

European company law  
and the Sustainable Company:  
a stakeholder approach



# **European company law and the Sustainable Company: a stakeholder approach**

**Vol. II**

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# Introduction

**Sigurt Vitols and Johannes Heuschmid**

The political debate over the governance of the company and its proper role in society currently revolves around two broad alternatives. The *shareholder* concept of the firm prioritizes the role of shareholders in corporate governance and sees increasing shareholder wealth as the primary function of the company. Advocates of the shareholder model generally argue that competition between different systems of company law should be encouraged in order to maximize business choice. The *stakeholder* approach in contrast takes a pluralistic view of the groups ('stakeholders') that the company is responsible for and which should have a voice in corporate governance. Supporters of this view believe that company law should empower stakeholders and encourage companies to follow 'high road' strategies.

Since the 1990s initiatives to reform company law and corporate governance in Europe have been guided mainly by the shareholder concept of the firm. However, the financial crisis has seriously damaged the reputation of this model. The general view is that the crisis was caused (at least in part) by the obsession of many managers and investors with short-term share price performance. Frequent media reports of high executive pay and new bank bailouts continue to feed the public perception that things are 'not in order' with our present system of corporate governance. Misguided incentives in this system appear to be rewarding greedy and fraudulent behaviour. Criticism of shareholder models of the firm has also increased within the scientific community; econometric research shows that the crisis was linked to stock market-oriented remuneration schemes for managers, particularly in the financial sector. These results support the argument that the financial crisis would not have been as bad if the stakeholder model had been in place. Nevertheless, limited progress has been made in advancing the stakeholder approach to the firm, in part because those interests supporting the shareholder model

remain powerful, in part because the pro-stakeholder forces have not united around a single alternative.

In the book *The Sustainable Company: a new approach to corporate governance* (Vitols and Kluge 2011) members of the GOODCORP network of trade union and academic experts make a contribution to this debate by developing a vision of a company which is sustainable along social, ecological and financial dimensions. This concept of the Sustainable Company combines elements of the postwar stakeholder model of the firm with more recent concerns with sustainability. This distances it clearly from the shareholder value model of the firm. The book defines the core elements of the Sustainable Company as: 1) a commitment to stakeholder value, 2) stakeholder voice in governance, 3) reporting on social and economic impacts, 4) the adoption of a sustainability strategy and specific goals, 5) remuneration schemes based on sustainability instead of share price and 6) ownership by long-term responsible investors. Worker involvement in governance is emphasized since workers have a particularly long-term interest in the sustainability of the firm. Furthermore, the book outlines characteristics of the supporting framework needed to encourage the development and diffusion of the Sustainable Company, including strengthening worker rights through worker involvement and collective bargaining, reregulating the financial system, imposing financial transactions and carbon taxes and strengthening cooperation between trade unions and civil society actors such as NGOs.

In the year since the publication of *The Sustainable Company*, members of the GOODCORP group have worked hard to publicize this new approach. The book was launched at the Athens Congress of the European Trade Union Confederation (ETUC) in May 2011 and at a conference in Brussels in July 2011, which included members of the European Commission, European Parliament and ETUC. Since then it has been presented at numerous academic conferences, doctoral workshops and seminars for worker representatives. Overall the book has enjoyed a positive reception from policymakers, researchers and practitioners as a timely contribution to the debate on rethinking corporate governance.

The immediate political context of *The Sustainable Company* was a reopening of the debate on corporate governance and company law in the wake of the financial crisis. The last comprehensive statement on the EU's approach to governing the firm, it should be recalled, was the 2003 Action Plan on Modernizing Company Law and Enhancing Corporate

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Governance in the European Union (COM (2003) 284 final). This Action Plan, which drew heavily on a report written by a High Level Group of Company Law Experts (2002) appointed by the European Commission, was inspired by a decidedly shareholder-value oriented approach which emphasized strengthening minority shareholder rights and encouraging competition between national company law regimes.<sup>1</sup> This Action Plan announced a series of initiatives to be undertaken in this area. Although not all proposals were passed, a number of important directives were implemented, such as the Takeover Bids Directive and the Cross-Border Mergers Directive. The result has been an important shift in many Continental European countries in the direction of an Anglo-Saxon, market-driven model of corporate control.

The reopening of this broad debate at the European level was initiated by the European Commission through the appointment in late 2010 of the Reflection Group on the Future of Company Law. This group, composed mainly of legal experts, was charged with analyzing current problems in European company law and suggesting initiatives to deal with these problems. The group's report (Reflection Group 2011) was presented and discussed at a major conference entitled 'European Company Law: the way forward' on 16/17 May 2011.

The Commission also organized two wide-ranging public consultations in this area. The first consultation, which took place in 2011, focused on the appropriate framework for corporate governance at the European level. Topics addressed included the organisation and role of boards of directors and issues such as recruitment and diversity; the rights and responsibilities of shareholders; the monitoring and implementation of corporate governance codes; and the scope of applicability of corporate governance regulations. In early 2012 a second consultation addressed the topic of the future of EU company law. This was also quite wide-ranging, including topics such as: the purpose of company law; action on specific directives such as the proposal on Cross-Border Transfer of Registered Seats and the revision of the Cross-Border Mergers Directive; and European company legal forms like the European Company (SE) and the European Private Company (SPE).

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1. For a positive overall assessment of the Action Plan and its impact, written in part by some members of the High Level Group, see Geens and Hopt (2010). For a critical view see Horn (2011a and 2011b).

A distinct shift in public opinion on the stakeholder approach can be seen in the results of these consultations as well as in the broader political and scientific debate on corporate governance and company law. For example, Richard Lambert, head of the Confederation of British Industry (CBI), reports that his members expect that a 'more collaborative approach would emerge with different groups of stakeholders' (The Economist 2010: 1). Nevertheless, the bulk of the business community and a substantial minority of the academic community continue to resist the changes in company law needed to implement the stakeholder model. One argument frequently used by this group is that the shareholder model has only been partially implemented in practice and thus cannot be blamed for the financial crisis. For example, the head of corporate activism at CalPERS, America's largest public pension fund, was quoted in *The Economist* as claiming that '...this is a phoney war between shareholder capitalism and stakeholder capitalism, as we haven't really tried shareholder capitalism ... Rather than giving up on shareholder value, let's have a real go at setting up shareholder capitalism' (The Economist 2010: 4-5). Shareholder-oriented company law experts remain influential in policymaking networks. They were well represented in the Reflection Group, whose report emphasizes the desirability of using European law to increase competition between national regulatory regimes, which however significantly increases the pressure for a race to the bottom.

The continuing influence of the shareholder approach and the Commission's reopening of the debate on company law motivated the GOODCORP group to start work on this, the second volume in the Sustainable Company series. Although calls for an alternative to shareholder value are widespread, currently there is a deficit both in theoretical approaches to the firm which combine worker involvement and sustainability approaches, and in proposals for specific company law instruments (including EU legislation) which would help realize the vision of the Sustainable Company in practice. To help fill this gap, the GOODCORP group decided to follow up on the first volume (which outlined a general approach to the Sustainable Company and its governance) and write this new book to specifically address issues in the area of company law.

The first four chapters of the book address the important topic of theories of the firm and different approaches to company law. Andrew Johnston in Chapter 1 reviews developments in stakeholder theory. The theory of the productive coalition, which was formulated by Blair to address the deficits of the shareholder value model and earlier stakeholder theories,

has the advantage of clearly defining the central role of workers. A newer ‘governance of social cost’ approach also provides an interesting if not yet fully developed variant of stakeholder theory. In Chapter 2 Inger Marie Hagen and Bernard Johann Mulder draw on the work of Rawls and Elster on justice and fairness to develop an innovative approach which introduces a distinction between internal stakeholders (workers and shareholders) and external stakeholders. Thus both workers and shareholders have a right to representation on company boards. In the third chapter Aline Conchon contributes to this line of analysis by arguing for a holistic approach to company law. Up to now the tendency of most legal scholars and the European Commission has been to deal with company law separately from labour law. However, due to the central role of workers in the firm, company law and labour law should be seen as intertwined legal fields. Jan Cremers in Chapter 4 provides a historical account of the European-level approach to company law and its effect on national systems. Originally, the European Commission pursued a project of company law harmonisation on the basis of high standards which were designed to discourage competition between national regimes. However, in the past two decades there has been a clear shift away from harmonisation and towards promoting regulatory competition. This has helped erode standards in national systems of company law.

The next group of chapters discuss in detail how a new programme of harmonisation and the protection of stakeholders could be achieved in practice. In Chapter 5 Johannes Heuschmid examines how European company law could be improved by strengthening worker rights as a matter of good corporate governance. A first step in that direction would be to establish a pluralist notion of the company in EU company law, as is the tradition in many Member States. As a second step, flanking measures such as board-level participation rights are required in order to ensure that this principle is properly implemented. In the sixth chapter Jonas Malmberg, Erik Sjödin and Niklas Bruun outline the current discussion on company law and two possible routes to protect and enhance employee involvement in the EU. The first would be to adopt an EU-wide minimum standard for employee involvement through European legislation. The second would be to pursue the option defined in the Treaty on European Union (TEU) for enhanced cooperation between the EU member states that want to promote both social and economic integration. In Chapter 7 Marie Seyboth criticizes the sections of the Reflection Group report dealing with co-determination. The current challenges for the German system of co-determination are highlighted, including the

problem of avoidance of co-determination by foreign companies with administrative headquarters in Germany. The outlook for the future of worker participation as an element of democracy in Europe is also discussed. The next chapter, authored by Wolfgang Däubler, analyzes the potential of investor agreements as a new instrument for safeguarding worker rights. Recently, the German trade union IG BAU was able to negotiate an agreement with the Spanish construction company ACS, the new investor taking over the German construction company Hochtief. This instrument could be used in a number of restructuring situations and would be particularly interesting for protecting worker interests in countries without a tradition of board level employee representation. In Chapter 9 Ingemar Hamskär analyzes a legal case in which the European Court of Justice ruled that an employee representative violated insider information rules by communicating with his trade union about a planned merger with the bank he sat on the board of. This case shows that securities law overly restricts the rights of board level representatives from communicating with employees and trade unions. It is a pressing need to find a better balance between labour law on the one hand and company and securities law on the other hand. In the tenth chapter Isabelle Schömann discusses the current state of worker information and consultation rights as the ‘poor relation’ of EU social legislation. These information and consultation rights are fragmented over several directives, which contain different definitions and standards. The European Commission’s ‘fitness check’ of three directives dealing with information and consultation is criticized and the ETUC’s recent demand for European minimum standards for worker involvement is supported as a better way forward. In Chapter 11 Carsten Herzberg analyzes new approaches to involving the community in the governance and modernisation of public utilities. A number of innovative cases using different mechanisms for including community ‘voice’ are analyzed. These show that there are alternatives to privatisation of state enterprises which are in the interests of both employees of the public utilities and the community.

The next few chapters deal with specific topics in the debate on European company law. In Chapter 12 Janet Williamson critiques the UK Stewardship Code, which was launched in July 2010, as well as the concept and operation of ‘enlightened shareholder value’, introduced into the UK by the Companies Act 2006. This idea of enlightened shareholder value is based on a number of flawed assumptions about the behaviour of investors and companies. Although the idea of the Stewardship Code is welcomed, it cannot be expected to solve the problems caused by the gap

between the concept of enlightened shareholder value and reality. In the thirteenth chapter Beate Sjøfjell summarizes the motivation behind and tentative results of the ‘Sustainable Companies’ research project, which shares many of the same concerns of the GOODCORP initiative. The deficiencies of CSR, mainstream corporate governance and environmental law in achieving sustainability are core concerns of this research project. The project sees a pressing need to reform company law to fundamentally change the way our companies operate. Chapter 14, written by Janja Hojnik, analyzes the current state of practice in sustainability reporting, which is a key part of the Sustainable Company. Directive 2003/51/EC, which deals with accounting requirements, includes language on environmental and social reporting ‘where appropriate’. However, in practice this has not been interpreted as a binding norm. As a result most sustainability reporting has been done on a voluntary basis, resulting in low levels of transparency. Modernizing accounting rules through introducing binding obligations on companies would advance sustainability reporting considerably. The final chapter presents the ETUC’s analysis of the problems with the current system of worker involvement, corporate governance and company law at the EU level. A demand for European minimum standards for worker involvement as well as a list of proposals for the reform of specific company law directives are presented.

While the book does not offer answers to all theoretical and regulatory questions regarding company law, it does provide a general conceptual stakeholder approach to the firm and a number of specific legislative proposals. The hopes of the GOODCORP network are that this second volume will influence the debate on EU company law as well as further academic and policy-oriented work on sustainable alternatives to shareholder value. In doing so it will help keep the momentum going which was started with the first book in the series and will be continued in future activities of the GOODCORP group.

The co-editors would like to thank a few people who have made special contributions to this project. Lut Coremans at the ETUI provided highly competent and tireless administrative support for the project. High quality translations of three of the chapters and language checks of most of the other chapters were done by Paul Skidmore. Stefanie Roth, Marion Obermaier, Juliane Binder and Marcus Wolf checked and formatted references. Finally, Norbert Kluge, who co-founded the GOODCORP network when he was at the ETUI, continues to be a source of motivation and inspiration for the group.

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# Chapter 1

## Recent developments in stakeholder theory: from the productive coalition to the governance of social cost

Andrew Johnston

### 1. Introduction<sup>1</sup>

Since the 1980s, policy debates about corporate governance have been dominated by a contractual model which insists that the sole goal of corporate management should be to enhance shareholder value as expressed by the company's share price. According to this view, since shareholders are dispersed and diversified, they do not have the correct incentives to hold management to account. This task therefore falls to the corporate governance system, which is supposed to supply the carrots (stock options and other 'high-powered incentives') and sticks (threat of hostile takeover) that encourage managers to raise the share price. The influence of the shareholder value model can be clearly detected in many aspects of European corporate governance systems. The original proposals for a takeover directive sought to prohibit managers from defending against unwelcome takeovers, while the first 'Winter Report', which was produced for the European Commission, concluded that takeovers are 'basically beneficial' because they discipline management where shareholders are dispersed (High Level Group 2002a: 2).<sup>2</sup> More recently, in debates and arguments about how the EU ought to regulate hedge funds and private equity, adherents to the contractual model repeatedly – and influentially – opposed intrusive regulation on the basis that these alternative investors enhance social wealth by disciplining self-interested

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1. Some of the research on which this chapter is based was supported by a New Researcher Grant from the University of Queensland.
  2. A second 'Winter Report' made detailed proposals for reform of European company law on the basis of an assumption that 'shareholders are the residual claimholders (they only receive payment once all creditors have been satisfied) and they are entitled to reap the benefits if the company prospers and are the first to suffer if it does not. Shareholders need to be able to ensure that management pursues - and remains accountable to - their interests.' (High Level Group 2002b: para. 3.1).

managers. Its influence can also be detected in the spread of corporate governance codes, whose primary goal is to make executives accountable to shareholders. Finally, its influence can be detected in the way politicians of all stripes view the exponential rises in executive pay over the last two decades with equanimity.

This chapter examines two recent developments in stakeholder theory which highlight the limitations of the contractual model of corporate governance. In contrast to earlier stakeholder theory, which treated as stakeholders all those ‘affected by’, or able to affect, corporate activities, these more recent theories identify stakeholders by reference to market or governance failures within the corporate ‘nexus of contracts’. The productive coalition approach, which builds on the work of Margaret Blair, insists that employees who specialise their skills to a corporation’s requirements cannot adequately protect their interests through contract, and so require protection of their interests through corporate governance. The governance of social cost approach suggests that, while employees may be a special category of stakeholder because of their proximity to a single corporation and particular vulnerability to expropriation, other groups may also be harmed by corporate decision making. These other stakeholder groups are less monolithic and harder to identify, but they too require some measure of protection, given that the corporate governance system gives managers powerful incentives to create shareholder value by externalising costs onto society. Under this approach, the corporate governance process operates to trace these harmful effects and develop socially acceptable solutions to them.

The chapter begins by briefly examining the historical origins of stakeholder theory and the emergence of the shareholder value model of corporate governance. It then examines the productive coalition theory, and the demands it makes of the law. Following that, it examines the governance of social cost approach to stakeholding, which makes greater demands on regulators but potentially provides the basis for a reflexive, dynamic stakeholder model which could better align corporate decision making with the common good.

## **2. From shareholder owners to shareholder value**

This first section examines how corporate theorists responded to the ‘separation of ownership and control’ which occurred in the late nine-

teenth century as corporations began to raise financial capital from outside investors. The view that corporate managers ought to take account of stakeholder interests became widespread and relatively uncontroversial. It then describes how the contractual model of corporate governance emerged as a response to these assumptions and refocused attention on the position of shareholders.

Classical economics had generally assumed that entrepreneurs would manage their property efficiently so as to produce profits, and therefore maximise social wealth. As companies expanded in size and raised capital more widely, not all shareholders could – or wanted to – be involved in management. This had important implications for the assumption that businesses would necessarily be managed so as to increase social wealth, and with it the social interest or the common good. From the 1920s onwards, a number of theorists examined the implications of this separation of ownership and control for classical economic assumptions.

Robert Brookings first recognised in 1925 that ‘management and capital collectively constituted ownership’ and of the ‘gradual recognition of the evil possibilities which resulted from the carrying over of the ancient legal concept of unlimited ownership into a social setting where its significance was very different’ and the resultant ‘demand for “industrial democracy”’ (Brookings 1925: 18). He concluded that

The more completely management is separated from ownership the more it comes to be regarded as the representative of all the cooperating parties and conflicting interests, and not simply of the stockholders .. while the trade-unions and the politicians have been increasing the external pressure on the manager, the internal pressure from the stockholders has decreased. Management is thus coming to occupy the position of trustee, and to maintain its position it must serve the public with the greatest efficiency consistent with a fair return to labor, and with the return to capital necessary in order to keep it in industry (Brookings 1925: 21–3).

In a famous 1931 article, Berle argued that ‘all powers granted to a corporation or to the management of a corporation .. are necessarily and at all time exercisable only for the ratable benefit of all the shareholders as their interest appears’ (Berle 1931: 1049). He did however recognise that shareholders had become ‘passive’ property owners who merely had a set of economic expectations, in contrast to earlier, ‘active’ entrepreneurial owners (Berle 1932: 1369–70). This left the control of property

in the hands of corporate managers. Berle accepted that it was as yet unclear as to whether in law the shareholders would maintain their 'primary property right over residual income' or whether it would be shared in some way with other claimants, but he was sceptical that the correct approach was to 'grant uncontrolled power to corporate managers in the hope that they will produce that development' (Berle 1932: 1372).

However, in his more famous discussion of the separation of ownership and control, co-authored with Means, which is viewed as the beginning of the modern corporate governance debate, Berle abandoned this apparent aversion to leaving such discretion in the hands of management. Berle and Means' radical conclusion, which is rarely cited these days, was that the separation of ownership and control had divided the entrepreneurial function between managers and shareholders. As a result, the company had been turned into a quasi-public institution, in which managers should be charged with balancing the claims of the great variety of groups and assigning the income stream in line with public policy, rather than simply maximising returns to shareholders.

Once they recognised that the logic of private property no longer applied, these theorists argued that company directors ought to pursue their vision of the common good by taking into account both shareholder and non-shareholder interests. This may have been the first articulation of a stakeholder vision of the corporation. The main argument raised against this approach was not that shareholders ought to take priority over other interests, but that there was a danger that directors would become completely unaccountable. This approach ushered in the era of managerialism, which saw managers to a considerable extent balancing the claims of the corporation's different stakeholder groups, even if they were under no legal compulsion to do so. This continued until financial capital reasserted its power, beginning with the first wave of hostile takeovers in the 1960s, and then again in the aftermath of the stagnation of the mid-1970s, and brought the shareholder interest back to the forefront of the corporate governance debate.

From the 1980s, advocates of shareholder primacy began to argue that the corporation was a mere legal fiction, which was better understood as a 'nexus of contracts'. Corporations were therefore simply a group of interconnected contracts for the sale and purchase of already existing things: claims on the income stream; labour; land; financial capital and

the goods or services produced.<sup>3</sup> These theorists argued that employees, for example, freely entered into their employment contracts with the corporation, and so must, by definition, be better off as a result. They must have valued their wages under that contract more highly than the other possibilities open to them, such as enjoying leisure, working for themselves or working for another firm. The same would apply to consumers and lenders who voluntarily entered into contracts with corporations which must have made them better off than alternative uses of their money. It was then only a small step to insist that the interests of all these 'stakeholder' groups were fully protected by the terms of their contracts, and therefore they had no need of any protection through the corporate decision making process, whether in the form of authorising managers to take account of their interests, or in the form of rights to participate in decision making. Other stakeholders, such as local communities and the environment, which have no contractual connection to the corporation, should be protected by specific legislation as necessary.

The key implication of this was that there was no distinction between the firm and the market; instead there was simply a 'multitude of complex relationships (i.e. contracts)' (Jensen and Meckling 1976: 311). This change of frame allowed its advocates to sidestep the issues arising from the separation of ownership and control, and to rely on the familiar argument that, as a market, corporations would automatically, as if by an invisible hand, further the interests of society. Accordingly, intervention in the internal affairs of corporations could not be justified in the absence of market failure.

It was argued that the one group affected by market failure was the shareholders, who contract for a residual claim to what is left over after all other contracting groups have been paid their fixed entitlements. They could therefore justify additional protection through the corporate decision making process, and this explained corporate law's default allocation of rights to them. According to this model, shareholders contract with management 'for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock' (Easterbrook and Fischel 1991: 36). Alone among the contracts which make up the corporation, this contract is incomplete. Uncertainty about the future, bound-

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3. These are economic rather than legal 'contracts', which implies that they are reciprocal arrangements which are allocatively efficient, but are not necessarily legally binding in relation to all the risks which arise.

ed rationality and transaction costs make it impossible for shareholders to specify in advance precisely how managers should advance their interests. This argument appears plausible, since it is clearly impossible to anticipate the risks and opportunities with which corporate management will be faced in the future. The fundamental impossibility of drawing up an exhaustive, complete contract between shareholders and management offered an explanation for the default governance structure provided by law for modern corporations. Managers are granted considerable discretion, but the shareholders retain a number of rights in the corporate governance process which they could use to hold managers to account, thereby maximising the value of their residual claim. In the language of agency theory, the shareholders were the principals, managers were their agents, and shareholder rights could be used to reduce agency costs. When these rights are used to increase the value of the shareholders' residual claim, while all other contractors were being paid fixed claims that made them better off, social wealth would be increased.

This comprehensive model of the corporate 'nexus of contracts' left shareholder primacy theorists facing one main difficulty: although shareholders theoretically valued these rights very highly, in practice they did not exercise them. This was described as 'rational apathy' and a collective action problem. No rational shareholder would expend the time and effort to improve corporate governance by monitoring management and intervening, because other shareholders would free ride on their efforts. The whole field of corporate governance sprang up to resolve this problem, and this theory justifies many of the innovations witnessed over the last few decades. Hostile takeovers use the current share price to identify and remove managers who underperform in shareholder value terms;<sup>4</sup> incentive pay is supposed to align executives' incentives with the interests of shareholders; and corporate governance codes require a majority of the board to consist of non-executives with a view to protecting the shareholders against the self-interest of executives. These solutions to the 'agency problem' facing shareholders were for the most part market adaptations rather than legal interventions, at least in the beginning. The UK's City Code on Takeovers, which greatly

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4. As Henry Manne argued as long ago as 1965, 'Apart from the stock market, we have no objective standard of managerial efficiency' (Manne 1965: 113). The efficient markets hypothesis appears to have remained intact – for the time being at least – despite the obvious pricing failures in the run up to the global financial crisis.

facilitated hostile takeovers, was a self-regulatory measure put in place by the City of London to give greater protection to shareholder interests than was available in company law (Johnston 2007). The UK's corporate governance code, which resulted from a review of the 'financial aspects of corporate governance', was also a self-regulatory response, this time to a perceived lack of accountability of management to shareholders. Both of these instruments were the product of their time and place, but both now form an essential part of the blueprint for shareholder value corporate governance in Europe, and are disseminated through a combination of directives, soft law and investor pressure.

