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Corporate governance and employee power in the boardroom: An applied game theoretic analysis☆

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ABSTRACT

The debate on employee representation on corporate boards has received considerable attention from scholars and politicians around the world. We provide new insights to this ongoing discussion by applying power indices from game theory to examine the actual voting power of employees on boards and its effect on firm performance. Based on unique panel data on the largest listed companies in Germany, we find an inverse U-shaped relationship between labor power and Tobin's *Q*. Moderate employee participation in corporate board decision-making can enhance firm value.

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1. Introduction

For decades, the role of the board has been one the most heavily analyzed topics in the field of corporate governance. Many experts believe that the board is the key instrument for minimizing agency costs arising from the separation of ownership and control in publicly traded companies. Thus far, researchers have investigated various board characteristics, such as board size (e.g. Raheja, 2005; Boone et al., 2007), the independence of directors (e.g. Hermalin and Weisbach, 1988; Linck et al., 2008), bankers on boards (Dittmann et al., 2010), or simultaneous outside directorships (e.g. Fich and Shivdasani, 2006, see also Adams et al., 2010 for an extensive overview of the literature on boards in general). Most of the studies on boards generally aim at identifying the optimal board structure by investigating how certain board characteristics affect

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board actions and corporate performance. Despite the large number of analyses, both empirical and theoretical studies have provided ambiguous results with regard to the effectiveness of certain board characteristics on corporate governance. One of the most controversial debates between academics, politicians, and practitioners about optimal board composition concerns (mandatory) employee participation.

Employee representation on boards is a common feature of the continental European corporate governance system that differs notably in certain respects from the intensely analyzed Anglo-Saxon shareholder system (Shleifer and Vishny, 1997). Several countries with some of the most productive economies in the world, including France, Germany and Japan, emphasize the role of the stakeholders in a company within their corporate governance system (Hoshi, 1998; Schmidt and Tyrell, 1997). Against the background of the recent financial crisis and the subsequent worldwide economic downturn, it has been widely recognized that a stakeholder system of corporate governance that relies on cooperation between managers and employees, may enhance firm performance in the long run. The latest discussion of this perception further motivates us to analyze how employee representation on boards affects corporate performance. We examine the case of Germany, where employees on boards are common, to conduct a comprehensive theoretical and empirical investigation.

Germany is an ideal case for analyzing firm monitoring by employees on boards, so-called co-determined boards, because employee directors are granted by law the same voting and decision rights as all other regularly elected supervisory board members. According to the German stock company act ("Aktiengesetz"), all supervisory board members are responsible for reviewing firm performance, selecting the chief executive, determining executive compensation and shaping long term strategic objectives. Operative leadership is assigned exclusively to the management board, which is strictly separated from the supervisory board. No executive is allowed to serve simultaneously as a monitoring director on the supervisory board of the same company or vice versa (see Prigge, 1998 for a survey of German company regulation). While supervisory board members have similar tasks and duties as monitoring directors on a one-tier board, the clear distinction between executives and monitoring directors in two-tiered boards is supposed to lead to a relatively high monitoring intensity, compared to one-tier board systems (Adams and Ferreira, 2007).[3] Since the executives receive more advice from non-executive board members in a one-tier board compared to a two-tiered board, however, the first-best outcome for shareholders will often be achieved with a one-tier board. Supplementing this finding, Gillette et al. (2008) show that two-tiered boards adopt institutionally preferred policies more frequently, but tend to make less profitable investment decisions. Apart from Germany, many other countries around the world have a corporate governance system with legally mandated two-tiered board structures, for example, Austria, Belgium, China, Indonesia, Spain, or Taiwan. Other countries allow either one-tier or two-tier boards, e.g. France and Switzerland.[4] As such, the present study may also contribute to the emerging debate about the effectiveness of different corporate governance mechanisms around the world (see Khanna et al., 2006 and the cited literature). Moreover, there seems to be no reason to assume that employee representatives would act fundamentally differently on one-tier boards compared to two-tier ones, suggesting that the findings from this study may also add new insights to the general discussion on optimal board composition in one-tier board systems (e.g. Ahern and Dittmar, 2012; Dahya and McConnell, 2007 and the literature review by Adams et al., 2010).

The largest obstacle for a reliable empirical identification of the impact of co-determination on any corporate outcome variable is the fact that German co-determination laws limit firms to realize one out of merely three different proportions of labor representatives on the supervisory board. These proportions are determined primarily by the legal form of the company and the number of employees, and partly by the sector in which the company operates. Limited liability companies (GmbHs) and public stock companies (AGs and KGaAs) comprising fewer than 500 employees, as well as all private companies and companies pursuing mainly ideological objectives, such as media or religious companies ("Tendenzbetriebe"), are exempt from co-determination.[5] Such companies usually do not have a supervisory board, or if so, their workers' quota is zero. Limited liability companies with more than 500 employees, as well as AGs and KGaAs with more than 500 but fewer than 2001 employees, are obliged to grant a third of their supervisory board seats to their employee representatives.[6] In larger public stock companies, including KGaAs, half the seats of the supervisory board are assigned to worker representatives. It is important to note that the chairman of the supervisory board is always elected by the owners of the company and holds a double voting right in case of a deadlock, thereby resulting in quasi-parity instead of pure parity. A neutral chairman only exists for companies in the coal and steel industry.

Given this low variance of employee representation, which is also closely linked to other characteristics of companies and is barely separable from them, empirical investigations have often focused on the analysis of status changers or the effects of changes of the relevant laws (see Gerum and Wagner, 1998 for an overview). More recent studies have aimed at

[3] In practice, however, many supervisory board members are in close contact with the management board members, making the two-tiered board more similar to a one tier-board than the rules would suggest.

[4] A more complete list of countries sorted by the predominant board structure is provided by Adams and Ferreira (2007).

[5] An exception from this rule applies to publicly traded corporations (AGs) with fewer than 500 employees that were founded before 1994 and are not related to ideological businesses or run by a family. These companies are required to have one-third of the supervisory board seats assigned to employee representatives.

[6] In all firms having more than 2000 employees, according to Section 15 co-determination law ("*Mitbestimmungsgesetz*") one employee representative has to be elected from the middle or top management, while no member of the management board is eligible. All other employee representatives are elected out of the group of regular employees. Firms with more than 500 but fewer than 2001 employees are obliged to grant one-third of their supervisory board seats to employee representatives out of the group of regular employees.

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