. While the collapse of communism has removed the most extreme examples of employee ownership, Germany and other countries mandate that workers be represented on corporate boards, and most western democracies encourage employee share ownership through tax, compensation, and pension policies. However, it is still unclear whether employee ownership or representation on the corporate board of directors increases firm value or productivity. This study exploits a natural experiment in mandated employee representation conducted in France – a major western country with both a market economy and a long tradition of robust worker employment protection – to determine whether giving workers control rights without cost to them creates value, and whether directors elected by employees who are also shareholders have a differential impact on firm value than do directors elected by workers as a right of employment.

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Employing a sample of French companies provides a unique institutional setting for empirical analysis. French law mandates that employees of large publicly listed companies be allowed to elect directors for two reasons. First, privatized companies must reserve two or three (depending on board size) board seats for directors elected by employees by right of employment. Since privatized firms are easily the largest and most valuable companies in France, this requirement induces significant representation on the boards of an important and highly visible group of companies by directors elected by workers who are not also shareholders. Second, employee-shareholders in any publicly listed firm have the legal right to elect one director whenever they hold at least 3% of outstanding shares. Additionally, French law allows but does not mandate that listed firms may adopt a two-tiered supervisory and management board structure, as per the German model. Taken together, these regulations and governance options have engendered employee representation on the boards of over one-fifth of the largest French companies, but have also created significant cross-sectional variation in the extent and type of employee board representation. Examining large French companies also allows us to study whether varying levels of employee representation impacts firm value and performance differentially than does the fixed representation mandated by Germany and, most importantly, whether employee representatives elected by right act and impact firm policy differently than do representatives elected by employee-shareholders and by shareholders who do not work for the company. Our sample further allows us to directly test whether directors elected by employees by right reduce corporate payouts and whether directors elected by employee-shareholders act like other employees or act instead as value-maximizing shareholders who recognize the need for the firm to pay an adequate cash return to its investors.

Finally, our sample enables us to examine how the differing types of employee board representation impact the size and meeting frequency of corporate boards. Since privatized companies or those that acquired a privatized firm are required to offer board representation to employees as a right, there is no presumption that these directors' positions would be created absent a legal mandate. Thus, firms which must offer these seats should have larger boards than do otherwise similar, non-privatized companies that are allowed to set board size in a value-maximizing manner. Additionally, directors elected by employees by right are union representatives who are paid their normal wage for attending board meetings, but must pass on the union the directors' fees they receive. This fact alone should make directors elected by right relatively more eager to attend board meetings than are directors elected by shareholders, since their opportunity cost of time is lower, and this tendency will be accentuated if directors elected by right see board meetings as a means to lobby managers for higher pay or other employee conditions.

Using a comprehensive sample of firms in the Société des Bourses Françaises (SBF) 120 Index from 1998 to 2008, we study the financial impact of the two types of employee representation. We find that directors elected by employee shareholders significantly increase firm valuation and profitability, but do not significantly impact corporate payout (dividends and share repurchases) policy or board organization and performance. This value-enhancing effect of employee-shareholder representation remains after adjusting for endogeneity, after excluding privatized firms from the sample, and after performing numerous other robustness checks. Directors elected by employees by right significantly reduce payout ratios, and increase board size, complexity, and meeting frequency—but do not significantly impact firm value or profitability. These representatives are usually observed only in privatized companies or in companies that acquired privatized firms in the recent past, so an important question is whether our key finding of reduced payouts resulting from elected employee representation on the board of directors is simply a residual from examining privatized companies. We perform multiple robustness checks and verify that elected employee representation reduces payout even when we control for former state owned firms, when we use firm fixed-effect regressions, and when we instrument for employee representation using two-stage least squares. We also find that companies with directors elected by right by employees have larger boards than do other companies and these boards meet significantly more frequently. On balance, employee representation on corporate boards seems to be at least value-neutral, and may actually increase firm valuation and profitability when employee-shareholders elect company directors.

This paper is organized as follows. Section 2 surveys the literature on employee ownership and corporate board representation, while Section 3 describes the French institutional background and the laws mandating different types of employee representation. Section 4 describes our sample and presents univariate analyses of the impact of the two types of employee board representation on corporate valuation, financial policies, and internal board organization and performance. Section 5 presents regression analyses of these effects, while Section 6 presents robustness checks, adjusts for endogeneity, and discusses the implications of the study's key findings. Section 7 concludes.

2. Theoretical motivation and hypotheses development

In this section, we discuss the theoretical and empirical literature on the impact of employee ownership and representation on firm value and financial decisions.

2.1. Employee participation in governance and firm value

It is not clear whether employee participation in corporate governance should increase or decrease firm value. Alchian and Demsetz (1972) show that, when there is perfect information, control rights should optimally be entrusted in one agent, the firm's owner. Jensen and Meckling (1976) show that agency problems arise whenever there is a separation of ownership and control and that institutional arrangements arise to ameliorate these costs. Fama and Jensen (1983a) examine the governance problems that arise when ownership and control are separated, as occurs naturally in most large companies, and describe the optimal allocation of control rights to residual claimants when this occurs (Fama and Jensen, 1983b). These theoretical works suggest that the