The nexus of contracts model provides intellectual support for a system of corporate governance oriented towards short-term shareholder value as reflected in the current share price. Until recently, stakeholder theory was confined to a political perspective and was not able to articulate an economic response to this model. At its broadest, it defined stakeholders as 'any group or individual who is affected by or can affect the achievement of an organization's objectives' (Freeman 1984). As such, these groups ought to be taken into account by managers in order to achieve the long-term success of the firm. However, this pluralism left it open to accusations of indeterminacy by shareholder value theorists, who claimed it would simply result in managerial unaccountability (Jensen 2002). Recent developments in stakeholder theory have focused more sharply on the flaws in the economic methodology underlying the pro-shareholder conclusions drawn from the contractual model to demonstrate that shareholder value and social wealth cannot necessarily be equated. This is important because arguments for a stakeholder model of corporate governance must be grounded in an economic as well as a political logic.

### **3. Margaret Blair and the productive coalition**

The most important theoretical challenge to the argument that increasing returns to shareholders can be equated with an efficient allocation of resources, and therefore increasing social wealth, was advanced by Margaret Blair (Blair 1995). Blair's argument revolves around the notion of firm-specific human capital (FSHC), which refers to skills acquired by employees in a particular employment context, which have no value in other employment contexts. These investments are desirable from an efficiency standpoint because they enable the employee to be more productive in that employment, and therefore to generate quasi-rents.

In order to encourage employees to specialise their skills to the firm's requirements, managers have to promise employees wages which rise in line with their increasing productivity. Those wages will be above market rates, and reflect the fact that the firm is sharing the proceeds of the productivity gains generated by the employee's specialisation with the employee. Blair estimates that the returns to employee investments in FSHC are of a similar order to shareholder profits (Blair 1995: 266).

The difficulty with employee investments in FSHC is that they cannot be governed by an *ex ante*, legally binding contract. Governance has to take the form of an implicit contract which is not legally binding because corporate managers do not know in advance the extent to which particular employees will specialise or their likely contribution. The essential point is that, where employees specialise their skills to the needs of the corporation which employs them, their contract will, like that of the shareholders, be incomplete, and, like shareholders, they will be vulnerable to agency costs. Under the threat of hostile takeover, or in response to the incentives provided by their own contracts to increase shareholder value, corporate managers may breach the implicit contracts they made with employees, and distribute the surplus to the shareholders and themselves, increasing the share price but imposing agency costs on the employees.<sup>5</sup> The more this happens in an economy, the less willing employees will be to invest in FSHC, and the lower their productivity will be. This contracting problem amounts to a market failure, and if investments in FSHC are to be encouraged and productive coalitions held together, the employment relationship must be embedded within a protective governance structure, just as the shareholder-manager relationship is.

There has been considerable debate as to the form this governance structure should take, and whether the law should provide default or mandatory rules, or perhaps even a menu of options for corporations to choose from. Many shareholder value theorists simply deny that employees invest in FSHC (see, for example, Romano (1992)). Those that do recognise the possibility of investments in FSHC resist more pluralist forms of corporate governance through a variety of strategies, including claiming that only managers make significant investments (Coffee 1988) or in-

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5. Shleifer and Summers advanced the important argument that hostile takeovers which result in breaches of implicit contracts are 'rent-seeking and not value-creating exercises' which can actually reduce social wealth (Shleifer and Summers 1988: 42).

sisting that employees, either individually or collectively, can get around their contracting problems and design a system of severance payments to protect their investments (Easterbrook and Fischel 1991: 37; Fischel 1984: 1067-8). Insisting that employees can obtain legal protection for their investments through contract is a vital step in support of the shareholder value argument that corporate governance should be a single purpose mechanism aimed at reducing the agency costs imposed on shareholders. This is not a convincing argument, since employees who invest in FSHC face contracting difficulties at least as serious as those facing shareholders. However, advocates of shareholder value have studiously ignored this critique.

Margaret Blair's position on this question is that the system of managerialism which lies at the heart of corporate law provides an adequate basis for the governance of investments in FSHC. In this view, the various groups who invest in the corporation hand over control rights to the board, and the board act as 'mediating hierarchs' between the competing claims of, for example, employees and shareholders with the aim of holding this 'productive coalition' together. The corporation is a means of locking in investments and becomes the locus for a political contest over the distribution of the contractually unallocated quasi-rents or surplus generated by specialisation (Blair and Stout 1999: 277 and 323).

There are difficulties with the assumption that current corporate law could fulfil this mediating function, both because it gives control rights over the board by default exclusively to shareholders (Mitchell 2001: 99), and because the broader corporate governance system exposes executives to strong pressure to maximise returns to shareholders in the short term. Given the existence of these extralegal incentives, David Millon wonders whether it is 'possible to conceive of a set of legal rules capable of establishing this state of ivory tower autonomy' which is necessary for managers to play the role of mediating hierarchs (Millon 2000: 1027-9).

Blair's work is fundamental to any policy discussion of stakeholding for two reasons. First, it shows that a stakeholder approach to corporate law can be justified on efficiency grounds. Second, it shows that managerial autonomy is one of the mechanisms by which corporations could be governed in the interests of all stakeholders. Mitchell's and Millon's critiques of the productive coalition model emphasise that there would be a need for legal reform before managerialism could be relied upon as the foundation for a stakeholder model of corporate governance. At the very

least, fairly far-reaching changes would be required to the rules on hostile takeovers and executive remuneration, both of which are intended to align managerial interests with those of shareholders and therefore undermine the impartiality which is essential if they are to play convincingly the role of mediating hierarchs. Such reforms would be politically very difficult, and this does call into question the viability of using renewed managerialism as the basis for governing corporations which operate as productive coalitions. However, two relatively recent developments give cause for hope. First, the Takeover Directive<sup>6</sup> gives the Member States the option of making managers more autonomous from shareholder pressure by not allowing them to opt out of a prohibition on defensive measures against hostile takeovers. While this was a pragmatic compromise which was necessary for the adoption of the directive, it does accommodate greater diversity in terms of corporate governance across the Member States (see Johnston 2010). Second, since the financial crisis, the European institutions have perceptibly changed their approach to executive pay. Where previously the Commission was content to issue recommendations that executive pay should be aligned with shareholder interests, there is now a greater willingness to intervene, even if, to date, this has been limited to restricting practices within financial institutions which are thought to encourage excessive risk-taking and so threaten the stability of the financial system.<sup>7</sup>

The alternative to governing productive coalitions through greater managerial autonomy is to grant rights to participate in corporate governance to employees. Agency theorists justify the law's decision to grant governance rights to shareholders on the basis of a hypothetical bargaining process, which assumes that the shareholders value the rights most highly, since they alone can use them to increase the value of their residual claim. These theorists argue that if employees value rights to

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6. Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12.

7. See Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, OJ L 329, 14.12.2010, p. 3, which provides for supervisory review of remuneration policies in credit institutions and investment firms, and Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1, which regulates remuneration policies in hedge funds and private equity firms.

participate in corporate decision making, it is open to them to bargain and pay for them. Legal intervention, they claim, will damage the efficiency of the nexus of contracts, and cannot be justified. Some theorists argue that the default grant of rights to shareholders can become quasi-mandatory as endowment effects and network externalities create barriers to reallocation of the rights, even where this would be more efficient (Sunstein and Ullmann-Margalit 2000; Klausner 1995). This implies that it is not appropriate to assume that corporate governance rights are allocated efficiently to shareholders simply because the employees fail to bargain to reallocate them. Other theorists argue that there are considerable obstacles to employees bargaining for participation rights, and that legal intervention can be justified as a solution to market failure (Sadowski *et al.* 1999; Smith 1991).<sup>8</sup> Finally, Germany's imposition of mandatory employee codetermination has been justified on the basis that it is a 'beneficial constraint' which forces companies to compete on the basis of employee skills and product quality rather than on the basis of cost (Streeck 1997). As well as supporting rights to participate in decision making, these arguments also support less far-reaching participation rights, such as employee information and consultation, which through the institution of dialogue can generate greater trust between the parties and reduce management's willingness to breach implicit contracts. Again, however, if weaker participatory rights are to support investments in FSHC, changes to the corporate governance system will be required. One key implication of the productive coalition model is that employee participation in corporate governance has a key role to play in supporting the specialisation which will give European companies a comparative advantage on global markets.

#### **4. Constructing social cost – a new model for the stakeholder company?**

The productive coalition model is very important because it challenges the shareholder value model from within its contractual methodology,

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8. Transaction costs too may prevent efficiency-enhancing reallocations of rights. However, economists such as Oliver Williamson, who explain corporate governance structures on the basis of transaction costs, appear reluctant to extend their analysis to the difficulties facing employees where they cannot know the extent of their future investments in FSHC (Johnston 2009: 84-5).

and suggests that market failure is not confined to the relationship between shareholders and managers. It shows that corporate governance should have a broader scope, which at the very least ought to encompass employees as key stakeholders who face particular vulnerabilities to opportunism. However, it is possible to go further and argue that the scenario dealt with by the productive coalition model is one example of a whole swathe of market failures which arise where corporate managers focus exclusively on producing easily quantifiable increases in short-term shareholder value at the expense of longer-term and more nebulous costs to society and the various corporate stakeholders. Even though employees have a contractual link to the corporation, they find it impossible adequately to protect their interests by means of contract alone, and the gaps in protection give corporate management scope to redistribute the contractually unallocated surplus to the shareholders and themselves (via their shareholdings and stock options). Other stakeholders also face a risk of corporate opportunism, and are also likely to face considerable barriers to bargaining for protection of their interests because they do not have a contractual link with the corporation.

The conventional, shareholder value approach contends that stakeholder interests should be protected through a combination of bargaining and regulation, giving the corporate governance process the single purpose of ensuring that shareholder wealth is maximised. However, the assumption that bargaining and regulation will result in an efficient and socially adequate level of protection is questionable.

The majority of law and economics scholars argue that, as long as there is a clearly defined system of property rights, those who are affected by the corporation's activities can rely on their property rights, or bargain for protection of their interests. In their view, if rights are not reallocated by a bargain between those concerned, it follows that they are allocated efficiently, that is, to their most highly valued use. Following their (arguably flawed) reading of Coase's seminal 1960 article, 'The Problem of Social Cost', they do recognise that transaction costs will sometimes prevent stakeholders and corporations from concluding contracts which would enhance social wealth. In that situation, it is commonly argued that the courts should allocate property rights to the party which values them the most highly. The overall aim is to bring about the allocation of rights which would have resulted from bargaining between the parties in the absence of transaction costs. The difficulty with according such primacy to bargaining as a solution to social cost is that there are numer-

ous significant barriers to stakeholders bargaining with corporations for protection of their interests. The social costs which affect communities are often nebulous and difficult to prove. Affected groups have to emerge and organise themselves (Callon 2008). There are problems of free riding, and corporations faced with allegations of creating social costs can exploit community interdependencies, making coercive settlement offers or otherwise exploiting vulnerabilities (Parchomovsky and Siegelman 2004). These factors mean that agreements between corporations and their stakeholders will be few and far between, and that the absence of an agreement reallocating rights cannot be equated with efficient resource allocation. Moreover, since the law's allocation of property rights is frequently unclear *ex ante*, any bargain which does emerge will be more akin to a 'mutual accommodation' than an efficiency enhancing reallocation (Simpson 1996).

In contrast to its emphasis on 'Coasean bargaining', conventional law and economics spends remarkably little time discussing regulation, which is viewed as *prima facie* inefficient because it interferes with market outcomes. However, in his original article, Coase was far less reticent about discussing the possibility that regulation might be used to correct social costs, although he doubted whether intervention would normally enhance social wealth. Coase argued that, before they intervene, regulators need to give greater consideration to the effects of their proposed actions on social wealth, and compare them with doing nothing, in which case the cost will be left where it falls, or reallocated by bargaining between the parties, depending on the incidence of transaction costs (Coase 1960). In particular, he argued that regulators should take account of the direct costs and benefits of their proposed intervention (in terms of its effect on existing patterns of wealth generation), the likely second order effects of intervention (as producers respond to the intervention) and the administrative costs of designing and enforcing the regulation. They should then compare these costs with the costs of doing nothing, which obviously does not give rise to any regulatory costs, but leaves intact the existing distribution of social costs (which may reduce social wealth), and gives rise to transaction costs where the parties seek to enter an efficiency enhancing contract to reallocate those costs. These are obviously not easy questions to answer *ex ante*.

Coase was pessimistic as to the prospects of justifying government intervention on the basis of a cost-benefit analysis, and concluded that 'most "externalities" should be allowed to continue if the value of production

is to be maximized' (Coase 1988: 26). Accordingly, social costs would remain 'ubiquitous'. Coase's pessimism as to the viability of regulation did not deter other agency theorists from insisting that social costs should be dealt with by government intervention, even whilst arguing against intervention in particular situations on the basis of cost-benefit analysis. This was a satisfactory outcome because leaving social cost entirely to the regulator left corporate managers with the clear goal of 'making as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom' (Friedman 1970). However, as Eric Orts puts it, this argument 'allows corporate executives conveniently to ignore the effects that their operations may have on society and the natural environment, except to the extent that these effects are translated into formal economic and legal constraints' (Orts 2005: 190).

There are considerable doubts about whether regulation alone can bring corporate decision making into line with the common good. First, as Orts emphasises, corporations can use their lobbying power to influence politics and prevent or at least limit regulatory intervention, which makes 'the Friedmansque argument that one can depend on the liberal democratic process to constrain business behaviour .. naive at best, or at worst, hypocritical' (Orts 2005: 191). Second, and more importantly, conventional instrumental regulation is in a secular crisis. Increasing social complexity and the tighter coupling of financial and productive systems means that regulators are confronted with what Teubner calls the regulatory 'trilemma': regulation is 'either irrelevant, or produces disintegrating effects on the social area of life or else disintegrating effects on regulatory law itself' (Teubner 1987: 21). These concerns that regulation will be – at best – ineffective in achieving its goals creates further pressure on regulators not to intervene in an attempt to cure the social costs of economic activity.

Where regulation appears unfeasible under the cost-benefit analyses now carried out as a matter of course by regulators, and contracts between dispersed stakeholders and corporations face insurmountable obstacles, only 'ethical custom' stands in the way of highly-incentivised managers 'making as much money as possible' by imposing social costs on stakeholder groups. However, ethical custom is of marginal relevance to the governance of social cost. Self-interested but 'enlightened' proclamations of corporate social responsibility are more likely to be public relations exercises than genuine attempts to address the social costs of

corporate activities. Corporations can profit by externalising costs onto society where they are not prevented from doing this by regulation or contract. Where they do this, increases in shareholder value cannot be equated with increasing social wealth or furthering the common good. Where shareholder value is created by externalising costs onto society and the environment, this is simply a wealth transfer rather than the generation of a surplus.

The issue for stakeholding theory now – and in the future – is whether a more viable and cost-effective means of governing social cost is possible, so as to bring corporate governance into better alignment with the common good. As is well known, Teubner argues that the law can get around the probable failure of instrumental regulation by adopting a reflexive approach (Teubner 1993). This entails designing and imposing procedures which work with the logic of the system which it is sought to regulate (here, the corporation), rather than imposing substantive outcomes on it from the outside, which will simply act as an irritant, changing the way the system responds to its environment without necessarily achieving the regulatory goal. One form of procedural regulation, which has been used fairly frequently, has been to require corporations to allow stakeholders to have input into their decision making processes as a means of protecting their interests. As discussed above, employee participation is the best example of this. Another possibility is to require directors to take account of both the public interest and the corporate interest in their decision making. The reason that this kind of intervention is more likely to be successful is that it works with the logic of corporations, which systems theory treats as a form of organisation, consisting of linked decisions. Reflexive regulation channels corporate decision making to take greater account of its impacts on its environment but without prescribing the content of those decisions. It allows more effective governance of social cost than is possible through conventional regulation, albeit that it does not guarantee that any particular instance of social cost will be internalised by any particular corporation.

Yet both of these stakeholder approaches also suffer from limitations. Granting participatory rights to stakeholders requires that they be identified in advance. This works well in the case of employees, where the regulator recognises that they face a number of risks, including opportunistic breach of their implicit contracts by management and an inability to diversify their investments. However, it is more difficult in the case of other stakeholder groups, where the incidence and distribution

of risks and social costs may be more uneven. Conventional approaches to stakeholding are essentially static, with stakeholders given rights only if they fall into one of those groups whose interests are considered by regulators to be at risk. While a reflexive approach relieves the regulator of having to determine substantive outcomes, there are serious epistemological problems to be resolved before social costs can be governed. The regulator cannot simply impose an obligation on directors to take account of the common good or public interest in their decision making, because it cannot be assumed that the board are in possession of all the facts about the corporation's effects on its social and natural environment. However, any attempt on the part of the regulator to bypass this difficulty by designating the corporation's stakeholders in advance risks the return of the trilemma, if unaffected groups are given rights or affected groups are excluded. The essence of the problem is that, once we move beyond employees as the most obvious stakeholder group, it becomes increasingly difficult for a regulator to catalogue those affected by corporate activity. Moreover, the distribution of social costs may cut across any regulatory categories. Perhaps the solution is to treat identification of affected groups as the end point, rather than the starting point of the regulatory process. As Michel Callon emphasises, affected groups emerge when individuals or small groups are concerned by and inquire about a particular externality, or 'overflow' of corporate activity, as he puts it. As those affected identify matters of common concern, 'new, original and often unforeseen identities emerge, which sometimes demand to join the collective and recompose it' (Callon 1998 and 2008).

At present, then, both shareholder value and stakeholder models are static, identifying those with a residual claim in advance, and then considering different ways in which their interests can be protected through the corporate decision making process. This works well in the case of clearly defined groups like employees whose interests are clearly at risk from corporate decision making, but far less well in relation to other, more nebulous stakeholder groupings. Michel Callon's work hints that a dynamic approach to stakeholding is possible, in which those with a stake in each corporate decision are identified on an ongoing basis through a reflexive process of fact construction, rather than through a one-off,

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9. As O'Sullivan points out, the possibility of market and technological changes mean that both shareholder and stakeholder regulation risk becoming 'de facto theories of corporate welfare' (O'Sullivan 2000: 56).

ex ante determination by a regulator or a best guess by a board, which does not possess all the relevant facts but is charged with furthering the public good. Under a dynamic approach, those who consider themselves affected by corporate activity would have the opportunity to engage in a process of dialogue with corporate decision-makers with a view to reaching agreement not only on the nature and existence of the 'overflows' of corporate activity, but also on ways in which the costs which result might be minimised or eliminated. Callon describes this as a hybrid forum because it is a place where 'facts and values ... become entangled' (Callon 1998). The forum's function is to establish 'an acceptable alignment between what one knows (or believes one knows), what the actors want and expect (which is often contradictory) and the procedures to follow to elaborate norms'. The output of the hybrid forum is a set of facts which are acceptable to all concerned and a means of reconciling differences about those facts, at least for a limited period (Callon and Rip 1992).

Callon never explicitly applied these ideas to corporate governance, but it is suggested that they provide important insights into how constructivist processes might be used to create a better alignment between corporate activities and the common good. We are now in a position to sketch out, in a very preliminary way, an institutional framework which would allow the interests of stakeholders to be protected through corporate governance in a dynamic rather than static way. In addition to giving designated stakeholders, such as employees, rights to participate in decision making or to information and consultation, the law could require corporations to establish hybrid forums on a regular basis, allowing affected groups to meet with managers to trace the actual or potential effects of corporate decisions on them, and to identify solutions to those adverse effects. This process would allow the corporation's other stakeholders to be identified on a case-by-case basis and externalities to be internalised in a satisfactory way.

The question arises of whether this reflexive process should be legally mandated or a voluntary matter for corporations. Voluntary action on the part of corporations is normally dealt with under the rubric of corporate social responsibility (CSR). Since 2001, the Commission has viewed CSR as 'a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment' (Commission 2001). However, the Commission recently announced that it was abandoning this approach and now considers CSR as a mechanism by which corporations internalise the costs they impose on their stakeholders. Under this new

approach, CSR refers to ‘the responsibility of enterprises for their impacts on society’ (Commission 2011: 4-6). Inter alia, this will require that corporations ‘have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the aim of maximising the creation of share value for their owners/ shareholders and for their other stakeholders and society at large; [and] identifying, preventing and mitigating their possible adverse impacts’. In terms of ‘identifying, preventing and mitigating’, corporations are ‘encouraged to carry out risk-based due diligence, including through their supply chains’. This change in approach is broadly to be welcomed. Under the previous approach, CSR encompassed any ‘socially responsible’ action which improved the corporation’s reputation, and therefore its profitability. This meant that spending on charity and the arts, for example, was viewed as socially responsible, even though there was no connection between the beneficiaries of this largesse and the corporation’s business activities. Under the new approach, CSR will be more firmly connected to the effects of the corporation’s business activities, and will encompass far fewer pure public relations exercises. More importantly from the perspective being discussed in this book, CSR will become one possible mechanism by which corporate activities can be governed in the public interest.

In fact, the Commission’s new approach begins to blur the line between CSR and stakeholder-oriented corporate governance. While CSR remains primarily voluntary, and the Commission continues to place considerable emphasis on the ‘business case’ for social responsibility, it also notes the ‘supporting role’ of public authorities in introducing ‘a smart mix of voluntary policy measures and, where necessary, complementary regulation, for example, to promote transparency, create market incentives for responsible business conduct, and ensure corporate accountability’. In this early phase of the Commission’s new approach, it is not clear whether regulation aimed at ensuring accountability is envisaged at national or supranational level. It might be suggested that regulation will be necessary to require corporations to meet with affected groups. Without an obligation to meet, managers would be likely to avoid meetings with groups wherever this is likely to generate adverse publicity. In line with the discussion above, corporations might be required to meet and engage in discussions with affected groups in order to promote accountability. Subject to appropriate procedures being established, this would potentially enable otherwise invisible social impacts to be traced.

Once it has identified its 'adverse impacts', the corporation would then be expected voluntarily to 'prevent and mitigate' them in order to demonstrate its social responsibility. This will not pose any difficulty where there is a 'business case' for doing so. However, in addition to identifying these 'win-win' situations, this more intrusive approach to CSR is likely to identify impacts which cannot be internalised profitably, and these are less likely to be dealt with voluntarily. Corporate decision-makers will run up against the same corporate governance constraints which undermine the prospects of mediating hierarchy in the productive coalition model. Will managers really be likely to take decisions which sacrifice the current bottom line in order to mitigate social impacts?

At this point, stakeholder approaches to corporate governance part company with CSR. In order to be effective, a dynamic stakeholding approach would require, at the very least, a legal obligation on management to do something about any 'adverse impacts' identified in meetings with affected groups. At its most prescriptive, an obligation might be imposed on directors to internalise externalities of which they become aware in the course of these consultations. Less prescriptively, and more in keeping with the managerial core of company law, directors might be obliged to take 'adverse impacts' into account as an aspect of a broader obligation to manage the corporation in pursuit of the common good. There would clearly be significant political obstacles to imposing this type of duty on corporate decision-makers. However, this chapter has sought to demonstrate that shareholder value is not an adequate proxy for social wealth, and that economic arguments can be used to support a stakeholder-oriented approach to corporate governance.

In concluding this discussion of a stakeholder approach to governing social cost, three caveats should be raised. First, this chapter has not sought to argue that employee codetermination should be replaced with a more flexible approach. The economic arguments for mandating employee participation in corporate governance have been clearly articulated by theorists such as Blair, Sadowski and Streeck. Economies can gain comparative advantage by putting in place an institutional structure which encourages firm-specific investment by employees. The procedures for identifying and governing social cost advocated in this section would operate in addition to – and not in place of – existing employee participation rules. Second, this chapter has not sought to argue that social costs should only be addressed within corporate governance. Mandatory regulation through legislation remains indispensable, particularly

in relation to the intractable environmental problems facing us. However, regulation will frequently be incomplete, inadequate or missing entirely for a variety of reasons, and, where that is the case, requiring companies to construct and address the social costs their operations create would be a useful complement. Third, a number of issues remain to be ironed out. What procedures would the hybrid forum follow? Would the law become involved in the event of disputes? What would happen if participants acted disruptively or in bad faith? These are difficult questions that require further research. Here it can simply be noted that both corporate law and administrative law have dealt with similar issues for many years without paralysing decision making or descending into doctrinal incoherence.

## 5. Conclusion

This chapter has sought to demonstrate that confining the corporate governance, or decision making, process to the narrow function of furthering the shareholder interest is a lost opportunity. The corporate governance process is often the most effective means of governing, or exercising control over, the social costs of corporate activity. Indeed, the currently dominant shareholder value approach may even exacerbate the problem, as corporate managers have powerful incentives to externalise as many costs as they can in order to increase the corporation's share price.

That the law might intervene in corporate governance in pursuit of the common good has been recognised since at least 1975 when Christopher Stone argued in favour of 'more straightforward "intrusions" into the corporation's decision structure and processes than society has yet undertaken' (Stone 1975: 121). Of course, this has been fiercely and repeatedly resisted by advocates of shareholder primacy on the all-too-familiar basis that making corporate managers accountable to more than one constituency would release them from all accountability. However, leaving aside their unreasoned insistence that employees can protect their interests through contracts, shareholder value theorists have not offered a convincing response to Margaret Blair's argument that employees who specialise their skills to the corporation's requirements are vulnerable to managerial opportunism just as shareholders are. Their lack of concern for employees in this situation suggests that these theorists may be more concerned with achieving a preferred distribution than improving alloc-

ative efficiency. Their contractual model of corporate governance – with all its failings – remains the main argument against greater employee participation in corporate decision making. This chapter has hopefully demonstrated some of the dominant model’s weaknesses. Advocates of shareholder value have shown even less interest in sociological arguments that economic activity always creates overflows. Friedman was happy to accept that governments can regulate to control externalities which are ‘widely regarded as sufficiently important to justify government intervention’, but then to argue that, as a rule, they should avoid doing so because the costs of intervention are normally higher than the benefits and because it somehow reduces ‘freedom’. This argument forecloses the possibility, first suggested by Brookings, and later taken up by Berle and Means, that corporate governance could become a political process, with managers seeking to identify means to further the common good through engagement with the various groups who consider themselves affected by the corporation’s activities. This is what a true stakeholder model of the corporation would look like: directors and managers would be under an obligation to further the interests of the corporation, whilst internalising all the externalities of which they become aware in the course of their legally required engagement with stakeholders, with participation rights granted to shareholders and employees as the corporation’s residual claimants.

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# Chapter 2

## Why stakeholders?

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### 1. Introduction

#### 1.1 The topic, purpose and point of departure

The distinction between stakeholder and shareholder theory – and their advocates – is dominant in the literature on companies and governance. At the core of the debate is the question of whether or not state interference in company activity is perceived as legitimate. A further issue in the debate is the question of shareholder rights and the possible role of the state of empowering other stakeholders at the expense of shareholder power.

Two very simple questions make up the foundation of this discussion: Who owns the companies? And: Who has the right to make decisions about company activities? Here the question arises of whether the principle of private property can be applied to the question of company control and governance. By using property rights theory (Demsetz 1967)<sup>1</sup> and agency theory (see e.g. Jensen and Meckling 1976) the answer for the advocates of shareholder theory is: Yes! Advocates of the other tradition, i.e. stakeholder theory, emphasise that people inside and outside the company have a right to exercise ‘voice’ in its affairs because the company’s activities might influence their lives. In other words, the company has responsibilities vis-à-vis a number of stakeholders.

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1. ‘Three important criteria for efficiency of property rights are (1) universality – all scarce resources are owned by someone, (2) exclusivity – property rights are exclusive rights; and (3) transferability – to ensure that resources can be allocated from low to high yield uses. In Demsetz’s (1967) neoclassical economic framework, all three criteria are in place (in the long run)’ (Mahoney 2004).

But what is the basis for arguing that specific groups of actors have a right to be included in decision making processes and bodies in a privately owned company in a capitalist economy? For shareholder theorists, property rights lead to 'shareholder democracy' and legal regulation of decision making power, voting and election procedures and certain company bodies. Up to now, stakeholder theory has to a far lesser degree defined such rules and regulations (Clarke 1998). Assuming that stakeholder interests should be represented: how should stakeholders be selected and how should principles for representation and election procedures be determined? The stakeholder theory answer to this question could be characterised as a mixture of opinions on the legal framework and normative or moral statements. The legal framework defines the company's legal liabilities towards the state, shareholders and other contractual partners as the basis of the moral responsibility of any company.

For stakeholder theorists, the reasons for Corporate Social Responsibility (CSR) are seen as either instrumental (the so-called business case) or as an overall moral duty. Little attention has been devoted to the normative foundations for stakeholder rights; stakeholders are seen as important due to their contribution to productivity and profit, either directly (through production) or indirectly (through company reputation in the consumer and/or capital market). The moral obligation is taken for granted without any thorough consideration of its democratic foundation. The result is that the relationship between CSR and political regulation remains ambiguous or vague in stakeholder theory. Political regulations in this, as in any other sphere of society, need democratic arguments and foundations to be legitimate. Thus, the importance of self regulation remains a common feature of both shareholder and stakeholder theory. Company actors shall and must decide on company activities and where to draw the line between company activity and the outside world.

However, we need to ask who these company actors are and which interests are to be included as part of company interests and how these interests are legitimized. The foundation of this legitimacy is the main issue in this chapter: what makes a stakeholder a legitimate stakeholder with rights to participate in company decision making? The legitimacy may in principle be drawn from two sources; from the legal framework or from an understanding of fairness (or justice). The legal definition of property rights is our point of departure when analyzing this framework.

When entering the area of fairness we use the work of John Rawls (1971, 2001) on social justice and in particular Jon Elster's (1992) concept of local justice when scarce goods are distributed.

In this chapter we argue that the legal framework and theory of fairness define and legitimize the stakeholders that are entitled to participate in the company's decision making. These legitimate stakeholders are the shareholders and the employees.

## 1.2 Definitions and delimitations

What does it mean to participate in decision making processes in a private company? In order to answer this question we need to define both 'decision making processes' and 'company'. Our point of departure is a strict definition of power distribution as distribution of board seats, which implies that power is a 'divisible good' materialized as board seats. Our focus is on decision making power. We do not investigate whether or not board actions are important for the organisation (and stakeholders' interests) as such; here we assume it is true and do not look into implementation power (Falkum 2008), agenda power (Bachrach and Baratz 1969) or thought control (Lukes 2005).

Our analytical approach is quite simple: taking the current legislation as our point of departure, how can we argue for introducing new stakeholders onto the board? What are the normative foundations for shareholder representation today? Is it possible to use the same normative foundations for new stakeholder groups and does this imply the need to define certain participation rights for these other stakeholders?

The present owners of the company are subject to a number of restrictions. Through company law as well as a number of other legal acts, the state (or legislator) has defined the framework for ownership and the activity of shareholders. These restrictions need a democratic foundation in order to be legitimate. We ask: is it possible to use the same democratic arguments to defend the right of other stakeholders to elect 'their' director(s) to the board?

The company is defined here as a work organisation. This definition emerges in three steps: First, an organisation is a collective of individuals with common objectives (Morgan 1988; Dotevall 2009; Bergström

and Samuelsson 2012; Johansson 2011). Second, this organisation is regulated by contracts; at the core of the organisation we find the employment contract, since only through paid labour can the objective of the organisation be fulfilled (Hagen 2012; Dotevall 2009; Bergström and Samuelsson 2012). The objective depends on processing input and the goal is reached by producing added value or surplus. Third, the work organisation is a legal person operating in a market; added value is not realized until the product is sold.

This chapter is divided into four parts. Following these introductory remarks we present the legal framework in part two, that is the legal position of property rights and the connection between property rights and the right to dispose of or control the property. Then we turn the table and move on to distribution of board seats in part three: if board positions are distributed according to fairness criteria, which stakeholder groups will be among the privileged? This line of thought is elaborated by using Elster's concept of local justice and the four different distribution principles; equality, merit, need and productivity. In the final part we return to the question of democratic arguments and the effect on different stakeholder interests.

## **2. Property rights in a capitalist economy**

### **2.1 Some general remarks**

We hardly need to argue that the question of company control is important. Companies, mainly in the form of limited companies (private as well as public) are the most important production units in the industrialized world. A number of multinationals have turnovers far greater than the GNP of some countries. Dividend, or the result of company activity, is one of the most important distribution criteria of wealth. Privately owned companies are inseparable from private property.

Western – if not all – social systems rely on the assumption of private property rights as a given and fixed phenomenon, almost considered as natural law. The foundations of private ownership can already be seen in Roman law and have developed into a central part of individual human rights as they are now known. The principle of property rights and its affiliation with powerful interests in society has made it appear to be eternal and independent of all codification. The principle has also had

immense significance as a political, judicial, economic and social argument. Property rights can be said to be a formalised principle of a social/behavioural pattern (the contract, organisation forms, etc. (see Lindgren, Magnusson and Stjernquist 1971)). Within the industrialised part of the world, the idea of property rights in the liberal market economy is that they shall be decentralised so that economic decision making will be done by individual producers and consumers. This has indeed occurred to a great extent.

Property rights are given extremely strong legal protection in several legal systems in the industrialised part of the world. Ever since the 1776 United States Declaration of Independence and the 1793 French Declaration of the Rights of Man and Citizen, up through the United Nations declarations on human rights issues, property rights have enjoyed a strong position (see Eckhoff and Sundby 1991). The International Labour Organization (ILO), the Council of Europe and the European Union have followed up on the importance of property rights. Through this legislation on property rights, the individual's human and fundamental rights constitute not only a moral, but also a legal principle. These principles are mainly enforced in the national legal systems.

From an economic perspective, property rights constitute an institution that forms an essential condition for the liberal capitalistic market economy on which the Western social order is built. However, there is no general definition of the concept of property rights, which tend to be defined negatively (see e.g. Håstad 1996); the owner is allowed to use his or her property according to their own free will, provided that there are no limitations defined by law or by contract signed by the owner. Property right is the most absolute right to a property, but it can be restricted or changed through legal or conventional means. A general restriction on proprietorship is provided by necessity; the owner is responsible that his or her possession or belonging can be at disposal by anyone to avoid imminent and unanticipated danger that could cause greater damage than the damage created by the encroachment.

Proprietorship symbolizes a complex system of both privileges and obligations. For describing the legal system, the concept of proprietorship is used as an instrument and the concept does not per se refer to something specific (cf. Ross 1951; Håstad 1996). As a legal concept, the concept of proprietorship is an intermediate link, a so-called middle term (see Ross 1958 and Lindahl 2004) which connects circumstance (legal facts in

issue) and meaning (legal consequence). From a legal perspective, the concept of proprietorship is dependent on the context and couples legal facts in issue (circumstances) with legal consequence (content). The actual situation and the legal rules applicable to the situation in question decide what legal facts are at issue and should be coupled with the legal consequences.

Proprietorship in company and labour law has to be conceptualized in a private law context. It is not sufficient to refer to proprietorship *per se* to apply legal rules, because proprietorship as a legal concept has to be coupled with legal facts at issue and legal consequence.

## 2.2 Association and property rights

The principle of property rights is used by individuals, collectives and corporations as an argument against the state's attempt to regulate the exploitation of property (Berle 1923; Nozick 1974; Åhman 2000.) The companies owned by the shareholders are private property. Thereby the interest of ownership is protected against external (governmental) requirements of control. This argument can be used against encroachment on the proprietor's interest through industrial democracy and employee involvement. If the employees' interests are equal to shareholders' interests when legitimizing involvement and authority, reasons other than property rights have to be used as justification.

From a legal standpoint, ownership of a company means indirect joint ownership. This is regulated by company law, whose starting point is to protect the partners' or the shareowners' monetary interests and the investors' interests. Company partners' rights and obligations are regulated by the relevant law applying to the specific company form. Shareholding results in both property right and obligatory right. Property right implies both an economic right and an administrative right. Obligatory right is only connected to an economic right and is based on a contract (Mellqvist and Persson 2011). The holding of shares involves the right to a share of the company and, by that, indirectly to the company's wealth. This is expressed e.g. in the 2005 Swedish Companies Act.

A joint stock company is an association of capital and as such a legal person separate from the owner of the company. The joint stock company is nevertheless legally bound to act in the interests of shareholders, who

are at the same time principals. That follows from the ideological principle that the company's property is private property, which is protected by the constitution. The contract constituting a joint stock company establishes competence for the management of the company. The joint stock company is also legally bound to act in the interests of shareholders by the legislation regulating the joint stock company's constitution, through which the representatives of the management of the company obtain status in the company's organs. Thus, the management's competence is defined by both contract and legislation (cf. Samuelsson 2005: 465).

The objective of the company's business is the generation of profits for distribution to the shareholders, i.e. of invested financial capital (Bergström and Samuelsson 2012; Sandström 2012). Considering the importance of the joint stock company's capital base and the absence of personal liability of the shareholders, it is essential that dividend payouts have to be strictly regulated. As a starting point, the possession of shares grants substantial influence through the share owners' right to direct and control. Shareholders' interests are the dominant decision making criteria. As residual risk-takers, the shareholders derive their right to exercise control in the company, including the appointment of the management of the company. Furthermore, the shareholders as residual risk-takers have an incentive to supervise management and govern the company (Bergström and Samuelsson 2012). In Europe, this shareholder governance model has attempted to disperse the powers of the company through different models, such as a dualistic company management structure, interlocking boards of directors (i.e. boards of different companies with common directors), cross-ownership of shares between companies, corporate alliances, registration requirements for possession of shares, rules on insider trading, etc. It is however the company's management that, under the supervision of the board of directors, has the competence to implement the objectives of the company.

However, corporate governance models have developed towards other interests than maximizing shareholder value. This applies e.g. to business ethical considerations, but also to CSR. The aim of business is not only a question of maximizing shareholders' interests, but also of a wider social interest or engagement through which the distinct interests in the company are taken into account. Of course, it is conceivable, even probable, to discover an opposition between the shareholders' interests of maximizing profit and other stakeholders' interests. Typically,

these stakeholders are consumers, suppliers, employees, the local or regional community, banks and other financiers, and the management of the company (Freeman 1984). As shown above, property rights are negatively defined in the legal framework. The most important limitations are aimed at protecting minority shareholders and creditors. That shareholders have a favourable position in the company follows from the utilitarian point of view that self-interest drives individuals to increase their wealth and that this self-interest at the same time benefits society at large (Samuelsson 2005). In the 2005 Swedish Companies Act, when the joint stock company has an objective other than the generation of profits for distribution to the shareholders, this should be stated in the articles of association. These articles can be altered by a majority of the shareholders. In the Swedish case, there is no requirement for the joint stock company to have a (moral) responsibility to operate as a socially responsible company, neither if the company bases its legitimacy on contract or law, nor by international norms for corporate governance (Samuelsson 2005). Such a requirement can be stated in internal policies of corporate governance (cf. Governmental Bill (prop.) 2004/05:85 Ny aktiebolagslag (Sweden)) or in the articles of association.

It can be argued that a commitment to social responsibility means a shift of power from shareholders to the management of the company or to the legislator. According to the rule of law ideology in democratic states, the legislator already has the option to define or demand expectations on company decision making. And of course, when considered a profitable strategy, the company might take other interests than profit maximisation into consideration ('business case').

### 2.3 Decision making processes inside the company – the implications of property rights

Not only legal scholars, but also social scientists, emphasize the importance of the nature of the owned object. The types of decisions that can be made are dependent on the object owned. This applies both to the level of state regulation of ownership and to how ownership establishes authority towards other actors and possible contract partners. This authorisation is important both for the company as such, for the owners and for the relationship between different owners. The protection of minority shareholder rights is one of the common features of all company law. Shareholding, i.e. the ownership of shares, generates certain rights

but not complete disposal rights over the company. Here it is important to add that shareholders enjoy risk protection, i.e. the fact that shareholders may not suffer losses larger than their investments in shares and that share ownership does not imply any responsibility for company debt or other commitments. This is the core of the limited company as an economic construction, which allows shareholders to manage and minimize risk. As Engelstad (2011: 125, our translation) puts it: ‘If the amount lost by bankruptcy exceeds the company’s share capital, the rest of the loss is shifted to “society”, that is employees, creditor, suppliers and others.’ This shifting of risk is an important argument for state interference; the fact that society covers the loss provides the normative foundation for regulation of private property rights.

Armour *et al.* (2009) lists the main features of a company or a business corporation, i.e. i) legal person, ii) limited liability, iii) transferable shares, iv) delegated management under board structure, and v) investor ownership.

The focus in this chapter is on the board as a company decision making body with comprehensive authority which is elected by the shareholders. The authority to elect the board can be conceived of as the most important shareholder right, which is even more important than the possibility of proposing certain issues at the general assembly. The general assembly has no direct ability to instruct management; but even if limited, the possibility to instruct the board is far more extensive. The shareholders depend on the board to enforce their interests in the control and governing of the company. The degree of possible instruction from the general assembly to the board varies between jurisdictions. The Nordic countries are distinguished by a large degree of discretion and a relatively broad span of authority. The shareholders, by using the general assembly as their tool, may basically ‘do anything’ as long as they do not violate any legal acts or current contracts self-imposed or signed by the company.

The legal basis for the behaviour of management vis-à-vis the interests of actors other than shareholders, particularly employees’ interests, also varies widely between countries. In the Anglo-American countries the organisation of companies is characterised by a monistic (one-tier) board system, with a board coordinated by a managing director in close cooperation with the chairman of the board of directors. There is no formal division between a supervisory body and executive board in the one-

tier board system. All directors form one board, including both executive and non-executive (independent) members. In many continental European countries, e.g. Austria, Germany, France and the Netherlands, the governing structure of the company consists of a dual (two-tier) board system. In such a system the board is divided into a supervisory board and an executive board with a strict division of functions. In this system the supervisory board appoints the executive board and controls the management and the administration of the company. The Nordic corporate governance structure could be said to be somewhere in between the one-tier and two-tier board systems (Nørby 2001). The board is responsible for the company's organisation and the administration of the company's matters and also appoints the managing director. Employee representatives are members of this board. The managing director is subordinate to the board of directors, but runs the day-to-day management of the company pursuant to guidelines and instructions issued by the board. This system is not a one-tier system, because there are two management bodies in the company, but also not a two-tier system, because these bodies are not equal.

## 2.4 Internal and external stakeholders

In Table 1 we make a distinction between potential internal and external agency conflicts. Here we use the notion of 'agency conflict' to i) pinpoint the fact that all stakeholders might be perceived as the owners of the company and thus in the position of being the principal in the agent-principal relation, ii) look at conflicts between what we define as the internal actors (or stakeholders) and iii) examine possible conflicts between the company and the external actors. Some of these actors have the possibility to safeguard their interests through legal contract; this is indicated in the third column. In the last column we have indicated a sort of quasi-contract safeguarding or different 'soft law' obligations. We will however focus on the legal contracts. Table 1 below illustrates the focus we have chosen in this chapter.

Safeguarding interests through contract is the basis of company law. This must be analysed in line with contract law principles. These principles are critical not only because contracts are important mechanisms to avoid or solve conflicts, but also because of the central position of the residual risk argument in all corporate governance debates. The argument states that, since all other stakeholders but the shareholders are

Table 1 Internal and external stakeholders: potential conflicts and safeguards

	Potential conflict	Contractually safeguarded stakeholder	Safeguarded by policies and other mechanisms
Internal agency conflicts (internal stakeholders)	CEO vs. shareholders	CEO (by his/her employment contract)	Corporate Governance codes
	CEO vs. employees	Employees (employment contract) and collective agreements)	Employer policy and self imposed obligations
	Shareholders vs. employees		Corporate Governance codes
	Shareholders vs. shareholders	Shareholders – only if shareholder agreements	Corporate Governance codes
External agency conflicts (external stakeholders)	Company vs. Creditors Suppliers Costumers Environment Local community State	Creditor Suppliers Costumers	Corporate Governance codes Codes of conduct Reporting and transparency obligations

safeguarded by contract, the shareholders must be in control and are the legitimate owner of company surplus. Only the unsecured group of actors has a sufficient incentive to make the company prosper, since groups with secured interests will ‘stop’ at the fulfilment of the contract. The company as a ‘nexus of contracts’ is the prevailing view of the firm among economists (Parkinson 2003). The company is viewed as a collection of contractual relations between actors on the input side and actors on the result side. By using contract theory we might argue that companies wish to reduce their transactions costs in the market and the contract is the major tool. The different actors or individuals are perceived as ‘economic man’, i.e. as formally rational actors, and the relationship is built on the wish to maximize their utility. The contents of the contracts define the responsibility of the company towards other actors (or contractual partners). This strengthens the ‘legalistic view of the firm’ (Richter 2010: 628): no contract, no responsibilities.

However, from a strictly private law perspective, it can be debated to what extent the joint stock company really is built upon the idea of a nexus of contracts. The joint stock company is a capital organisation, with little or no rights and obligations vis-à-vis the owners (shareholders). The main right for the shareholders is to benefit from increasing capital. The company – with its rights and obligations – is constituted

by the legislative system, by which the company is found on normative (legislative) binding procedures, due to inter alia the important role in economic society the joint stock company has. This perspective will not be elaborated further in this chapter.

As a starting point we might look upon the different relationships as a result of contracting in a free market. The rationale behind the contract is twofold. First is the principle of freedom of contract, or the fact that the legislator entrusts actors to organise relationships between themselves because all actors have the right to control their own property. Freedom of contract and property rights are two sides of the same coin. Second, on the next level, we have to include an assessment of the content of the contract. To use a different phrase: we look at how dangerous or detrimental to the interest of the society the contract might be (e.g. employment contracts might imply a level of damage to health that might ruin the state economy because of high medical costs). If so, the state has a legitimate right to step forward and regulate the content of the contract. In addition to the interests of society (or overall welfare), the need to correct unequal market power is important, as the state needs to protect the interests of the weaker actor.

The state confines the extent of 'freedom of contract' by referring to both welfare or efficiency arguments and fundamental rights (as the assumed least powerful actor needs to be empowered). At the same time the state, based on the important and normative foundation of private property, needs to ensure the 'freedom of contract'. This double commitment may be viewed in light of the two principles of John Rawls (see also below). First: 'each person is to have an equal right of the most extensive basic liberties compatible to a similar liberty for others' (Rawls 1971: 60); freedom of contract could be conceived as a basic liberty. And secondly: 'Social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached positions and offices open to all'. The weaker contract partner needs to be empowered by the state in order to be able to enter into contract as an equal partner and thus be able to enjoy and attain 'attached position', even if this means that the state has to give the powerful partner less than their fair share.

### 3. Distribution of seats

#### 3.1 Stakeholder theories

Stakeholder theory takes into account of a much wider group of constituents than just the shareholders. Shareholder value is not paramount; instead a larger group of actors or interests is taken into account (Freeman 1984; see also above, section 2.2). The two different theories have different foci. Shareholder theory focuses on shareholder value to ensure that resources are used to maximum effect (i.e. not seldom maximum profit), due inter alia to the fact that the shareholders are the recipients of the residual free cash flow. Stakeholder theory in contrast focuses on the distinctive interests that the different stakeholders have and on balancing these interests. It could also be argued that the focus of stakeholder theory is on the long-run value of the company, rather than maximisation of value in the short-term. In this chapter we will, however, not further discuss these theories per se.

What standards should define the right to involvement in company decision making? Employees' interests are linked more closely to the company than most other stakeholders. In this chapter we argue that this internal link establishes an entitlement for the employees to be involved in the company's decision making, alongside with the owners of the vested capital.

As already briefly mentioned, Rawls' theory of justice as fairness focuses on the design and effect of social institutions. How can institutions be established which may ensure a distribution of social goods which will be perceived as fair by the citizens? Whether or not encroachment upon property rights is perceived as fair is an important practical political and moral question. Engelstad (2011) emphasises that state interference into private property is founded in market failures which creates unreasonable (or unfair) patterns of distribution. These patterns prevent (some of) the citizens from obtaining the resources needed to act responsibly on their own behalf and to pursue their possibilities according to our individual goals. But this possibility is also embedded in private property as such. Property rights are one of the basic foundations of our liberal democracy. Citizens have the right to feel secure and protected against encroachments on personal property and objects necessary for their subsistence. Property rights are considered a prerequisite for the ability to achieve individual autonomy and self-determination and thus also the ability to participate in representative democracy at local and national level.

The justification for state encroachment is twofold: 1) welfare of all and 2) the desire to establish well-functioning democratic processes and to ensure individual autonomy. However, as Engelstad (2011) also points out, the arguments protecting private property rights also support welfare and democracy. He states that theories of property rights have three arguments in common: i) labour – the object in question (the property itself) is the result of the labour effort of the owner; ii) efficiency – we need property rights in order to maintain the free market: without property, no market; and iii) democracy – the individual needs to be able to have his or her property at their disposal in order to become an autonomous individual, therefore this is the fundamental democratic right. Thus, labour and effort point to why ownership (of the object) arises, efficiency to why ownership is maintained and at disposal, and democracy points to the reasonableness of keeping one's property in order to use it as a basis for creating 'the good life' for oneself and to be able to participate in society in a democratic manner. This is in line with the cornerstones of what liberal capitalistic market economies are built upon, namely property rights, freedom of contracting, and freedom of trade; these cornerstones are essential for Western industrialised countries' economic and legal systems.

This discussion illustrates the complex nature of private property; we are using the same arguments to defend and at the same time to regulate private property rights. How then should property rights be treated as the foundation for decision making in private companies, for determining the legitimate constituency for the election of board of directors? Our way out of this dilemma is to focus on the distribution of goods and look for legitimate distribution criteria based on the three arguments above: why ownership arises, why it is maintained and why it is continued (kept). An emphasis on labour, efficiency and democracy (or equality) in a particular distribution process makes Elster's (1992) framework of local justice the natural point of departure.

Labour, productivity and equality are also important arguments in Rawls' theory of justice as fairness (1971), even if his analysis concerns the structure of social institutions and their distributional effects. Rawls' idea is that these institutions comply with two (sometimes counted as three) principles. The first principle is that of greatest equal liberty. This equality may only be violated in two ways, either as a result of (the principle of) equality of fair opportunity (positions are to be open to all) or by making sure that the worst off ends up in a better position (the difference principle).

Labour enters the picture by pointing to the fact that the first principle implies that we all have an equal right to the results of our working efforts.<sup>2</sup> Both parts of the second principle are also important to us, when entering ‘positions open to all’ individual effort is important and a legitimate source of inequality. The violation of the first principle (equal right to the result) is obvious in a capitalistic market economy, since the surplus is in the hands of the shareholders. It is, however, hard to argue against the fact that capitalism with its unequal distribution of means of production has increased the over-all standard of living. The worst off is better off; the distribution is in line with the principle of difference. In his later work Rawls (2001) seems to be highly critical of what we might label as ‘unregulated property rights’. The society, or the state, or the legislator, has both a right and an obligation to regulate the means of production in a far stricter way than to regulate personal property. This is in line with our legal point of departure; with a negative definition of property rights, it is legal facts in issue and the legal consequence of property rights that determine the situation. The consequence of one’s ownership of a personal object (e.g. a house) is something different than in the sphere of action of shareholders.

### 3.2 Different distribution criteria

In this chapter we consider board seats as a scarce good: which of the possible interest groups, which stakeholders, should be able to participate in electing one or several directors? The possibility to represent certain stakeholders’ interests in the most important decision making body in the company is defined as the result of a distribution process that must use fair selection criteria to be perceived as legitimate. To illustrate this line of thought: the criteria behind the stakeholders’ right to elect board members is analyzed; then we examine whether the use of this particular criteria make room for a legitimate claim from other stakeholder groups for board seats.

The different distribution criteria, or principles, emerge by asking a set of very simple questions (Elster 1992; Engelstad 1992; Hagen 1995,

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2. Føllesdal (1999) points to Rawls’ emphasis on ‘labour theory of value’ and thus his use of John Locke, Adam Smith and Karl Marx. All three maintain that all individuals who contribute to the making of a good have a right to an equal share.

1999) about the different actors and their characteristics or features. The basic questions are: should different characteristics make a difference?

1. No! This implies using equality as the distribution criteria. All actors, irrespectively of any individual feature (gender, wealth, education etc.) should be considered in the same way and have the same right to any scarce good. Using equality as our criterion might be possible by entrusting the election to political democracy, or, in other words, by leaving it to the elected politicians to appoint company boards. Below, we will refer to this as the equality principle.
2. Yes! And the first follow-up question is whether the emphasis should be placed on individual or group characteristics?
  - a. Group characteristics, e.g. all individuals with this particular feature will be treated equally in the distribution process. This will imply that membership in a given group (e.g. NGO members, citizens in a local county, all female citizens, etc.) have the right to participate in the election of board members. We refer to this as the membership principle.
  - b. Individual characteristics only. When this choice is made, one needs to ask about or separate the features in question.<sup>3</sup> To be able to do so time is introduced by considering former, present and future features.
    - i. Former characteristics. This covers the circumstances where the actor has used his or her characteristic to obtain or earn the right to the good in question. In this context, it might be deposited capital or work effort. The actor deserves a part of the good because of his or her former contribution. This is referred to as the principle of merit.
    - ii. Present characteristics. What features does the individual have at a given point of time? If present features are to be important they must be connected to needs; what you did or earned on former characteristics is a question of merit, and a future feature is a question of what one might do in the future (see below). The principle of needs concerns what the individual needs now. In our context this principle implies actors with the need to be

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3. These questions might obviously also be asked when distinguishing between different group features

protected against harmful company activity. Environmental hazard or violation of labour rights comes easily to mind and customers of a monopoly have a legitimate claim to participate.

- iii. Future characteristics. How can, based on their features, the individual contribute to production? What are the future company inputs or requirements? This is referred to as the productivity principle, for example the board should consist of highly competent directors.

By answering these questions five distribution criteria or principles can be drawn up: equality, membership, merit, need, and productivity. The principles as such are empty; they have no substance until arguing – in a normative way – why it is fair to distribute according to one of the criteria. For example: i) democratic values are important arguments for equality, ii) it is fair that people, who have invested their time or capital in a company, should have a say in controlling the company, and should therefore be given a chance to elect board members, iii) by emphasising the importance of company surplus as the financial basis for the welfare state, productivity is used as the guiding principle, iv) individual needs must be fulfilled or v) individual needs to be protected against company harm is the highest priority.

The membership criteria might be seen as a secondary principle due to the fact that the normative arguments behind the choice of principle would be the same whether or not we focus on individuals or groups of individuals with that particular feature. Do individuals fit into the particular prioritised group, and would it be possible to either identify any group interests or organise an interest formation process?

### 3.3 Criteria in the present regime

How then might the different criteria in present legislation be identified? Shareholders are the most important constituency in all board member elections and are entitled to elect the majority of the board in all jurisdictions.<sup>4</sup> However, in 19 out of 30 countries in the European Economic

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4. The German *Montanmitbestimmung* is an exception. Also to some extent quasi-parity code-termination, however, if there is a tie vote between labour and shareholder representatives, the chairman (always elected by the shareholders) has the tie-breaking vote.

Area (EEA), the employees are entitled to elect board level representatives (BLERs). The arrangements differ to a large degree (Conchon 2011) and in no country are BLERs found in all company forms and sizes, but the characteristic of 'being an employee' is widely recognised in Europe. In a number of countries, more than half of board members must be citizens from EEA member states. In certain types of companies, e.g. financial institutions or investment funds, board members must demonstrate industry competence and experience. As the first country, Norway introduced gender quotas in publicly limited companies; several other countries are considering such quotas. Property, work effort, geography, competence and gender are features found in the legislation of one or more countries.

But it is important to add that, besides work effort, the characteristic is a requirement for the directors elected by the shareholders; they might elect whoever they choose, as long as the ones chosen comply with the regulation. Whether or not the shareholders want to emphasise certain interests in line with the particular feature, e.g. female or geographical interests, it is entirely their own prerogative. Thus, only two interests are represented: capital and labour, or shareholders and employees.

How then, might the different criteria for examining the normative arguments behind these distributions of board seats be used, and may the same criteria be used to support the inclusion of new stakeholder interests into the board?

### 3.4 Capital

The value creating factor capital can consist of many different kinds of assets. It can comprise tangible and intangible assets, natural resources and labour. Capital represents power. These powers vary, depending on the individuals that are competent to exercise the power.

Property as a criterion for participation or, in this context, the individual characteristic of being a shareholder (owning shares) is built on the principle of merit. The shareholder has invested capital in the company and deserves to have a say and to have their interests considered. The normative foundation for merit is work; only by original work may capital emerge (cf. Fahlbeck 1998), either by paid labour, by the shareholder himself or as the result of the shareholder's legitimate right to use the

result of work by others (inheritance, partner(s), etc.) as a capital input. Merit is the normative foundation for the shareholders' right to elect board members, the driving force of shareholders' right. As a second principle, equality is used as an organising devise: one share – one vote. The number of shares equals the invested effort.

Now, moving on, we analyze shareholding as a present or future characteristic. It hardly seems relevant to use needs as an argument in this context; need for position is not a legitimate need here. And further, based on the fact that risk management and minimisation is the rationale for the company (i.e. shareholders cannot lose more than what they paid for their shares), need as means for subsistence hardly seems relevant. The fact that the actor bought shares indicates assets above what is needed for subsistence, and thus the need for return on investments (and the right to elect representatives in order to secure this return) is hard to defend. It does not seem fair to use need as a criteria here to benefit people who might sell their shares to satisfy their needs. On the other hand, we might argue that the importance of securing their investment is a significant argument. However, this argument refers to the future and thus the productivity principle. In order to survive, the company needs shareholders who want their invested capital to stay (secure) in the company.

If the productivity principle is based on the demand of the company in the future, which characteristics are important for the company's prosperity and well-being? It seems obvious that the company needs to be controlled and governed in a way that prevents shareholders from selling all their shares at the same time. And further, the company may need new capital in the future. But, is this argument strong enough to defend the right of the present shareholders to exclusively elect the board? We need to look at the nature of capital, that is, the ability to obtain the necessary input. This ability is independent, thus whether it is the present or a future investor is not decisive.<sup>5</sup>

To sum up, the right to be represented on the board due to the characteristic 'shareholder' is based on the merit principle. Work effort is the

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5. Who are the shareholders and what and how might the owners (especially the larger ones) contribute to the company? This is an important question in the corporate governance debate. Who the owners are is, however, a question of the characteristics of owners (knowledge, skills, network, long v. short-term interest etc.) and not a characteristic of capital itself.

normative argument behind merit. When put in action, the principle of equality is used to organise and regulate the election process. In other words, we end up with shareholder democracy as the main tool for electing the board of directors.

### 3.5 Labour

Let us now turn to the employee-elected representatives. How can the distribution criterion be used to understand the normative foundation for this arrangement? The employees' right to elect their representatives are, as with the shareholder, based on the principle of merit; the employees have put a lot of effort into the company and they deserve to have a say at the board level. This argument is twofold: value added and profits are made by human processing of input; capital in itself does not create value (see Fahlbeck 1998). And secondly: if profit was made, the employees have not received the entire surplus, i.e. part of the surplus is taken away from the ones who made it, and thus merit is involved.

Employee representation may also be justified by the need criterion. Employees need their employment to continue and this need is often connected to a particular company in order for the employee to make the most of his or her abilities and competence, e.g. through firm-specific skills. The relationship between the company and the employee is not based on risk management, as we would argue is the case for shareholders. Employees may, like the shareholders, exit the company, but in contrast to the shareholders, no capital for subsistence is realized as a result. Shareholders can choose alternative investments, while the employees face a labour market that may either be very difficult or not able to utilize their company-specific knowledge. Furthermore, it might be added that, while employees are necessary for providing labour, shareholders are not the only actors who provide financial capital.

We would also argue that the productivity principle is in favour of employee interests being represented on the board. The future of the company and the future level of productivity depend on the employees and their knowledge. It is far easier to change shareholders than to replace the workforce. It would probably be easier and far less time consuming to raise new capital than to acquire the particular competences which the current employees have. Capital is more easily replaced than knowledge,

or to put it a different way: it is easier to make changes in your investment portfolio than in your labour contract.

The characteristic ‘employee’ is important as a foundation for participation in company control and governance when using all three criteria; merit is build up by the work itself, the employees are in need of their employment for their subsistence and the employees are important for the company’s future, thus their interests need to be represented. The equality principle is used when organising the election of board level employee representatives (BLERs); one employee – one vote. In some countries we do find some sort of membership principle; for example, in Sweden a collective agreement is a prerequisite for demanding representation while in the largest publicly limited companies in Germany the national trade unions nominate representatives to the supervisory board.

The ‘standard’ or authoritative justification for shareholders’ right to control is the residual risk argument. All other stakeholders might rely on their contractual rights (employees have rights through the employment contract; the creditors have claims through their contracts, as well as the suppliers, and so on). So the lack of contractual rights for shareholders justifies their call for a right to ‘the rest’, and in order to secure this ‘rest’, they need to be in control. The residual argument may, however, could also apply to employment. Employees do receive a reward, but some of the surplus created by them is withheld from them. It is argued that work, or processing input, is the normative foundation of property rights, thus, it could also be argued that the labour contract is incomplete. Neither future profit nor future wage increases are contractual.

### 3.6 Stakeholders not (presently) represented on the board

In Table 1, management, creditors, suppliers, customers and the state are also included as stakeholders. The state (or the legislator) plays a subordinate role in stakeholder theory. A stakeholder position implies that the state as such represents a self-interests in conflict with other stakeholders in the company. The state might – as a state – have certain interests regarding employment and tax revenue, but has in principle no interests in a particular company as such. Any conflict of interests between the state and the other stakeholder interests must be perceived as

an ordinary political dispute between the political majority and minority, and solutions are found in the political process.

It might be argued that management deserves a dedicated stakeholder position. The managers – as private persons – might have a certain interest in the company. But in fact this will be either a private interest, as any other employee might have, or specific interests connected to being an agent of the principal, i.e. the shareholders and the board.

Creditors and suppliers are in a prominent position since they are completely covered by contract. This makes the merit criterion irrelevant; no merit is developed. It is also hard to argue for board positions for these interests when looking at their present characteristics or focusing on their needs. They do need the company to honour the contract, but needs beyond that are caused by either an incomplete or an unfair contract due to competition, market failure or misuse of power. Representation on the board would not alter these circumstances.

Considering the customers, the principle of merit might be rejected, since former contact with the company has been as a contractual partner and, in most cases (monopoly excepted), a free and market-based contact has regulated the relationship with the company. Any overcharge has been accepted. The principle of need only applies to monopoly companies and, as in our supplier example, including this interest group on the board does not alter that situation.

Turning to the productivity principle, the customers are important, if not decisive, for company's future. Customer interests on the board could provide important input on product design, etc. But even so, organizing customers as a constituency seems to be an impossible task. And in addition, we will have to assume that what might be the most important customer interest (low price) will be neglected by the customer representative when performing his or her board duties. Individual interests in a cheap product do not reconcile with the directors' duty to the company's general interests.

Company environmental responsibility, locally as well as on a global scale, is an important part of the CSR debate and a crucial issue among the stakeholder advocates. Environmental interests need to be taken into account because most company activities have implications both for the environment at such and for actors dependent on environmentally

sound surroundings. This argument leans on the principle of merit; the environmental interest deserves to have a say because the environment or environmental harm has been (an unpaid) input into company production. The principle of merit, based on previous work effort, favours both the shareholders' and the employees' demand for board representation. How then will environmental interest end up in our distribution based on the four criteria?

The use of an unpaid input might, however, be conceived as someone establishing a (financial) claim on the company. Inviting environmental interests to the board would be equal to inviting creditors, which would imply that the board should function as a creditor towards the company. Unlike shareholders and employees, this claim does not connect to work effort, but to harm or exploitation of common goods. And secondly, while the merit argument concerns the effort of the present employees and the present capital of the shareholders, the actors claiming environmental harm as an input might not be the present actors, but also both present and future generations. Thus, any legitimate claim of the environment or the local county needs political legitimacy.

Turning to future characteristics, environmental harm transforms into an input needed to continue company activity. However, the company's future need in this regard hardly justifies a board seat. When environmental harm is defined as an input we need to dedicate ownership to the environment: someone needs to own e.g. the land and 'offer' the company the possibility to harm this land. Ownership implies that we need to return to merit.<sup>6</sup> The need for this dedication implies that we need to return to political regulations; nobody may 'own' the environment or even the possibility of exploiting their own property (e.g. farmland or rivers) beyond sustainable limits.

In addition, and more in line with traditional stakeholder theory critique: using need for protection as a criterion is hard to combine with reasonable secondary principles, that is: which individuals have this particular characteristic and how to elect their representatives? Using geographical

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6. This argument is naturally not valid in the case of air pollution, since it is possible to own both land and water (rivers, seashore) but not the air. But, in contrast to water- or land pollution, air pollution is also less local, thus making it more difficult to decide who the victims of that particular company are. Asthmatics far away are greater victims than non-asthmatics closer to the factory.

borders and equality seems like the only option. This would either imply building a parallel system with the only aim of electing board members or using the existing political arrangements like the local council as constituency.

Summing up, need as a distribution criterion is tied up in the present; earlier (and unfulfilled) need, which may be tied to company activity, must be grounded in the principle of merit, i.e. someone did something that deserves to be rewarded because of a contribution to the establishment or continuation of the company. This reward, however, is a claim on the company and not a legitimate demand for representation on the present board of the company. Future needs may only be connected to company activity as such in order to be a legitimate distribution criterion; the need for environmental protection may be fulfilled by alternative power mechanisms, the most obvious being political regulations. The principle of need belongs to the normative stream of stakeholder theory, while the principle of productivity belongs to the instrumental; in order to demand a say you have to prove your worth to this company, e.g. the characteristic 'knowledgeable' in general is not important, your characteristic must make a difference for company future and company productivity, the company needs your specific knowledge.

#### **4. Representing shareholder interest and attending to shareholder interest?**

The equality principle as a legitimate foundation for the distribution of board seats is rejected. This is done on several levels: First, equality means setting aside private property as a democratic value. Second, history has shown that state ownership in the old Eastern European way has important welfare implication. Third, and as a consequence of our first objection; some sort of company ownership or contractual commitment to the company is needed to make a legitimate claim for participation.

Quite contrary, by using the different distribution criteria, we end up by assigning board level participation rights to labour and capital, i.e. the same interests we find in the legal framework. The normative foundation behind this choice of interests is found in present work, the labour contribution itself. Only through labour might legitimate control rights emerge; this is the democratic foundation for property rights. The relevant question then is: how distant from the actual work (from the worker transforming input into surplus) may the result, the capital itself, be,

and still claim control rights? Rawls (2001), as we have seen, makes a distinction between personal belongings and the means of production. Even if Rawls does not want to take an absolute stand, his advice is clearly to build political instructions able to control capitalism in a ‘social democratic manner’.

Merit is the far most important foundation for shareholder legitimacy. Merit is also important when we focus on employee representation at board level. But, the ‘being an employee’ characteristic also makes sense on both the need and productivity principles.

It is argued that any claim anchored in merit must be based on having a company attachment or connection, a relation between the actor(s) and the company. Companies organise their relationships through contracts. The more precise and extensive the contract is, the less merit is achieved, because the contract will cover the exchange between input provided and payment. The less precise the contract (and purely ‘social contracts’ are included), the more merit is created. To measure this ‘non-contractual’ merit is complicated; it seems reasonable to assume that this places demands on the political process to make the claims and rights legitimate. We return to this issue in the concluding paragraph.

The principle of need has important points in common with normative stakeholder theory. Need emerges when people are affected by company activities. Democratic values imply that the ones affected have the right to participate in the decisions. However, if the principle of need is the foundation of a legitimate claim to participate, it is necessary to make a distinction between the different social roles of the individual. A citizen has a legitimate need to be protected against e.g. environmental contamination. One’s need for a product as a customer is a far more complicated question. Choosing the particular product is the choice of an individual, a result of their autonomy, and it seems reasonable to say that they have no claim or right to buy that product from that company. The crux of the matter is how to emphasise the different needs and how the needs of different actors may be weighed against each other. In the end only democratic procedures might legitimate the distribution.

The productivity principle resembles in many ways the part of stakeholder theory closest to traditional management literature. How can we take care of the different interests needed for the company to grow and prosper? Which stakeholder interests are decisive for company produc-

tivity? Employees and the actors on the capital and consumer market are indispensable. These different actors affect the market in different way. In addition: we need to distinguish between the actors who are important to that particular company and actors able to sell the same characteristic on the market at the same price and with more or less equal transaction costs. Employees are in a unique position because they might incur severe costs when searching for alternative buyers of their labour. Again, one also has to add that, without a direct attachment to the company, one ends up with arguing the merit principle based in labour.

The principle of need is based on the relationship between the individual and the company; you have to be affected by company activity. Merit, on the other hand, does not only need a relationship as such, but a direct attachment to the company; merit is only possible to develop by adding surplus value to the input, either directly by own labour or indirectly (through prior labour) by providing capital. This argument, besides being based on the labour argument, also depends on whether or not there is any alternative way of fulfilling the legitimate claims of the actors. The shareholders and the employees of a company might only secure their interests by participation in the decision making process of the company; their interests may only realized through the company's activities. A citizen might both be affected by and observe environmental harm that needs to be compensated and/or prohibited, but the citizen does not necessarily do this by participating in decision making processes in the company. Several measures are possible, the most obvious being a ban on the production process as such or the substance in question. These measures need to be taken into consideration by the authorities in order to be legitimate; only then is it possible to violate the interests of the stakeholders to keep the production process running.

## **5. Interests legitimizing involvement: some concluding remarks**

Summing up the discussion in this chapter, labour and capital seem to be the two legitimate stakeholders for electing the board of directors. The relationship between the two stakeholders has not been discussed so far.

The possession of shares is thus an interest or a joint ownership and constitutes a share in a company's value. The company is through this

mechanism owned by the shareholders (Fahlbeck 1998). Does this mean that investment of financial capital should be given preference vis-à-vis the investment of labour or designers of product or business concept? Does it matter whether the investment of financial capital is intended for the long or short run? The long-term investor's engagement calls to mind the engagement of the core workforce. Both are interested in the welfare of the company and its ability to yield a good return and reinvest. Their interest differs in the way that the financial investor can exit more easily than the employee if business does not meet expectations, whilst an employee often does not really have this choice to leave. The short-term investor has a more immediate interest in business profitability. The core workforce does not typically have this interest, because it is more interested in sustainable business in the long run. The financial investors' interests can coincide with the more mobile or coveted workforce, but hardly with that of the core workforce. In these circumstances, is it justified to grant to any of these groups greater influence than to the others?

The investment of financial capital does indeed often provide a condition for the realisation of work or an idea, but the investment of labour is the investment that directly shapes value: 'Nothing material has any intrinsic value, only work or the fruits of work can turn into something or value. "Capital" is created by humans and ruled by human labour. The bulk of capital is collective, even if owned by private individuals or institutions, e.g. private investment funds or pensions' (Fahlbeck 1998: 251).

In order to legitimize the power advantage of financial capital, it has been given precedence vis-à-vis the investment of labour and of other investors. This condition has been a necessary prerequisite for the rise of the liberal capitalistic market economy system (Eckhoff and Sundby 1991). The financial investors have been and are dependent on the investments of labour and, in order to exercise powers superior to the work force and others, the financial investors have awarded themselves the right to exercise these powers. In employment and labour law this is obvious in most Western European countries, giving the owners managerial prerogatives through the employer.

The employees' possibilities to support themselves are not protected by property rights. This is instead a matter of regulation through the employment contract. In the employment contract, the balance of powers between the employee and the employer typically does not prevail. This imbalance in the employment relationship can, however, to some extent be equal-

ised by the trade unions' position on the labour market and by collective agreements. The application of the principle of property rights leads to the exercise of powers over other individuals by the management of the company as a representative of the company's owners (Renner 1929).

According to principal-agent theory, costs arise as a consequence of the principal's and agent's differing interests. These costs have to be reduced. The only principal in the joint stock company is the shareholder. The other, including the employees and trade unions, are to be regarded to as agents. By exercising their rights to take decisions at the general meeting, the shareholders supervise the board of directors, which in its turn supervises the managing director. This, however, assumes independent members on the board (Samuelsson 2005).

What legitimizes the right to participate in a company's decision making? In this chapter, it is argued that property rights are one legitimizing force for participating. However, it is also argued that all internal stakeholders are legitimate participants in decision making. Thus, both shareholders and employees are equally entitled to participate in company decision-making.

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# Chapter 3

## Regulating company law: the need for a holistic approach

Aline Conchon<sup>1</sup>

### 1. Introduction

‘In recent times ... the adoption of European company law initiatives has become more difficult’ states the European Commission as a preamble to its public consultation on the future of European company law launched mid-February 2012.<sup>2</sup> However, difficulties in implementing company law at European level are not a new phenomenon, as lengthy legislative processes have long been a characteristic feature of this field of law. For example, it took somewhat more than thirty years to adopt the European company statute (the *Societas Europaea* – SE)<sup>3</sup> (Schwimbersky and Gold 2009), twenty-one years separate the first proposal for a tenth directive (European Commission 1984) and the adoption of the Cross-border Merger Directive<sup>4</sup> in 2005, and after almost thirty years of harsh debates the proposal for a fifth directive was eventually abandoned (European Commission 2001).

A common element in these legal initiatives is a concern with the regulation of board-level employee representation (referred to here as ‘BLER’), i.e. the issue of employee representation on the board of directors or supervisory boards in a decision making (as opposed to purely consultative) capacity. It is precisely the difficulty in finding satisfactory

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1. This chapter is based in part on an earlier publication (Conchon 2011a) which has been revised for the purposes of this collection.
  2. The public consultation can be viewed on the Commission’s website: [http://ec.europa.eu/internal\\_market/consultations/2012/company\\_law\\_en.htm](http://ec.europa.eu/internal_market/consultations/2012/company_law_en.htm)
  3. Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees.
  4. Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.

legal arrangements in this matter which explains the length of debate in relation to the SE (Horn 2008a: 86; Fioretos 2009: 1177; Sasso 2009: 287). Specifically, the European legislative bodies faced the challenge of devising a legal framework which respected the national provisions on BLER existing in 17 Member States plus Norway in diverse institutional settings (Conchon 2011b) and, at the same time, did not impose this employee participation system on BLER-free countries.

Given that this challenge was taken up and solved in the case of the SE Statute, how should we understand the current deadlock in pending company law proposals, especially the one dealing with the European private company statute (*Societas Privata Europaea* – SPE)? We argue that the European legislative bodies failed to learn the main lesson from their previous experiences, which is that any EU legal initiative in the field of company law has to embrace a holistic approach that grants equal consideration to labour law elements, given that employee information, consultation and BLER are a core element of the European social model, as enshrined in EU fundamental rights charters.<sup>5</sup> By repeating the error already made at the initial stages of previous legal initiatives, i.e. by isolating company law from other legal fields instead of adopting an integrated approach, the European Commission, in particular, has embarked upon a flawed law-making process with regard to the SPE.

This chapter aims at demonstrating our argument and at inviting policy-makers to systematically endorse such a holistic approach to law-making in the realm of the regulation of companies. Section 2 will critically assess the sharp differentiation and division of labour between the realms of company law and labour law and reveal the extent to which these two fields have to be considered intertwined. In light of a review of previous legislative processes, Section 3 will conclude that the holistic approach is, in fact, the prerequisite for the successful achievement of European legislative initiatives in this field. Section 4 will draw some policy implications deriving from our argument before making a few concluding remarks.

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5. Article 27 of the Charter of fundamental rights of the European Union and Articles 17 and 18 of the 1989 Community Charter of fundamental social rights for workers.

## 2. Company law and labour law as intertwined legal fields

The division of labour in the legal domain reflects the same divisions as in wider society (Durkheim 1893), i.e. with distinct specialisation in sub-fields such as family law, tax law, consumer law, and so forth. However, this should not prevent, when it comes to corporate governance issues, consideration of the links between one specific sub-field – company law – and others. As Zumbansen notes, ‘within the academy and the law school’s curriculum, corporate law is seen in concert with courses and issues in securities regulation and bankruptcy law’, and, he stresses, ‘but not with labor law’ (2006: 16-17). As the mainstream conception of company law focuses on the regulation of the relationships between managers, shareholders and other financial partners of a company such as creditors, conventional scholars and law-makers might indeed consider links with other legal fields such as tax law and the law of financial markets as being self-evident. Conversely, the interdependencies of company law and labour law are far less frequently treated as being self-evident, as other authors have emphasised (Mitchell *et al.* 2005: 417; Greenfield 1998: 283).

Such a conception of company law and labour law as separate and distinct legal areas is increasingly subject to criticism, especially in light of the current ‘global forces of rulemaking’ (Zumbansen 2009: 250). As Deakin puts it, ‘while labour law and corporate governance could once have been thought of as discrete areas for analysis, it is clear that this is no longer the case. The relationship between them has become both complex and paradoxical.’ (2004: 79). For Greenfield, on the other hand, ‘the taxonomy that insulates corporate law is artificial’ (1998: 286) as a consequence of the intrinsic constitution of the company which is not only composed of relationships between managers and financial actors but also of relationships between managers and workers, in the tradition of the stakeholder approach to firms (e.g. Blair and Stout 1999; Freeman 1984). Villiers follows Greenfield’s perspective when she states, ‘the two spheres of labour law and company law tend to be divided between social and economic goals. Generally, labour law is more concerned with social goals, aiming to regulate the relationship between employer and worker. ... Company law, on the other hand, focuses more directly on economic issues and on the relationship between managers and shareholders. ... This distinction does not explain why employee participation should be acceptable in the social sphere but not in the economic sphere, when the

reality is that measures adopted in the social sphere will have an impact on the economic sphere' (1998: 188-190). To this we can add: and vice versa.

Beyond scholars' debate, there are also pragmatic elements which point in favour of a holistic approach whereby company law and labour law are viewed as intertwined. The most relevant matter is BLER which is at the intersection of the two legal realms. Indeed, if company law is defined as the regulation of five basic legal characteristics of business corporations which are 'legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership' (Hansmann and Kraakman 2004: 1), then employee representation at board level pertains to company law. If labour law is defined as the regulation of 'three different but related relationships: the relationship between the employer and the worker; the relationship between the employer and the trade union; and the relationship between the trade union and the worker' (Ewing 2003: 138-139), then BLER, as a relationship between employer and employees or trade unions (depending on the manner in which employee representatives on the board are nominated), pertains to labour law. In fact, when considering the legal field in which BLER rights were enshrined in national legislation, it is clear that both interpretations coexist. As Streeck observed, 'workforce participation rights came to be written either in company law or in labour law' (1997: 644). Indeed, having regard to the 17 European countries with such legal provisions,<sup>6</sup> BLER rights are regarded as pertaining to the area of company law in 8 of those countries (the Netherlands, Norway, Denmark, Poland, Hungary, Slovenia, Czech Republic and Slovakia) while they are regarded as pertaining to the area of labour law in the 9 remaining countries (Germany, Austria, Luxembourg, Ireland, Portugal, France, Sweden, Finland).<sup>7</sup>

Thus, there is no self-evident ground for restricting the regulation of BLER to the sole area of labour law and to exclude it from the area of company law. On the contrary, as Hansmann and Kraakman argue, BLER has to be considered an integral element of company law irrespec-

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6. We exclude Spain from this empirical observation as BLER rights in this country are not enshrined in law but in collective agreements.

7. For a detailed presentation of these findings and the methodology used to establish this taxonomy, see Conchon (2011a: 22).

tive of its legal ‘origin’. ‘The statutory rules in many jurisdictions that require employee representation on a corporation’s board of directors – such as, conspicuously, the German or Dutch law of codetermination – qualify as elements of corporate law even though they occasionally originate outside the principal corporate law statutes, because they impose a detailed structure of employee participation on the boards of directors [or supervisory boards] of large corporations. ... These supplemental bodies of law are necessarily part of the overall structure of corporate law, and we shall be concerned here with all of them’ (Hansmann and Kraakman 2004: 16). Against this background, and in line with the North-American model of ‘progressive corporate law’<sup>8</sup> (e.g. Mitchell 1995; Greenfield 2006), we argue for a holistic or socio-economic approach to company law according to which relevant and meaningful law-making process requires company law, the law on financial markets, tax law, environmental law and, above all, labour law to be viewed as embedded, i.e. as mutually constitutive of companies’ regulatory framework. In fact, company law initiatives have only been successful when the European legislative bodies embraced such a holistic approach, as we shall demonstrate in the following section.

### **3. The holistic approach to law-making: the prerequisite for successful company law initiatives**

In this part, we undertake a comparison of the law-making processes of successful and failed EU initiatives in the area of company law seeking to establish the element which accounts for the difference between failure and success. The SE Statute, the SCE Statute<sup>9</sup> (*Societas Cooperativa Europaea* – European Cooperative Society) and the Cross-Border Merger Directive represent successful initiatives here, whereas the Fifth Directive on the structure of public limited companies illustrates a failed initiative.

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8. In short, progressive corporate law rejects the notion of the firm as characterised by mere agency relationships based on a nexus of contracts and advocates instead a notion of companies as ‘institutions with public obligations’ (Mitchell 1995: xiii).

9. Council Regulation (EC) 1435/2003 on the Statute for a European Cooperative Society and Council Directive 2003/72/EC supplementing the Statute for a European Cooperative Society with regard to the involvement of employees.

Because of its crucial role in the European legislative process, having a near-monopoly on initiating legislation and preparing draft proposals (Article 294(2) TFEU), we will pay particular attention to the law-making process taking place within the European Commission. We do so also for methodological convenience. Indeed, the consideration paid to the role of company law and/or labour law is easier to grasp in an EU institution where these two legal areas are subject to a highly-developed specialisation given the advanced organisational division of labour between distinct units. According to the Commission's organisation chart, company law is the exclusive remit of Directorate General (DG) Internal Market and Services unit F2 which has been recently renamed 'Corporate Governance, Social Responsibility', while labour law is the exclusive responsibility of DG Employment, Social Affairs and Inclusion unit B2 'Labour Law'. Unfortunately, there is no tool, website or database which allows for the attribution of an official text – be it an initial legislative proposal or its subsequent versions – to one of these units. However, the European institutions have equipped themselves with a tool, PreLex,<sup>10</sup> which indicates for each official document (such as a Communication) the DG responsible and the internal decision making mode within the European Commission.

Table 1 presents the involvement of Directorates General in the legislative process which led to the adoption of the SE Statute. Observers and scholars who studied the history of the SE Statute acknowledge that its successful adoption has to be imputed to a combination of three elements: (i) the adoption of the European Works Council Directive in 1994 which created a precedent by adopting a flexible approach to the regulation of employee involvement with the institutionalisation of a practice consisting in preliminary negotiations at company level for the social partners to agree on tailor-made designs for employee information and consultation procedures; (ii) the conclusions drawn in 1997 by the group of experts chaired by Etienne Davignon (European Parliament 1997), suggesting the adoption of a similar flexible and negotiation-based approach to BLER arrangements; (iii) the splitting of the SE legislation into a Regulation and a Directive, the latter being devoted entirely to the issue of employee 'involvement'. Table 1 adds to that analysis by presenting a new explanatory factor which is the equal involvement through

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10. PreLex, Monitoring of the decision making process between institutions, <http://ec.europa.eu/prelex/apcnet.cfm?CL=en>.

Table 1 DGs participating in the SE legislative procedure

Date	Reference (official documents)	Responsible DG	Commission decision-making mode
30 June 1970	Proposal for a Regulation COM(70) 600 final	Internal Market	Unspecified
30 April 1975	Proposal for a Regulation COM(75) 150 final	Internal Market	Unspecified
8 June 1988	White Paper COM(88) 320 final	EC Vice-President Internal Market, tax law and customs	Not applicable
1989 Split between a Directive and a Regulation			
24 August 1989	Proposal for a Regulation COM(89) 268 final – SYN 218	Internal Market	Empowerment procedure
24 August 1989	Proposal for a Directive COM(89) 268 final – SYN 219	Internal Market	Empowerment procedure
6 May 1991	Proposal for a Regulation COM(91) 174 final – SYN 218	Internal Market	Empowerment procedure
6 May 1991	Proposal for a Directive COM(91) 174 final – SYN 219	Employment	Empowerment procedure
14 Nov. 1995	Communication on worker information and consultation COM(95) 547 final	Employment	Oral procedure

Source: PreLex.

the empowerment procedure<sup>11</sup> of two different DGs. On the one hand, DG Internal Market took charge of the pure company law components of the statute (capital requirements, accounting, legal registration, etc.) and, on the other, DG Employment dealt with traditional labour law elements, that is issues of employee information, consultation and participation. The successful law-making approach identified here appears holistic, granting equal consideration to company law and labour law elements.

11. Under this decision mode, the Commission ‘empowers’ one of its Members (e.g. DGs) to take measures on its behalf (see Article 13 of the Rules of Procedure of the European Commission annexed to Commission Decision 2010/138/EU, Euratom) which provides the DG concerned with considerable leeway.

The same observation can be made when looking at Table 2 which presents the involvement of DGs in the legislative process relating to the SCE. Again here the success of this legal initiative cannot be said to rest exclusively on the involvement of two different DGs. However, the participation on an equal footing by DG Enterprise in charge of company law aspects<sup>12</sup> and by DG Employment in charge of labour law aspects, as both were empowered, undoubtedly contributed to the successful achievement of this legal initiative using a holistic approach.

Table 2 DGs participating in the SCE legislative procedure

Date	Reference (official documents)	Responsible DG	Commission decision-making mode
18 Dec. 1991	Proposal for a Regulation COM(91) 273 final – SYN 388	DG Enterprise	Oral procedure
18 Dec. 1991	Proposal for a Directive COM(91) 273 final – SYN 389	DG Enterprise	Oral procedure
6 July 1993	Proposal for a Regulation COM(93) 252 final – SYN 388	DG Enterprise	Empowerment procedure
6 July 1993	Proposal for a Directive COM(93) 252 final – SYN 389	DG Employment	Empowerment procedure

Source: PreLex.

The story looks a little different when it comes to the Cross-Border Merger Directive as only one DG – DG Internal Market – was involved as shown in Table 3. An important distinction here is that, in this case, the internal decision-making mode used within the Commission was the oral procedure and not the empowerment procedure. This oral procedure (Article 8 of the Rules of Procedure of the European Commission) entails that the draft text is submitted to the meeting of the College of Commissioners for oral discussion, thus allowing other DGs to present their opinions. Moreover, decisions under the oral procedure are usually adopted by consensus except when a Member requests a vote to take place in which case the decision is adopted by the majority of Members. Although it is not possible to know whether a vote took

12. We cannot find an explanation why the responsibility for handling company law matters in relation to the SCE was devolved to DG Enterprise and not DG Internal Market.

Table 3 DGs participating in the Cross-Border Merger Directive legislative procedure

Date	Reference (official documents)	Responsible DG	Commission decision-making mode
14 Dec. 1984	Proposal for a Directive COM(84) 727 final	Internal Market	Written procedure
11 Dec. 2001	Withdrawal of Commission proposals COM(2001) 763 final	Not applicable	Not applicable
18 Nov. 2003	Proposal for a Directive COM(2003) 703 final	Internal Market	Oral procedure
6 July 1993	Proposal for a Directive COM(93) 252 final – SYN 389	DG Employment	Empowerment procedure

Source: PreLex.

place,<sup>13</sup> use of this procedure means that DG Employment had the opportunity to influence the Commission's final proposal and, hence, for labour law matters to receive genuine consideration.

Of course, adoption of a European legal text requires much more than input from the European Commission alone. The importance of political compromises between national governments reached in the Council and the European Parliament should not be minimised. However, it remains the case that the joint and equal action of company lawyers located in one DG and labour lawyers located in another appears to be a distinctive element of proposals which finally made it into law. The most patent illustration of this proposition is given by the legislative procedure for the draft Fifth Directive shown in Table 4. This draft Directive, with proposals fairly similar to the initial proposal for an SE Statute, sought to establish throughout the EU the German model of *Mitbestimmung*, i.e. a two-tier governance structure composed of a supervisory board and a management board with compulsory one-third employee representation in the former. The dead end reached in the legislative procedure caused the European institutions to abandon the proposal in 2001. Unlike the procedures used in relation to the SE and SCE Statutes, in this case, the law-making process within the Commission involved only

13. Minutes of the College meeting that took place on 18 November 2003 do not specify this point.

Table 4 DGs participating in the draft Fifth Directive legislative procedure

Date	Reference (official documents)	Responsible DG	Commission decision-making mode
27 Sept. 1972	Proposal for a Directive COM(72)887 final	Internal Market	Unspecified
28 July 1983	Proposal for a Directive COM(83)185 final	Internal Market	Written procedure
13 Dec. 1990	Proposal for a Directive COM(90)629 final – SYN 3	Internal Market	Written procedure
20 Nov. 1991	Proposal for a Directive COM(91)372 final – SYN 3	Internal Market	Empowerment procedure

Source: PreLex.

one DG – DG Internal Market – which benefited from the empowerment procedure, i.e. there was no significant involvement of other DGs, and the approach was focused solely on company law.

Thus, there are convincing grounds for asserting that the holistic approach which combines the company law and labour law perspectives is one reason, even if not the main one, for the success of legal initiatives relating to the regulation of companies and for the resolution of related deadlocks. It is thus difficult to understand why the same path has not been followed in recent attempts. For instance, the proposal for a SPE Statute is in the sole hand of DG Internal Market, hence of company lawyers.<sup>14</sup> Aside from the debate on the relevance of a holistic approach i.e. the procedural path taken, it is also hard to understand why lawmakers decided not to repeat in relation to the substance the approach which had proved successful in previous legislative initiatives. Instead, and for a reason which is difficult to justify, when publishing its proposal for the SPE, the European Commission favoured the pure company law perspective and did not consider the existing model of the SE Statute on the ground that ‘reopening the employee participation debate in the context of the SPE would expose the SPE to an unreasonable political risk’ (European Commission 2008: 33). In fact, exactly the opposite has happened (the proposal for the SPE reached a dead end in May 2011 following the ninth attempt to find a political compromise at the Council under

14. PreLex does not specify the mode governing the decision making procedure followed within the European Commission.

the Hungarian Presidency<sup>15</sup>) as, in the words of Picard, ‘it is precisely the absence of serious European-level reflection on codetermination [BLER] that hinders progress on European company law’ (2010: 106).

The rationale for such a counter-intuitive approach might well be found in the influence of the expert groups advising the European Commission in the field of company law. In relation to the SPE, the minutes of a meeting of DG Internal Market’s advisory group indicate that a group member ‘underline[d] the importance not to impose any model of workers’ participation and in particular not to put in place the same regulation of the SE in this matter’ (Corporate Governance and Company Law advisory group 2008: 3). Experts’ discussion on a potential 14<sup>th</sup> Company Law Directive related to the cross-border transfer of company seats follows the same pattern: ‘There was also a suggestion that the issue of workers participation should be dealt with differently from the SE Statute and the cross-border mergers directive’ (Corporate Governance and Company Law advisory group 2006: 4). Such reluctance towards the repetition of a holistic approach is much less surprising when one learns of the composition of such expert groups, which are almost exclusively filled with company lawyers and the like.

#### 4. Some policy implications

At least two key policy implications derive from our analysis. The first relates to the law-making process within the European Commission and the second to the work and composition of expert groups advising the European Commission. As regards the first, it is clear that, for legal initiatives dealing with the regulation of companies to be successful, specialists from several legal fields have to be included, in particular labour lawyers and company lawyers. Given the organisational configuration of the European Commission, this implies that DG Employment and its labour law unit needs to be involved on an equal footing in the process leading to the drafting of proposals. In this regard, equal footing is the key as interservice consultations do not accord the DGs consulted an in-

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15. The Hungarian Presidency was the fifth successive presidency which attempted to reach a unanimous decision on the proposal. Earlier attempts by the French, Czech, Swedish and Belgian Presidencies all failed. For a history of the legislative procedure related to the SPE see <http://www.worker-participation.eu/Company-Law-and-CG/Company-Law/European-Private-Company-SPE/History>.

volvement equivalent to that of the DG heading the internal process. In one way or another, company lawyers have to act in concert with labour lawyers located in other Commission units.

The second implication associated with a holistic approach is that when a high-level expert group is convened to think about the perspectives for European company law, whether invited to reflect on ‘a modern regulatory framework for company law in Europe’ (Winter *et al.* 2002), or ‘on the future of EU company law’ (Antunes *et al.* 2011), its composition should reflect that integrated approach by gathering multidisciplinary experts, including labour lawyers. Reflection of previous endogamously convened expert groups suffered from groupthink which tended to overstate one particular notion of company law, namely the agency model with a shareholder-value orientation to corporate governance (Deakin 2009) situated within a market-based system of regulation (Horn 2008b). While in the integrated approach that we advocate stakeholders and, in particular, employment relationships are considered, the closed expert groups disregarded those issues. In fact, several members of the European Corporate Governance Forum [ECGF] ‘pointed to possible risks of including employees or other stakeholders into the corporate governance debate’ (European Corporate Governance Forum 2006: 2). This perspective was emphasised by an ECGF member at a 2010 meeting: ‘A member responded to the idea of empowering employees. He is not in favour of that. He also reminded the Forum that the behaviour of employees was one of the factors in the crisis. He also spoke about shareholder value. In the UK this is defined as long term value, implicitly protecting employees’ interests.’ (European Corporate Governance Forum 2010: 2).

Some would argue that stakeholders are granted significant consideration by being part of such groups. In that connection, it is interesting to observe that of the 50 individuals making up the various expert groups which advised DG Internal Market in the field of company law and corporate governance,<sup>16</sup> only two were labour lawyers and/or trade union representatives. Such a weak representation of labour law experts might

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16. Our analysis is based on the two experts groups mentioned above (Winter *et al.* 2002; Antunes *et al.* 2011), the members of the European Corporate Governance Forum which ran from the end of 2004 to July 2011 ([http://ec.europa.eu/internal\\_market/company/docs/ecgforum/new-meberlist\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/new-meberlist_en.pdf)) and the members of the group of non-governmental experts on corporate governance and company law set up in 2005 which ran until 2009 (see Commission Decision of 28 April 2005 establishing a group of non-governmental experts on corporate governance and company law (2005/380/EC). According to the register of

well explain why, despite the fact that the ‘influence of workers’ representation on companies’ boards’ was raised as an issue worth investigating as part of the 2008-2011 work programme of the ECGF (European Corporate Governance Forum 2008), no in-depth discussions took place. It might also explain why ‘the issue of employee representatives on boards was not looked into in the Green Paper [on an EU corporate governance framework]’ (European Corporate Governance Forum 2011: 2) as noticed by an ECGF member.

Furthermore, a more balanced composition of such expert groups might also help address the ‘democratic deficit’ in the ‘expertocratic’ policy-making process (Verdun 2005; Harcourt and Radaelli 1999, quoted by Horn 2008b), especially given the significant impact of such groups on actual policy-making. Indeed, the core issue arising from the composition of such expert groups is their legitimacy and accountability. As Barbier and Colomb put it: ‘The public space at the EU level is actually fragmented into a myriad of forums and arenas, where actors with unverifiable legitimacy and obscure and changing networks have their say in influencing the final substantive compromises which are transformed in draft legislation proposed to the Council.’ (Barbier and Colomb 2011: 11). The reflection of a holistic approach through a more diverse composition of expert groups could also help counterbalance the ‘democratic deficit’ in the use of public consultation in the field of company law (Cremers *et al.* 2010). Unlike the social policy field where the Commission is required to consult the social partners (Article 154 TFEU), in the area of company law they do not have any special voice. A requirement to consult the social partners in this area, too, would help ensure a more integrated approach to the regulation of companies.

## 5. Conclusion

‘The appropriate goal of corporate law is to advance the aggregate welfare of a firm’s shareholders, employees, suppliers, and customers without undue sacrifice – and, if possible, with benefit – to third parties such as

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16. (cont.) Commission expert groups and other similar entities (<http://ec.europa.eu/transparency/regexpert/index.cfm>), DG Internal Market is also assisted by an informal and permanent Company Law Expert Group (E01456). However, as this expert group is composed of ‘national administrations’, the register does not list the individuals involved and, hence, these experts could not be included in our calculations.

local communities and beneficiaries of the natural environment' (Hansmann and Kraakman 2004: 18). Sharing this definition, we invite policy-makers at European level to consider all these actors when it comes to regulation of company-related issues, i.e. to adopt a holistic approach which grants not only company law as such, but also environmental law and labour law an equal level of consideration. Corporate governance regulation can no longer be viewed as pertaining exclusively to the sub-field of company law but should be regarded as requiring an integrated and multidisciplinary approach. Such a holistic approach will have to encompass several legal areas such as '(i) corporate law, (ii) financial market regulation, and (iii) labour law' within the 'tripartite institutional structure' described by Cioffi (2000: 576) or could follow the 'law of the productive enterprise' which combines 'the insights of political economy, with aspects of company law, the law of contract, and labour law' as developed by Collins (1993: 91, quoted by Ireland 1996: 299). To conclude, we would like to stress also that we assume that such a holistic approach would help counteract the current 'race to the bottom' which is emerging as a consequence of recent and pending European company law initiatives which are putting national regimes into competition on the ground that national differences can distort competition (Deakin 2009). The 'race to the top' should become once again the goal pursued by the European legislative bodies, and the holistic approach to law-making can help in achieving this.

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# Chapter 4

## From harmonisation to regulatory competition

Jan Cremers

### 1. Introduction

Over recent decades the shift in EU policy on corporate law issues has been remarkable.<sup>1</sup> During the initial period of EU company law making, mainstream policy was characterised by the goal of harmonising the legal framework for companies all over Europe. According to that approach, the internal market needed to be established through a regulatory programme leading to a stable, non-competitive equilibrium. This was to be based on an EU corporate law regime which guarantees a level playing field between the Member States.

However, under the influence of neo-liberal ideology and following the entrance of the more Anglo-Saxon style according primacy to economic freedoms, which quickly gained ground also in the corporate law community, the legal framework for companies itself became a factor of competition, comparable to other factors such as infrastructure, labour costs or mobility. The new purposes of company law were: flexible models, freedom of choice in relation to establishment, cost reduction, easy set-up and other simplification measures.

The moment of this shift lies somewhere in the early 1990s. In hindsight, the first important impulse at European level came with the conclusion of the Maastricht Treaty in 1992. The subsidiarity principle introduced into EU legislative procedures in that period facilitated a transition from harmonisation to ‘soft’ law making and open coordination. The Lisbon strategy formulated at the Council meeting in early 2000 emphasised the notion that the Union had to become an entrepreneurial, innovative

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1. On this shift see also Horn (2011a and 2011b).

and open Europe. According to the Lisbon Council, the competitiveness and dynamism of businesses were directly dependent on a regulatory climate conducive to investment, innovation, and entrepreneurship. Therefore, further efforts were required to lower the costs of doing business and to remove unnecessary red tape (European Council 2000: conclusions 14 and 15).

This development can be seen as the political expression of an underlying paradigm change in the socio-economic field. Since the late 1990s, the objectives of strengthening shareholders rights and protection for third parties went hand in hand with the aim that company law ‘should provide for a flexible framework for competitive business’ (High Level Group of Company Law Experts 2002a and 2002b). According to this view, EU harmonisation should strive to further the trend towards increased flexibility and freedom of choice in respect of company forms. In May 1996 the SLIM initiative – Simpler Legislation for the Internal Market – was launched by the European Commission with the objective of identifying ways in which the Single Market legislation could be simplified. The fourth phase of SLIM launched in 1998 included the area of company law. This measure exemplifies the political climate which led to a distinct change in the EU approach. Initially, policy had aimed at providing equivalent safeguards throughout the EU for those who are involved in and affected by the affairs of a company with a view to preventing a race to the bottom. In contrast, the new policy had to facilitate the running of efficient and competitive enterprises in order to ‘meet companies’ needs’. Legal harmonisation had become ‘outdated’. Instead, the legal framework became a factor of competition.

The main messages in communications from the European Union on company law over the past decade became ‘smart regulation’ and, since 2008, a particular emphasis on ‘strategic action plans to reduce the administrative burden’. The competitiveness of the European economy has been the central point of concern and with its Better Regulation agenda (discussed in detail in section 4) the European Commission raised new expectations, especially among small and medium-sized enterprises (SMEs). Better Regulation is seen as a dynamic process that does not simply concern drafting rules but also includes the proper implementation and enforcement of the law by Member States.

In general, the justification for the Better Regulation agenda is the claim that regulatory frameworks in the EU are too unwieldy and complex.

This is seen as a major handicap on EU competitiveness, crippling European companies in relation not just to their US partners but also to emerging competitors coming from Brazil, Russia, India, China and South Africa ('BRICS') (BusinessEurope 2011). However, on Member State agendas with regard to company law, the main worries are not related to the US or emerging competitors. Apart from the presence of skilled labour, logistics and infrastructure, and host country location, all of which are seen as key factors determining business location decisions, companies nowadays weigh up a number of drivers when deciding in which country their registered office and/or head office should be located: national company law for the purpose of group restructuring or rationalising and harmonising the corporate structure of the cross-border group; the possibility of freely transferring the registered office; and above all, tax minimisation possibilities.

The deregulation policy that characterises current national and EU company law reform leads to a situation of an emerging transnational legal pluralism that, in the long run, might stimulate regime-shopping inside the EU rather than contribute to a more sustainable legal setting. This was in fact already expressed as an aim of EU policy in 2002 by the High Level Group of Company Law Experts in their plea for a light regulatory regime: the European Single Market is becoming more and more of a reality and business will have to become competitive *within* this market. Corporate regulation is supposed to serve that purpose.

This chapter is largely based on the results of an inquiry on the interaction of European and national company law, conducted by a unique network of academic and trade union experts, the SEEurope Network. The next section provides information on the network and its inquiry. Section 3 is dedicated to the flagship of EU company law, the SE statute. This is followed by a section on the Better Regulation agenda and whether there is evidence at national level for such an agenda. Section 4 also deals with the interplay between EU and national company law. Section 5 is dedicated to the changes in national company law in recent years followed by a section that deals with significant national disputes on two prominent drivers, attractiveness and competitiveness. In the final section at the end of this contribution serious question marks are raised concerning the role of different actors, including the role of the trade unions in this debate. Some critical comments are formulated with regard to the policy promoted, ending with a plea for an agenda that is more oriented to a stakeholder approach to corporate law reform.

## 2. The SEEurope inquiry

SEEurope is a project conducted by an international network of researchers under the leadership of the European Trade Union Institute. The project, which started in 2004, began by observing the transposition into national law of the European legal obligations related to the Regulation on the Statute for a European Company (SE). From that moment on, SEEurope research and monitoring in the field of European corporate law has been conducted with a view to meeting the needs of all practitioners in Europe involved in the founding of an SE and in the policy debate on participation issues in their countries. The network seeks to improve workers' negotiating position by offering information on existing systems of board-level representation and to promote a better understanding of participation among worker and trade union representatives. In addition, SEEurope sees its role as a provider of practical evidence-based research on these issues for the EU institutions.

The SEEurope network worked on a comparative exploratory inquiry in 2011 on national and European corporate law reform. In the resulting research report, which was partly based on national contributions of the network members, the conclusion was that a prominent element of recent national company law reforms has been the effort to outbid direct neighbours (Cremers and Wolters 2011).

The SEEurope inquiry collected information on the possible interaction between EU and national law. The SEEurope experts were asked to analyse in their respective countries whether EU provisions had triggered changes in national legislation or whether there were indications of upcoming developments referring to or anticipating future EU legislation in this field. In parallel, it was investigated whether EU/EEA Member States had requirements that needed to be addressed at the EU level and, if so, what those requirements involved.

The aim was to compile critical developments in order to be able to make a substantial contribution to the EU discussion. It needs to be made clear that EU legislation (and the interaction between national and EU rules) in the field of corporate law should not invite or contribute to regime shopping. In contrast, EU rules should include essentials that contribute to decent rules at national level. The race to the bottom cannot be the main objective of EU policy.

The inquiry did not provide a complete overview of all recent changes in national company law regimes, as this would have been far too ambitious. The investigations pinpointed a few items indicative of the changes in national company law. The focus was on the general characteristics of the changes. The result was therefore not an exhaustive update. The changes highlighted were, for instance, changes with regard to the initial capital requirements (such as one euro companies) and other capital position related issues; changes with regard to the balance of power and to liability (versus minority shareholders, creditors and workers); changes with regard to mandatory financial audits, registration and control; and, finally, changes with regard to arbitration, the protection of stakeholders and the settlement of disputes. In analysing these findings, particular emphasis was placed on the fact that, in recent years, the improvement of transparency and related items of disclosure and information have been put on the agenda. The involvement of different actors in the debate and the impact on worker involvement were also important references in this analysis.

### 3. The SE case in a nutshell

The EU's objective in establishing different forms of European company statutes, of which the SE Regulation was the most distinct, was to better meet companies' ever-changing needs. However, the most prominent project of harmonisation of European company law, the adoption of the European Company statute (SE), has not become the flagship of a series of successful European statutes. The different statutes (the SE, the SCE for cooperatives, the planned SFE for foundations, and the long pending SPE for private limited companies) were each supposed to provide a corporate vehicle that was uniform and legally certain, yet flexible in order to help companies do business more easily in Europe.

After a decision making process lasting 30 years, the EU Council agreed in December 2000 on the general principles for a Regulation on the Statute for a European Company (*Societas Europaea*, hereafter SE). The SE Regulation (Regulation (EC) No 2157/2001)<sup>2</sup> and the Council Directive supplementing the Statute for a European Company with regard to the

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2. Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ L 294, 10.11.2001, p. 1.

involvement of employees (SE Directive)<sup>3</sup> were adopted on 8 October 2001. In the slipstream of the SE, the Regulation on the European Cooperative Society (SCE) and the Directive on employee involvement in the SCE were concluded in July 2003.<sup>4</sup> The SE legislation entered into force on 8 October 2004 and, by mid-2007, all EU countries had transposed it into national law. The main purpose of the SE statute was to enable companies to operate their businesses on a cross-border basis under the same corporate regime. Companies could move across borders in the EU by moving their registered seats and headquarters. The aim was *an approximation of Member States' company law* (recital 3 in the preamble to the SE Regulation).

The starting point for any comparison between the attractiveness of national company law and the EU statute was the assumption that the SE might represent an interesting alternative to a domestic public limited liability company. This would be true in cases where there are major differences between the SE statute and national rules and procedures. In the meantime it has become clear that the SE statute has neither resulted in a uniform legal form across the EU nor in a convergence of corporate regimes (Ernst & Young 2009). The SE statute contains several references to national law and, behind its uniform facade, the SE statute is governed mainly by national legislation in various forms. Different documents produced by European Commission services confirm that, in the majority of Member States, the status accorded to an SE is little different from that of a domestic public limited liability company (European Commission 2010b and 2010c). The Reflection Group on the Future of EU Company Law recommended that the Commission should prepare a reform of the SE Regulation, as is required in the initial legislation, and take inspiration from the flexibility available to national companies. According to this Group, the amended Regulation should be simplified, which means that it should limit as much as possible the options offered to the Member States to determine the terms of application of the SE statute (Reflection Group 2011: 30).

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3. Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, OJ L 294, 10.11.2001, p. 22.

4. Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE), OJ L 207, 18.8.2003, p. 1, and Council Directive 2003/72/EC of 22 July 2003 supplementing the Statute for a European Cooperative Society with regard to the involvement of employees, OJ L 207, 18.8.2003, p. 25.

The SE Regulation required the European Commission to present a report on its application, including proposals for amendments where appropriate, five years after its entry into force. DG Internal Market and Services commissioned Ernst & Young to carry out this study, which was finalised in December 2009 and published on the Commission's website in March 2010 (Ernst & Young 2009). Furthermore, the European Commission launched an online consultation to test the outcome of the study (European Commission 2010a), while at the same time organising a conference on the SE statute. The aim of these activities was to examine the Ernst & Young findings and to provide the Commission with input on issues relevant for the assessment (European Commission 2010b). As the discussion on the Ernst & Young report shows, there is a very mixed assessment of the importance of the SE for companies. The argument that it strengthens the European profile or identity of a company has slowly vanished from the scene, and where it is still present, is basically used as a marketing tool.

Putting it in rather euphemistic terms, the SE Regulation has not 'encountered the overall success expected' (Ernst & Young 2009). The convergence effect has failed as the SE, behind its unified image, is still governed by different national corporate law regimes. In this respect, one could conclude that the ideas related to uniformity or approximation that the EU legislature sought to achieve were already history at the moment of the SE's adoption. The SE form was limping between two approaches: its starting point dated from the early stage of corporate lawmaking based on ideas of harmonisation and convergence, whereas its adoption and transposition into national law took place in a period when corporate policy had shifted to the paradigm of competitive legal pluralism.

In a critical assessment, the ETUI and its SEEurope network formulated several observations that had been neglected hitherto in the debate on the effect and functioning of the SE statute (see Cremers *et al.* 2010). A key point of the ETUI's criticism was the creation of empty and shelf SEs. It was doubted that the intention of the EU legislature in relation to the SE statute was to create companies without economic activities or employees. The Commission assessment failed to provide specific answers to the question why shelf SEs are created in such large numbers. The question does not concern the advantages accruing to a company that buys a shelf SE, but what the EU intends to do to combat this violation of the spirit of the SE legislation, that is, offering a European form

of corporate governance and not an instrument for regime-shopping. In the meantime, an ‘SE business’ initiated by corporate incubators (mainly situated in the Czech Republic) has shifted the SE onto the path of regime shopping related to corporate restructuring, tax evasion or other financial motivations.

Another observation was that, in the meantime, additional EU corporate law has been put in place, such as the Cross-Border Merger Directive,<sup>5</sup> which provides companies with alternative possibilities of moving their company seat. For example, the Cross-Border Merger Directive represents a cutting back of what has already been achieved in the SE directive in terms of worker participation rights. It imposes a higher threshold for mandatory negotiations on board-level participation in comparison to the SE, rising from 25 per cent to 33 per cent of the workforce in countries with worker participation rights; introduces a threshold of 500 in place of no threshold in the SE; limits the scope of negotiations to concern only participation; and contains no consistency with regard to information and consultation. Additionally, European Court of Justice (ECJ) judgments that were catalysts of the new competitive paradigm have had a strong impact on the debate, making it clear that locating the registered seat of a company in one State and the administrative and real seat in another is fully in accordance with the basic rule of freedom of establishment. For those purposes, shelf SEs might be the ideal vehicle. It looks as if the Commission sees it as its objective to incorporate the ECJ cases on freedom of establishment into EU corporate law. All in all, the business environment perspective is now dominant in assessing corporate law; from that point of view, what matters is the identification of ‘unnecessary administrative burdens’, which should be removed. Against this background, worker participation surfaces as something ‘alien’, labelled a type of ‘burden’.

The most important regulatory issues taken into account by a company deciding in which country its registered office and/or headquarters are to be located are: taxation, national company law, equity and debt restructuring facilities, and corporate restructuring facilities. Important in determining whether a European statute contributes to convergence or divergence is the fact that, in some EU countries, national corporate law has been instrumentally adjusted along the lines of the SE provisions. In

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5. Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJ L 310, 25.11.2005, p. 1.

particular, in some countries an option has been provided with regard to company structure at national level or rules on private firms have been eased in order to increase regime competition among Member States. The decision taken by companies to opt for the SE statute seems to have depended to a considerable extent on their assessment of the pros and cons of national regimes and the SE statute, and on ‘regime shopping’ in relation to tax optimisation and other financial arguments.

Although the Ernst & Young report was an effort to question the role of workers involvement through the backdoor, the fundamental debate on worker participation – achieved by a ‘historic compromise’ – was not reopened directly in 2010. In July 2011, the European Commission consulted the European social partners on the basis of the document *First phase consultation of Social Partners under Article 154 TFEU on the possible review of Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees*. The document identified three problematic areas concerning the rules on employee involvement contained in the SE Directive. The social partners replied in October 2011. BUSINESSEUROPE recommended the Commission to give priority to simplifying the SE Regulation, whilst the ETUC asked for a continuation of the dialogue on improving the SE rules (both the Directive and the Regulation).

All in all, this formed the background for the survey of the interaction between EU and national company law provisions. But before we come to the results of our country-based inquiry it is appropriate to have a closer look at several aspects of the present day corporate agenda in Europe.

#### **4. The Better Regulation agenda**

The EU’s Better Regulation strategy has several components. The first is the design and application of Better Regulation tools at EU level, notably the simplification of existing rules, including the reduction of administrative burdens and impact assessment. The second is a more consistent application of rules and principles throughout the EU by all regulators. The final component is the reinforcing of constructive dialogue between stakeholders and regulators at the EU and national levels.<sup>6</sup>

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6. See: [http://ec.europa.eu/governance/better\\_regulation/brochure\\_en.htm](http://ec.europa.eu/governance/better_regulation/brochure_en.htm)

In addition to evaluation, the use of ‘fitness checks’ has been introduced. The European Commission is merging its efforts to reduce the administrative burden with those to simplify legislation and has decided to resort more to stakeholder consultations and impact assessments as essential parts of the policymaking process. The Commission first drew up a ‘simplification rolling programme’, beginning with 100 simplification initiatives for 2005–2008. Since 2007, the simplification programme has been integrated into the Commission’s legislative and work programme.

In the Commission work programmes of recent years some initiatives related to company law issues are explicitly mentioned. One of these was the simplification of the Accounting Directives with the objective of allowing Member States to exempt micro-entities from accounting requirements and of reviewing the Accounting Directives (Fourth and Seventh Company Law Directives) to take account of the interests of small businesses. Another was the Directives on reporting and documentation requirements in the case of mergers and divisions. The proposals to reduce the translation and publication requirements of companies also fit in this scheme. The Commission has even justified the proposal for a Council Regulation on a European private company statute (SPE) by reference to the simplification agenda (European Commission 2009: 6). In contrast to harmonisation projects, the SPE proposal leaves national law largely untouched. The goal is to provide SMEs with an alternative form that would exist in parallel to national company forms. As part of a package of measures designed to assist SMEs, referred to as the Small Business Act for Europe (SBA), the Commission proposals also aim at reducing compliance costs for the creation and operation of businesses arising from the disparities between national rules both on the formation and on the operation of companies.

At the same time, the Better Regulation principles have been used unsuccessfully by some Member States as arguments against new European legislation, particularly in relation to the EU proposal for the SPE. The German Bundesrat (one of the German Parliamentary chambers) expressed doubts, for instance, about the respect for subsidiarity and whether the proposed harmonisation would achieve the objectives envisaged. The Dutch Parliament asked for a clear justification of the legal basis. They wished to avoid a situation in which national rules prohibiting abuses could be bypassed by European rules. Furthermore, they questioned the purported added value and the Commission’s forecast for the effective use of the European private company (SPE). In its answer,

the Commission pointed out that including a cross-border requirement as a condition for setting up a European Private Company would be inconsistent with the objective of the proposal, that is, to complete and improve the functioning of the Single Market and to make it more accessible for SMEs.

The question raised in the SEEurope survey was whether there were any signs at national level of an ongoing simplification process along the lines of the EU strategy. At national level we found several initiatives that do not necessarily adhere to the EU agenda, but which nevertheless can be seen as efforts to simplify the ‘business environment’.

National company law has been reassessed in the following areas:

- increasing exemptions for SMEs, for instance in the area of auditing standards, information and disclosure;
- flexible size of boards;
- the introduction of ‘alternative’ forms of annual meetings (teleconferences, digital or other online form of communication);
- the introduction of single information points (‘one-stop shops’);
- watering down of registration conditions and lowering of establishment thresholds, for instance capital requirements (this will be treated further in section 6).

It is fairly obvious that several of these simplification measures conflict with the pursuit of transparent and effective regulation. Some administrative obligations are not only useful, but can also be indispensable to monitor legality; or they serve other purposes than directly benefiting business. Relaxation of the registration requirements reduces the volume of information disclosed and opens the door to bogus practices and the misuse of legal persons and companies. Transparency is not improved by exemptions from (or by watering down) auditing standards.

Almost all observers stress that legislative developments in the EU have had a strong influence on national debates. It is important to note, however, that the range of impacts is fairly wide.

Company law in the ‘old’ Member States often goes back to the early stages of capitalism, with a subsequent history of constant modification and transnational interaction. EU developments were inspired by national changes and the founding fathers of the European Community

were, of course, 'biased' by the national models they knew or wanted to 'defend'. In that respect, we can observe mutual interaction and input. In this regard, the UK is a special case. The expectation there is that EU company rules should assist in freeing up the market in other Member States, which should encourage and make more transparent cross-border activity. Other Member States have reacted to this development, and as a result some national rules and traditions have come under fire.

The implementation of EU legislation has brought in new elements, which previously did not figure on national agendas. The introduction of a free choice between a single-tier or dual-tier system of corporate governance, for example, has clearly been introduced in many countries as a result of EU debates and deliberations. It is highly questionable whether this free choice, which was 'alien' to several jurisdictions, would have been introduced so quickly without the SE legislation.

The 'new' Member States all had to implement the *acquis communautaire* (often from scratch) and therefore had less influence on the model developed.<sup>7</sup> Candidate countries had to deal with chapter 5 (now chapter 6) of the screening guide of the *acquis* dedicated to company law. The company law *acquis* includes rules on the formation, registration, merger and division of companies. In the area of financial reporting, the *acquis* specifies rules for the presentation of annual and consolidated accounts, including simplified rules for small and medium-sized enterprises. The application of International Accounting Standards is mandatory for some public interest entities. In addition, the *acquis* specifies rules on the approval, professional integrity and independence of statutory audits (European Commission 2005).

## 5. Changes in national company law

The SEEurope experts reported on major changes in company law in their country over the past decade. The basic legal models provided for public and private companies were very similar in most countries. This partially stems from the 'one size fits all' nature of the rules. As a result, the statutory framework has historically applied to one-person private

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7. An overview of the chapters of the *acquis* is provided in How does a country join the EU? <http://ec.europa.eu/enlargement>

companies as well as to large public companies. Public debates on company law reform and corporate governance codes have often focused on the governance problems of large publicly-held firms, and policymakers' recommendations traditionally pinpointed such firms. These reforms assumed that corporate structures and director-specific provisions matter. Listing rules developed for stock exchanges were often given statutory authority, requiring that publicly-listed companies disclose compliance with a corporate governance code or explain in what instances they had not applied the code (referred to as 'comply or explain'). Private companies were encouraged to conform, but there was no requirement for disclosure of compliance.

However, most small firms and, in several countries, even many large companies are not listed. Non-listed companies, whether family-owned firms, group-owned firms, private equity and hedge funds, joint ventures and unlisted mass-privatised corporations and SMEs have particular problems. Innovations and changes in approaches to regulatory governance in non-listed companies will probably focus more on the protection of investors and creditors from managerial opportunism. In these circumstances, an effective legal governance framework must offer different mechanisms. The result, therefore, is legal pluralism involving a mixture of hard law and voluntary social norms.

The history of national and European company law-making and regulation has been marked in recent years by a growing diversity of interests and concerns. As a consequence, a hybrid and partially contradictory package of company rules has been developed. In general terms, as was expressed in several SEEurope contributions, the national changes range from the introduction of regulations necessary for disclosure and monitoring to deregulation in order to improve the 'business environment'. A plea for the strengthening of auditing principles and disclosure (after the financial crisis) can go together with the creation of substantial exemption mechanisms for SMEs. Adequate registration is crucial for transparency and for monitoring and enforcement of existing rules or the fight against 'letterbox companies', but – according to employers' – may obstruct or hinder the smooth functioning of business. Lowering the threshold of capital requirements is seen as a stimulus for innovative entrepreneurs, but at the same time creates possibilities for the establishment of sham businesses. Since the early 2000s, the mainstream thinking in this area seems to be that the objective of combating fraud and abuse of companies as accepted legal forms should be achieved through

specific law enforcement instruments outside company law, and should not be allowed to hinder the development and use of efficient company law structures and systems (High Level Group 2002b). The financial crisis has not (yet) changed this unfortunate starting point.

Based on the country reports, a few crucial items of concern that have been discussed over the past decade are identified:

**(a) Balance of power and interaction between primary stakeholders**

In general terms, the balance of power and interaction in the triangle of labour, capital and management has been modified in recent years in favour of shareholders (in listed companies). The position of shareholders has been strengthened (for instance, in the Netherlands by the right to appoint and dismiss the supervisory board or the right of approval of strategic board decisions) and there has been more attention to the protection of minority shareholders. In some countries, the position of the supervisory board members has been modified (for instance, in Austria: more rights and more duties) or strengthened (in Germany with a law that strengthens the role of the supervisory board in giving advice and supervision). In several countries the legal position and responsibilities of directors have been reformulated with management being portrayed as having a primary duty to protect shareholder value. This is fully in line with the position formulated in 2002 by the High Level Group of Company Law Experts: ‘Good corporate governance requires a strong and balanced board as a monitoring body for the executive management of the company. Executive managers manage the company ultimately on behalf of the shareholders’ (High Level Group 2002b: 59). Corporate governance and shareholders’ rights are about controlling the directors as the agents of the shareholders or, if control comes too late, about holding the directors accountable. The position of worker representatives has not been an item apart from – very recently – in Poland and the Czech Republic, where a weakening of workers’ involvement has been announced.

**(b) Transparency and disclosure**

Better information for shareholders and creditors, in particular better disclosure of corporate governance structures and practices (such as remuneration of board members) were already mentioned in the reports of the High Level Group, inspired by the existing US regulatory response to scandals such as Enron. The group admitted that ‘remuneration through grants of shares and rights to acquire shares does not take away fully the conflict of interests of executive directors and has some

negative side effects' (High Level Group 2002b: 68). As the share price is related to the reported financial performance of the company, the executive directors, who are also primarily responsible for accounting for the company's performance, have an incentive to produce financial accounts which overstate the performance of the company. Nevertheless, the recommendation was formulated that there was no need for a prohibition of remuneration in shares and share options, but that appropriate rules should be in place in terms of disclosure and of prior approval at the shareholders' meeting. The issue of a fair remuneration policy as such was not on the legislative agenda. This is in line with the policy of the European Commission. As yet the ambition has been to issue only a *recommendation* fostering an appropriate regime for directors' remuneration.

In the SE inquiry it was found that, in some western European countries, and especially those that were hit hard by the financial crisis, stronger rules on information and on transparency with regard to remuneration are being discussed, including legislation to require provision of information on company loans to directors. But in most cases this has not gone much further than the consideration of a requirement for a mandatory or advisory vote by shareholders on the remuneration policy. As a result of the crisis, a heightened general debate on the limitation of remuneration practices (in both the private and the public sector) has been initiated. Our impression is that, although this gives rise to a lot of public noise and media hype, in practice, there is little substantive legislation that systematically promotes a long-term perspective.

In Central and Eastern Europe (CEE) the debate seems to be completely lacking. The legislative process in those countries over the past ten years has been dominated by the implementation of the *acquis communautaire*. Moreover, most CEE countries are not (yet) a location for important financial institutions or other global players.

With regard to transparency and disclosure the country reports suggest that initiatives in the social field are mainly based on non-binding rules.

### **(c) Corporate governance issues**

Corporate governance issues have been on the agenda since the late 1990s. However, the most prominent voices from the business community keep stressing its voluntary character and their desire to remain with self-regulation. They generally argue that a European corporate governance code would not offer significant added value but would

simply add an additional layer between international principles and national codes. Furthermore, the European Commission has always emphasised that the key input for codes on corporate governance should come from the market and market participants. These codes are a means of building up reputation through voluntary compliance with rules of good behaviour. On this view, the EU can seek to coordinate the efforts of Member States to improve corporate governance through changes in their company laws, securities law (such as listing rules) or in their codes of corporate governance in order to facilitate the convergence of the corporate governance efforts of Member States. So far, the European Commission has complied with this wish with a soft law policy including non-binding recommendations. As a consequence, the only widespread forms of 'regulation' are voluntary corporate governance codes in their different national forms.

#### **(d) Diversity**

The main publications in the 2000s on modernising the EU regulatory framework for company law made no reference to the profile of the board's composition from the gender perspective. Annual corporate governance statements only had to state why individual non-executive or supervisory directors were qualified to serve on the board. Until recently, the stimulus and initiative came from outside the EU.<sup>8</sup>

The issue of putting more women on the boards of public limited companies has been picked up most prominently in Norway. A law concerning state-owned and municipal companies entered into force in January 2004, with a two-year transitional period. It was expected that public limited companies would follow suit voluntarily, with the legal provision setting a norm which was not legally binding. But as public limited companies did not act in 2004 and 2005, the government decided to move to full enforcement and Norway imposed a quota in 2006. By the end of 2010 all companies included at least one woman on their board, while 83 per cent had more than three women. Spain, which introduced quotas in 2008, increased the number of women on boards by 67 per cent.<sup>9</sup>

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8. The European Parliament called on the European Commission in a resolution adopted in spring 2011 to submit a plan to bring about phased increases in gender diversity with the aim of achieving at least 40 per cent representation for each gender on the boards of directors of financial institutions (within a reasonable period).

9. See: <http://www.ft.com/cms/s/0/525d2ee4-cfff-11df-bb9e-00144feab49a.html#ixzz1HAQn3cGh>

Some European countries – such as Germany and Belgium – are considering the regulation of diversity if companies do not change voluntarily. This debate has not (yet) affected workers' participation at board level. However, in Norway the rules also apply to the board and, importantly, worker representatives and shareholder representatives are counted as two different groups. Thus, female worker representatives may not compensate for a lack of female shareholder representatives and vice versa.

## 6. Attractiveness and competitiveness

Since the early 1990s, European countries have sought to attract and keep companies by lowering corporate tax rates. This downward trend has resulted in substantially lower tax levels. According to the OECD Tax Database and the World Tax Database, the average rates in the 'old' EU Member States fell from around 42 per cent in 1980 to 28 per cent in 2009. Corporate tax in the CEE countries ended even lower, at just 19 per cent in 2009.<sup>10</sup> As a result, countries are constantly seeking to underbid one another.

The question has to be raised whether a similar process has already taken place in the field of company law. Although there are indications that the entrance of foreign company forms at the national level is increasing in countries such as Germany, partly stimulated by recent ECJ rulings on freedom of establishment, there is not sufficient evidence to conclude that this is a growing trend. In some countries, the search for more attractive and competitive national legal forms is motivated by a desire to find a response to the limited company form (Ltd) provided for in UK law. The Ltd has no capital requirements and can be operated in any Member State. Some Member States take the view that it is important to create more competitive legal forms to prevent the widespread use of this UK legal form. The Reflection Group on the European Company Law assumes that this is the dominant development as many Member States appear to be in favour of increased flexibility by introducing options from other jurisdictions to supplement those already known (2011: 12). Other Member States have taken measures to anticipate the possible loss of companies having a national legal form as a consequence of the

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10. See: [www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase) and [www.bus.umich.edu/otpr/otpr/default.asp](http://www.bus.umich.edu/otpr/otpr/default.asp)

upcoming SPE Regulation. All in all there is reason to expect that company law will be subject to even more diversity in the future with more options and flexibility within the Member States.

Two major developments in terms of company establishment are visible in almost all countries: the lowering of capital requirements and the simplification of the registration procedure.

### **(a) Lowering of capital requirements**

In several Member States, capital requirements for the establishment of companies have been lowered. Reasons often cited in support such changes are the entrance of UK limited companies (not subject to any minimum capital requirements) and the need to increase the attractiveness of national legal forms. A further justification can be found in official statements by the European Commission and their main advisors, although the advice issued was neither consistent nor uniform. In the 2002 consultative document the High Level Group of Company Law Experts came up with possible justifications: ‘The only real function the current minimum capital requirement appears to have is to deter individuals to light-heartedly start up a company. They will have to furnish a minimum capital before they can start. The question is if this is sufficient reason to continue to require a minimum capital. If not, the alternatives are to either abolish the minimum capital requirement or to raise the minimum capital considerably’ (High Level Group 2002a: 25). According to the High Level Group, many states are successful in ensuring protection for the general interests concerned by less intrusive external means. But, in its final report, the Group had to admit, ‘we are not convinced that minimum capital, at its present levels, performs any other useful functions, but there is no evidence that it constitutes a hurdle to business activity either. It is probably wise not to spend much time on minimum capital in a reform to make the current system more efficient, and to direct attention to issues which are more relevant’ (High Level Group 2002b: 82). In the Ernst & Young assessment of the SE, the conclusion was drawn that its minimum capital requirement of 120 000 euro ‘turned out not to be a deterrent for small and medium enterprises’ given that a large number of the SEs already established are small to medium-sized companies (Ernst & Young 2009: 240).

### **(b) Easier registration**

In addition to changes to capital requirements, simplification of the registration procedure is considered a popular measure to create a more

attractive national legal form for incorporation. Most changes are introduced with particular reference to SMEs and contain measures to simplify registration systems and license applications, restrict the number of regulations and reduce the number of rules with regard to supervisory boards, etc. The fast track actions formulated by the European Commission to ease disclosure, registration and translation requirements are explicitly mentioned as key parts of the Action Programme on reducing administrative burdens in the European Union (European Commission 2008). The EU's reasoning in this area, as expressed in several Better Regulation documents, is simple and it seems that many countries follow the same reasoning. Namely, it is said that companies will benefit from reduced procedural requirements, as well as simplified and harmonised rules for accreditation, verification and registration. In addition, SMEs will benefit from reduced verification and reporting obligations and lower registration fees. As it is obvious, however, that most SMEs are national entities anchored in a particular locality or region, often pursuing activities that have no global dimension, intra-EU competition is not put forward as an argument in the relevant documents.

The lowering of requirements in order to boost one's position in the competitive rivalry between countries can be called into question. Lessons can be learned, for example, from the beggar-thy-neighbour tax competition mentioned above. The policy of reducing corporate tax has seriously impaired the ability of governments to respond effectively to the crisis, and to regulate their economies in a sustainable manner. Tax competition between countries that provides a possibility to relocate a company's headquarters to low-tax jurisdictions can easily lead to a race to the bottom, resulting in serious erosion all over Europe. Minimising costs to businesses on the basis of an alleged 'administrative burden' that takes no account of benefits to other stakeholders or the qualitative dimension of fundamental rights and provisions risks upsetting the traditional balance in European welfare states. Less regulation, therefore, is not necessarily better regulation.

In this intra-EU competition a crucial role is played by the ECJ's rulings on freedom of establishment. According to the ECJ, it constitutes a restriction on the freedom of establishment when a Member State (the 'host' State) refuses to recognise the legality of a company formed in accordance with the law of another Member State in which it has its registered office on the ground that the company has moved its centre of administration to the host State and when the effect of this refusal of

recognition is that the foreign company cannot bring legal proceedings to defend its rights under a contract in the host State unless it is reincorporated under the law of that State. The ECJ has ruled that the freedom of establishment requires the recognition of foreign companies established in accordance with the law of another Member State. It is not the purpose of this chapter to go into the details of these disputes, but it is obvious that the potential impact of these rulings on national principles governing worker participation is substantial. In Germany, in particular, the consequences of these rulings for board-level participation rules are hot topics of debate and a whole range of positions has been formulated assessing whether it is permissible for Member States to introduce protective national provisions. The full consequences remain to be clarified. Following the ECJ judgments in *Centros*,<sup>11</sup> *Überseering*<sup>12</sup> and *Inspire Art*,<sup>13</sup> a debate has started on whether a Delaware-like scenario could develop in the EU.

The US state of Delaware is trying to attract (re)incorporations with advantageous corporate legislation. If more US states introduce such measures a race to the bottom might commence. The fear is that the ECJ case-law will lead to an equivalent of the Delaware scenario in the EU. The initial steps taken in this regulatory competition between Member States are already visible. In order to attract companies from other European countries, the ultimate goal is to become the country with the most corporate benefits.

## 7. Concluding remarks

The development of the corporate regulatory framework and the related directives in the EU has often been divided in corporate law theory into ‘generations’ (Villiers 1998). In that scheme, the first generation is characterised by uniformity and prescription, the second generation by the optional choice of already existing national forms and practices, the third generation by increased flexibility and the fourth generation provides only a very general framework in a context of complete decentralisation. The first generation (which prevailed until the late 1970s) was still dominated by a policy in favour of a cooperative equilibrium and

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11. Case C-212/97 *Centros* [1999] ECR I 1459.

12. Case C-208/00 *Überseering* [2002] ECR I-9919.

13. Case C-167/01 *Inspire Art* [2003] ECR I 10155.

opposed to a race to the bottom. The next generations tried to provide business with more incentives by introducing greater flexibility and a range of options. This resulted, for example in the case of the SE following disagreements among the Member States, not in the introduction of a business form that provided a complete set of uniform rules without reference to national law, but to a significantly more flexible approach in relation to national law. In practice, it must be concluded, however, that, in the absence of uniform rules, a European business form does not bring real benefit in comparison to national business forms.

Without going into the details of this theory, it should be noted that the analysis is not complete as it focuses too heavily on legal norms. In this chapter the ‘political economy’ aspect of the corporate debate has been highlighted. After the demise of the harmonisation era, the corporate law debate has been dominated by the question whether the relevant policy proposed can deliver a sufficiently attractive tool for larger firms to engage in forum shopping activities. As a result, regulatory competition or legal pluralism steered by competition has come to the forefront and company law-making has become a factor in competition. The only convergence that can be registered is the deregulation and cutting back of requirements. There is a market for lawmaking at national and at EU level.

One question we still have to deal with concerns whether the risk of regime-shopping is serious. Or is this merely an (unintended) side effect of the legislative process that aims to infuse more flexibility into the laws of the Member States relating to company law? Scholars so far have mainly expressed doubts about a European Delaware in the field of company law: ‘Since its inception, the cooperative equilibrium has remained stable and largely intact, as a result of learning and adaptive changes made by the Member States and the European Commission. But, as demonstrated in the USA, the breakdown of a highly stable equilibrium could occur rapidly.’ (McCahery & Vermeulen 2005). The stability of the equilibrium depends crucially on the continued ability of Member States to protect their present legal system against possible competitive pressures from other Member States.

But, in this regard, the European Commission cannot be said to be of much help. To a certain extent, the SE rules, for instance, aimed to limit the right of establishment of pseudo-foreign companies and to create barriers to the introduction of competition concerning corporate form.

But nowadays, the Czech Republic is leading the way in SE formation, with more SEs on its commercial register than any other EU country and businessmen familiar with the law on the sale of shelf companies have not hesitated to provide interested buyers with such ready-made SEs. The question, of course, should not be what the main advantages are for a company to buy a shelf SE, but rather what the Commission intends to do to combat this violation of the spirit of the SE legislation. The Commission's reasoning, confronted with criticism on the production of shelf SEs – that is, SEs with no activities or employees, usually set up by specialist company providers for the purpose of selling them on to interested buyers – is very simple: the creation of shelf SEs by specialist providers in certain countries can be explained by the fact that making shelf companies available for sale is common there. Moreover, according to European Commission services, it is perfectly legal to create empty national limited companies.

A well-governed company should be accountable and transparent to its employees, its shareholders and other stakeholders. If competitiveness and attractiveness become the key messages of the agenda for national and European company lawmaking, it risks promoting a beggar-thy-neighbour policy in the Member States. It will guide Member States towards reforms of their national legislation which promote rent-seeking at other countries' expense. Domestic company law reform could then easily lead to a patchy process of transnational legal pluralism. The outcome is predictable: less specific protection of various stakeholders (minority shareholders, creditors and so on), dilution of workers' participation, fewer requirements with regard to registration, no capital requirements and increased exemptions from the legislation in force. The EU Better Regulation policy may not have been intended as – and certainly must not be allowed to become – an instrument for putting national regulations in competition with each other. However, key areas for possible reform and simplification must be tackled without jeopardising essential guarantees for transparency.

In this whole process the policy with regard to the involvement of the workforce is key. Reports that look at employee participation in the neutral sense of being part of public policy provisions or analysis that labels workers' rights as burdensome and presses for administrative cost reductions to enable companies to achieve the same production level with reduced manpower are of little help. Also the vision of the Reflection Group, namely, that the appropriate attitude for the EU legislature is not

to ask Member States which have not considered such a system or have deliberately decided against it to introduce it, fits in this type of reasoning (Reflection Group 2011: 53). First, these positions fail to acknowledge that participation rights are fundamental rights, enshrined in the various Treaties. Second, they are often already biased in their wording: which stakeholder's perspective is used to calculate social costs? Have the costs for workers of short-termism ever been calculated? Why does workers' involvement always have to be defended whilst the dictate of the market is taken for granted? Third, the narrow focus on labour costs of several studies in this area does not give justice to other costs that are seen as 'normal' in an organisation. For instance, what about the use of legal advisors or external business consultants (or are these just supplying services)? And, finally, the argument that the introduction of workers' involvement imposes 'a particular element of the national company law of some Member States on other Member States, where it is alien to the domestic law' is a non-argument (Reflection Group 2011). A whole range of legal obligations and internal rules can be labelled alien to particular national jurisdictions, for instance the one-tier board that previously only existed in certain Member States, but these became an integral part of the SE rules.

The paradigm shift in the corporate law debate identified here is the expression of a fundamental political change in the modelling of Europe that occurred gradually after the first enlargements (with the UK, Ireland and Denmark). In the European Community of twelve Member States, the cooperative equilibrium in the area of corporate law was still sufficiently stable to neutralise the diversity of legal regimes and, at the same time, to guarantee respect for each other's lawmaking autonomy. But the euphoric march of neo-liberalism following the fall of the Berlin Wall and the enlargement to a community of 27 Member States paved the way for this change. The European Union is no longer a community of Member States whose *acquis communautaire* includes corporate law mechanisms as the constitutional framework for an economic development based on cooperation and solidarity ('one for all, all for one'). The EU is nowadays first and foremost an internal market founded on competition, also between the Member States. Company law no longer functions as a Europe-wide principle for a decent level playing field and contrary to a race to the bottom. It is left to the Member States to use it as a safeguard or to see it as a factor in the competitive race, subject to market forces ('every man for himself and the market for us all'). From the epistemological perspective the corporate law community served, not initiated.

The paradigm change in corporate law-making that led to the introduction of competitive legal pluralism marks the advancement of neo-liberalism in the corporate law community. A corporate legal framework that is left to the market, or putting it somewhat differently, is subordinated to the market as simply one of the pliable factors in competition is everything but a precondition for stable and sustainable growth and investment. National and European legislators need to identify their own responsibilities. The crisis has demonstrated the limits of this type of corporate governance practice and has forced a rethink with regard to the finality of this form of governance in the context of corporate social responsibility. The question of whose interests a business corporation is intended to serve should be at the heart of EU policy in this area. Otherwise, it will be time to analyse the burdensome effects of capital. Cost-effective and efficient competition cannot do without fairness and social justice. Corporate regulation must constitute a building block of a socio-economic policy that favours decent and sustainable long-term investment, based on reliable and genuine establishments with strong involvement of key stakeholders.

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# Chapter 5

## The protection of workers under EU company law – the current position and future prospects

Johannes Heuschmid

### 1. Introduction\*

In light of the European Commission's recent Action Plan on European company law and corporate governance,<sup>1</sup> this chapter examines how European company law could be improved as a matter of good corporate governance to increase the recognition given to worker interests. The basic presumption underlying the following analysis is that company law should be structured to reflect a plurality of interests (also known as the 'stakeholder approach'). According to this approach, a company's management should manage in the interests of the company and, in that regard, take account not only of shareholder concerns but also of the concerns of workers and other groups involved with the company. A starting point of this kind can be found in many European legal orders.<sup>2</sup> The counterpart to the stakeholder approach is the 'shareholder value approach',<sup>3</sup> which requires management to be guided simply according to the interests of shareholders.<sup>4</sup> Under that approach, its primary obligation is to maximise shareholder welfare whether in the form of dividends, share price improvements or liquidation proceeds. This model is to be found chiefly in countries with a common law tradition, in particular, the United States and the United Kingdom.<sup>5</sup>

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\* Chapter 5 was translated from German by Paul Skidmore.

1. Action Plan on European company law and corporate governance, published on 12 December 2012, see: [http://ec.europa.eu/internal\\_market/company/modern/index\\_en.htm](http://ec.europa.eu/internal_market/company/modern/index_en.htm).

2. See below.

3. Within this approach, various supposed variations such as the 'enlightened shareholder value approach' are mentioned. See Grundmann, S. (2011), § 13, paragraph 461.

4. For a critique of this approach, see Vitols, S. (2011), p. 18.

5. Hopt, K. (2011), p. 476.

In the context of the corporate governance debate, the Commission's activities in the area of company law – prior to the financial crisis – adopted primarily the shareholder value approach. In other words, they focused on the interests of shareholders and the financial markets.<sup>6</sup> Since the financial crisis, a cautious change in thinking can be observed. In contrast to the Commission, the European Parliament has long favoured the stakeholder approach. For example, in a resolution adopted in 2006, it stressed that 'corporate governance is not only about the relationship between shareholders and management, but that other stakeholders within the company are also important for a balanced decision-making process and should be able to contribute to decisions on the strategy of companies'.<sup>7</sup> Notwithstanding the general approach taken by the Commission, support for the stakeholder principle is to be found also in some of its documents.<sup>8</sup>

There can no longer be any doubt that, in the context of the pluralist model, employees as a group occupy a special position amongst the stakeholders.<sup>9</sup> This view appears to be shared by the European Parliament which notes in the recitals to the abovementioned resolution that employee participation at the level of undertakings should be seen as forming an integral part of European corporate governance.<sup>10</sup> This is a reference to the rules on worker participation in company decision-making, that is, board-level employee representation.<sup>11</sup> Those rules allow workers to influence the composition of a company's most senior organs responsible for its management and/or the supervision thereof.<sup>12</sup> If the interests of workers are to be given effective and timely consideration, this should take place in the organ where the fundamental decisions are made.<sup>13</sup>

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6. Heuschmid, J. (2009), p. 262.

7. European Parliament resolution on recent developments and prospects in relation to company law of 4 July 2006 (P6\_TA(2006)0295), paragraph 14. See also W. Koberski, and J. Heuschmid (2010), p. 210.

8. Commission Communication on Preventing and Combating Corporate and Financial Malpractice COM(2004) 611 final, p. 4, and Commission staff working document SEC(2007) 1707, p. 28.

9. For a justification of this position, see Parkinson, J. (2003), pp. 481-509, at p. 491 et seq.; Johnston, A. in this book; Wißmann, H. (2009) § 282, paragraph 15; and Hopt (2011), p. 505.

10. European Parliament resolution, cited above, recital F. See Kleinsorge, G. (2011) in O. Wlotzke, H. Wißmann, W. Koberski, and G. Kleinsorge (eds) *Mitbestimmungsrecht, EU-Recht*, paragraph 1.

11. An EU law definition of this concept can be found in Article 2(k) of Directive 2001/86/EC (SE Directive).

12. Wißmann, H. (2011), *Vorbem.* paragraph 1.

13. Heuschmid (2009), p. 110.

Board-level worker participation has several positive effects. First, participation of this kind can encourage the taking of decisions which are focused on the long-term prospects of the company and, consequently, also on the retention of jobs. At the same time, this reduces the influence on company administration exercised by shareholders, whose perspective more often than not focuses on the short-term.<sup>14</sup> A further positive aspect is the fact that board-level worker participation tends to inhibit takeovers.<sup>15</sup> This is to be welcomed as takeovers generally involve adverse negative consequences for workers but do not necessarily facilitate a sustainable future for the company.<sup>16</sup>

This introductory section has established as a basic presumption that European company law should be structured to reflect a plurality of interests. Further, the proposition was advanced that, in the framework of that pluralist model, employees occupy a special position. The remainder of this chapter will examine how these objectives can be implemented in European company law. However, before making any specific proposals for reform, the existing EU legal framework for board-level worker participation will be outlined.

## 2. The current legal framework

Rules governing board-level worker participation are to be found in EU legislation establishing specific European corporate forms. In addition, rules of that kind are also included in certain company law directives on cross-border corporate reorganisation.

### 2.1 European corporate forms and board-level worker participation

As the law currently stands, provisions on board-level worker participation are to be found in the legislation governing the European company (*Societas Europaea* (SE)) and the European cooperative society (SCE). In the future, legislation on the European private company (SPE), on the

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14. Hopt (2011), p. 504.

15. *Ibid.*, p. 506.

16. On the negative consequences of the Takeover Directive, see Sjäffell, B. (2009), p. 343 et seq.

European foundation (FE) and on the European mutual society (ME) may be added to this list.

### **The European company (SE)**

Adoption of the Statute for a European company in 2001 heralded the introduction to EU secondary law of the first provisions on board-level worker participation.<sup>17</sup> That outcome was the result of some 30 years or more of negotiations, necessary in part to resolve the issue of board-level worker participation.<sup>18</sup> Therefore, in this context, it is legitimate to regard the SE as a breakthrough. The SE is based on two legal instruments, first, the SE Regulation<sup>19</sup> establishing the company law framework and, second, the SE Directive<sup>20</sup> with regard to the involvement of employees. As a consequence, the SE Regulation governs the following matters: foundation, company organs, structure, and transfer of the registered office. The SE Statute allows for a choice between a one-tier and two-tier system of governance. In addition to the general meeting of shareholders, the organs of the SE are, in the two-tier system, a supervisory organ and a management organ and, in the one-tier system, an administrative organ. Establishment of an SE is permitted only where there is a cross-border element.<sup>21</sup>

The SE Directive governs the involvement of employees both at plant level and in company organs. Unlike the legislation on board-level worker participation in several Member States,<sup>22</sup> the SE Directive does not establish any standards of its own concerning the number or proportion of employee representatives to be included within the structures for employee involvement or the thresholds necessary to trigger that involvement. Instead, the SE Directive restricts itself to the establishment of a negotiating procedure<sup>23</sup> which is intended to facilitate the negotiation of arrangements for the involvement of employees in the SE. The aim of the negotiating procedure is for company management and employee representatives to reach an agreement on the arrangements for the

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17. Kleinsorge (2011), EU-Recht, paragraph 4.

18. Ibid.

19. Regulation (EC) No 2157/2001, OJ L 294, 10.11.2001, p. 1.

20. Directive 2001/86/EC, OJ L 294, 10.11.2001, p. 22.

21. Kleinsorge (2011), EU-Recht, paragraph 8.

22. For an overview, see Conchon, A. (2011), pp. 12-13.

23. For a detailed account, see Kleinsorge (2011), EU-Recht, paragraph 13 et seq.

involvement of employees at various levels within the SE. Although, in principle, the parties are free to determine the agreement's substance, if this entails a reduction in participation rights, a special (qualified) majority is required. The underlying aim is known as the 'before and after principle'. This is intended to ensure that the formation of an SE does not result in a loss of existing employee participation rights. The management of the relevant company or companies must institute the negotiating procedure in accordance with the SE Directive as soon as the establishment of an SE is planned.

If negotiations fail, the SE Directive establishes standard rules to apply in default governing not only plant-level worker participation but also board-level worker participation. In accordance with the before and after principle, the standard rules are intended to ensure that existing rights to worker participation in the companies establishing the SE are maintained in the new SE. In relation to board-level worker participation, taking account of the number of workers in the SE covered by worker participation rights prior to its establishment, the most favourable set of rights is to apply.<sup>24</sup>

Although, initially, commentators were sceptical as to the prospects for the SE,<sup>25</sup> this legal form has become increasingly popular. In December 2011, the number of registered SEs recorded in the European Trade Union Institute's database exceeded the 1000 companies mark for the first time.<sup>26</sup> However, these include numerous 'shelf' SEs whose legal validity is not uncontested.<sup>27</sup>

The motives for establishing an SE are extremely diverse. These may include the internationalisation of the supervisory or administrative board or the establishment of a European corporate identity.<sup>28</sup> At the same time, establishment of an SE is often used in order to avoid board-level worker representation.<sup>29</sup> For example, it has been observed in Germany that companies established under national law approaching the relevant

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24. Ibid., paragraph 17.

25. Ibid., paragraph 59, with further references.

26. For further information, see <http://ecdb.worker-participation.eu/news.php> [accessed 26 February 2012].

27. Stollt, M. and N. Kluge (2011), p. 185; Eidenmüller, H. and J. Lasák (2011).

28. Eidenmüller and Lasák (2011), and Kleinsorge (2011), EU-Recht, paragraph 60.

29. Conchon (2011), p. 35 et seq.

thresholds for board-level worker representation (500 or 2000 employees) convert to SEs in order to avoid the introduction of board-level worker representation or its widening from one third of the members of the supervisory board to parity. In addition, establishment of an SE permits a company to reduce the size of its management organ which can also result in a loss of seats for worker representatives. Reports from practitioners indicate that this strategy is used particularly to remove trade union representatives from company organs.<sup>30</sup> Measures of that kind are possible because of gaps left by the existing legal framework for the SE. For example, the before and after principle embedded in the current SE acquis applies only in relation to the initial establishment of the SE. For structural measures carried out at a later stage, and which may considerably increase the workforce size, no rules have been established. The same problem arises on the activation of a shelf SE.<sup>31</sup> One can legitimately question whether this practice is compatible with the aims of the SE Directive. According to recital 18 in the preamble, the before and after principle 'should apply not only to the initial establishment of an SE but also to structural changes in an existing SE and to the companies affected by structural change processes'. Consequently, it comes as no surprise that there have been calls to revise the SE rules to ensure that structural changes following the establishment of an SE result in a renegotiation of the arrangements for employee involvement.<sup>32</sup> The existing deficits have led to considerable reservations amongst German trade unions in relation to the SE. For example, in the context of the recent takeover by the Spanish investor ACS of the German construction company Hochtief AG, the trade union IG BAU concluded an investor agreement with ACS which expressly excludes the conversion of Hochtief AG to an SE.<sup>33</sup>

### **The European cooperative society (SCE)**

On the coattails of the agreement on the SE, the European legislative bodies reached an agreement in 2003 on the legal framework for the European cooperative society. The legal framework is structured in a similar manner to the SE. The Statute for the European cooperative society

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30. Keller, B. and F. Werner (2009), pp. 416-424.

31. COM (2008) 591 final, p. 8; Eidenmüller and Lasak (2011).

32. COM (2008) 591 final, pp. 7-8.; Kleinsorge (2011), EU-Recht, paragraph 65.

33. For more on this, see the chapter in this book by W. Däubler.

is laid down in a Regulation,<sup>34</sup> supplemented by a Directive<sup>35</sup> with regard to the involvement of employees. However, the practical significance of this legal form remains rather limited.<sup>36</sup>

### **The European private company (SPE)**

Discussions are currently taking place at European level with regard to the introduction of the SPE. Whereas the SE *acquis* is aimed at large public companies, the SPE is intended to offer small and medium-sized companies an alternative to national legal forms such as the GmbH in Germany or the limited company (Ltd) under English law. The aim is to facilitate the cross-border activities of these firms.<sup>37</sup> The Commission presented its proposal for a regulation on 25 August 2008.<sup>38</sup> From the outset, numerous aspects of the company's structure have been the subject of controversy.<sup>39</sup> These include, in addition to the rules on board-level worker participation, the proposed minimum capital requirements and the provisions on the registered office of the company.<sup>40</sup> On the issue of board-level worker participation, the Commission proposal was entirely unacceptable, envisaging that such representation should be determined simply according to the law of the State of establishment.<sup>41</sup> This would have created a variety of incentives to circumvent or avoid board-level worker participation.<sup>42</sup> The original Commission proposal has been amended under various Council presidencies.<sup>43</sup> However, the existing areas of dispute have not been successfully resolved. Unless substantive rules on board-level worker participation are introduced, this legislative project is unlikely to succeed. A possible framework for substantive rules of that kind is set out towards the end of this chapter.

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34. Regulation (EC) No 1435/2003, OJ L 207, 18.8.2003, p. 1.

35. Directive 2003/72/EC, OJ L 207, 18.8.2003, p. 25.

36. Report from the Commission, 16.9.2010, COM 2010/481.

37. Sick, S. and R. Thannisch (2011), pp. 155-159.

38. COM (2008) 396 final. For an overview of the historical development of the SPE, see <http://www.worker-participation.eu/Company-Law-and-CG/Company-Law/European-Private-Company-SPE/History>.

39. For detail, see Koberski and Heuschmid (2010), pp. 209-210.

40. *Ibid.*, p. 207.

41. *Ibid.*, p. 210 et seq.

42. Sick and Thannisch (2011), p. 158.

43. *Ibid.*, p. 156. See also Koberski and Heuschmid (2010), p. 210 et seq. For an overview of the historical development of the SPE, see <http://www.worker-participation.eu/Company-Law-and-CG/Company-Law/European-Private-Company-SPE/History>.

## 2.2 Other secondary law instruments linked to board-level worker representation

In addition to rules establishing the European corporate forms outlined above, the EU *acquis* also includes Directives governing certain cross-border structural actions taken by companies established under national law and which, as a result, also include provisions to protect board-level worker participation.

The most important instrument in this category is the Merger Directive.<sup>44</sup> This was adopted by the Council on 19 September 2005 and required implementation into national law by December 2007. The Merger Directive establishes a common legal framework for the cross-border merger of companies established under national law. This is an option which under previous domestic law regimes had either simply been ignored or was burdened with numerous legal and administrative difficulties.<sup>45</sup> In addition to provisions concerning various company law issues, the Directive also includes in Article 16 measures to protect existing board-level worker participation in the merging companies.<sup>46</sup> In contrast to the EU corporate forms analysed above, the principal difference under the Merger Directive is that the company resulting from the merger is not a body established under EU law but remains governed by national law. Article 16 of the Merger Directive provides that, in principle, the scheme for employee involvement will be determined in accordance with the law of the Member State where the company resulting from the merger has its registered office. In the cases in which that would result in a loss of worker participation rights, the Directive provides for a negotiating procedure including standard rules to apply by way of default similar to the scheme established in the SE Directive. Given that involvement in the merger of a company subject to board-level worker participation generally triggers the negotiating requirement; such cases will always involve negotiations on worker participation structures.<sup>47</sup> In contrast to the SE scheme, the standard rules established under the Merger Directive are less favourable in certain respects.<sup>48</sup>

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44. Directive 2005/56/EC, OJ L 310, 25.11.2005, p. 1.

45. Kleinsorge (2011), EU-Recht, paragraph 85.

46. For details, see Heuschmid, J. (2006) pp. 184-192.

47. See Sick, S. (2010), paragraph 44, and Kleinsorge (2011), EU-Recht, paragraph 94 et seq. An exception to the negotiating procedure is provided for in Article 16(4)(a).

48. Kleinsorge (2011), EU-Recht, paragraph 94 et seq., and Sick (2010), SE und grenzüberschreitende Verschmelzung, paragraph 48.

Further, reference must also be made to the project for a 14th company law directive.<sup>49</sup> The purpose of this directive is to allow the cross-border transfer of the registered office of limited companies and, hence, conversion to a different legal form.<sup>50</sup> Policy-level discussions on the project have been ongoing for several years but have not resulted in any serious legislative proposal by the Commission.<sup>51</sup> As conversion to a different legal form may have considerable consequences for worker rights, possibly even the complete loss of board-level worker participation, protective mechanisms are essential. In this connection, the European Parliament recently adopted a second resolution calling on the Commission to present a legislative proposal for a 14th company law directive.<sup>52</sup> In addition to the issue of board-level worker representation, the question whether the directive should require the registered office and administrative seat of a company to be located in the same Member State proved particularly controversial in the Parliamentary debates.

## 2.3 Interim conclusion

The previous sections have identified that only limited individual measures have been adopted at EU level in the area of board-level worker representation. A coherent company law solution for ensuring workers' interests remains to be developed. At present, where companies decide to take advantage of their rights under the European *acquis*, workers can only be sure of board-level worker participation if, as a matter of national law, they are already accorded such rights.<sup>53</sup> This follows from the decision of the European legislature not to introduce an independent EU standard for worker participation but simply to establish a negotiating procedure. In addition, this limited scheme contains various weaknesses which can have an adverse impact on board-level worker participation.<sup>54</sup> For that reason, the EU *acquis* is often used in order to reduce or weaken board-level worker representation. In this connection, the absence of an independent EU standard for worker participation has proven to be a particular disadvantage.

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49. Koberski and Heuschmid (2010), pp. 213-214, and Kleinsorge (2011), EU-Recht, paragraphs 124-125.

50. Krause, R. (2004), p. 396.

51. Koberski and Heuschmid (2010), pp. 213-214.

52. On the first resolution (P6\_TA(2009)0086), adopted in 2009, see Koberski and Heuschmid (2010), p. 214. The second resolution was adopted on 2 February 2012 (P7\_TA(2012)0019).

53. Kluge, N. (2011), p. 167.

54. Conchon (2011), p. 35 et seq.

### 3. A future legal framework

This brings us back to our original question. How could European company law be reformed to secure worker interests in a more effective and coherent manner? There appear to be two important aspects here. First, legislation should define the notion of the ‘interests of the company’ – which management is required to respect – in pluralist terms. Second, in addition to this proposal to establish the stakeholder model as the statutory norm, this should be supplemented by a legal framework which ensures that stakeholder interests are indeed respected.<sup>55</sup> For the purpose of protecting worker interests in this context, as identified earlier, the concept of board-level worker participation is particularly well-suited.

#### 3.1 Pluralist approach to company law

Legal rules requiring management to adopt a pluralist approach when pursuing the company’s interest are to be found in many legal orders. Although the group of stakeholders to be considered varies somewhat, on the whole, workers are accorded a special status in this context.<sup>56</sup> The nature of this approach will be illustrated here by an examination of German law (taken to be representative of numerous legal orders in continental Europe).

#### The legal framework in Germany and other continental European countries

German company law has traditionally taken as a guiding principle the notion of the ‘interests of the company’.<sup>57</sup> Over many decades, that notion has been understood to mean that management should accord appropriate recognition to the plurality of stakeholder concerns.<sup>58</sup> A previous version of the Companies Act (*Aktiengesetz*) whose origins went back to the time of the Weimar Republic provided explicitly that the board should take account of the interests of various stakeholders.<sup>59</sup> Al-

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55. For a similar view, see L. Gower and P. Davies (2008), p. 519.

56. For a justification of this position, see Parkinson, J. (2003), pp. 481-509, at p. 491 et seq.; Johnston, A. in this book; Wißmann, H. (2009), § 282, paragraph 15; and Hopt (2011), p. 505.

57. For detail, see Spindler, G. (2008); Deipenbrock, G. (2010), pp. 17-18; Kuhner, C. (2004), pp. 244-279; and Hüffer, U. (2010) *Aktiengesetz*, § 76, paragraph 12 et seq.

58. Kuhner (2004), p. 252.

59. Koberski and Heuschmid (2010), p. 210 and footnote 52.

though that the provision was repealed as part of the 1965 reform to company law, the overwhelming majority of commentators presumed that this pluralist approach continued (implicitly) to apply. For example, the explanatory notes to the 1965 government bill introducing that reform considered it self-evident that, in pursuing company activities, the board must take account of the concerns of shareholders, workers and society at large. Doctrinal support for this principle can be found in various legislative provisions. These include, most importantly, the notion established in Article 14(2) of the Basic Law (*Grundgesetz*) that the use of property shall also serve the public good and also the legislation on board-level worker participation.<sup>60</sup> In philosophical terms, this approach draws on a variety of inspirations including Hegelian thought and Catholic social teaching.<sup>61</sup>

With the increasing popularity of the notion of shareholder value that emerged in the 1990s and continued into the first decade of the 21st century, certain legal writers began to express doubts as to the correctness of the pluralist approach taken in German company law.<sup>62</sup> However, the majority of commentators continued to support the pluralist approach. In any event, the 2009 amendments to the German Corporate Governance Code ought to have dispelled any lingering doubts. Following those amendments, the board has been required to adopt a pluralist approach to the notion of the ‘interests of the company’. Section 4.1.1 of the code is worded as follows: ‘The board is responsible for independently managing the company in the interests of the company, that is, taking account of the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.’ In other words, the interests of the company may be regarded as the sum of the various forces coincident within the company as a pluralistically structured association.<sup>63</sup> Naturally, these forces include the demand for profitability and the continued existence of the company.<sup>64</sup> At the same time, this principle also means that the board is neither required nor permitted to pursue its task of management guided simply by shareholder interests.<sup>65</sup>

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60. Kuhner (2004), p. 248.

61. *Ibid.*

62. Groh, M. (2000), pp. 2153-2158; Fleischer, H. (2009), p. 190. However, the shareholder value idea never took hold completely. See von Hein, J. (2008), p. 229 et seq. On this development, see Vitols (2011), and Deipenbrock (2010), pp. 17-18.

63. Hüffer (2012), § 76, paragraph 12 et seq.; Wißmann (2009), § 282, paragraph 15; and Koberski, W. (2011), § 25 *MitbestG*, paragraph 93 et seq.

64. Wißmann (2009), § 282, paragraph 15, and Hüffer (2012), § 76, paragraph 13.

65. Hüffer (2012), § 76, paragraph 12.

Thus, in the German legal order, the shareholder value approach has been completely undermined.<sup>66</sup>

Company law systems underpinned by a pluralistic notion of the interests of the company comparable to that inherent in German law are to be found in many other countries in continental Europe. These countries include France,<sup>67</sup> Italy,<sup>68</sup> the Netherlands,<sup>69</sup> Austria,<sup>70</sup> Switzerland<sup>71</sup> and the Scandinavian countries.<sup>72</sup>

### The different approach of common law countries

In the United Kingdom, the shareholder value approach traditionally prevails.<sup>73</sup> For that reason, it comes as no surprise that the courts have equated ‘the interests of a company’ to the interests of shareholders.<sup>74</sup> Consequently, of particular interest in this connection is section 309 of the Companies Act 1985 (subsequently repealed) which, at least in theory, mitigated that general focus on shareholder interests.<sup>75</sup> It was worded as follows: ‘The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general as well as the interests of its members’. However, its lack of enforceability was seen as a problem.<sup>76</sup> As part of recent company law reforms, that provision was repealed by the Companies Act 2006 and replaced by a watered-down provision in the new section 172.<sup>77</sup> Those reforms followed an independent review of

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66. Ringleb, H., T. Kremer, M. Lutter and A. von Werder (2010), section 4.1.1 of the code, paragraph 602, and Deipenbrock (2010), pp. 20-21.

67. Lord Wedderburn of Charlton (1993), vol. 109, p. 233.

68. Grundmann (2011), § 13, paragraph 462.

69. The Supreme Court of the Netherlands (Hoge Raad) has clarified that the interests of shareholders do not take precedence over the interests of other stakeholders. See its judgment of 13 July 2007 in ABN AMRO and Others, reported: JOR 2007, p. 178.

70. Section 70(1) of the Austrian Companies Act provides: ‘The board shall be responsible for independently managing the company with a view to ensuring the company’s interests taking account of the interests of shareholders, employees and the public at large’.

71. According to a judgment of the Swiss Federal Supreme Court, the objective of a company is not simply the pursuit of profits but also to secure other interests, for example, an existence for employees. Reported in BGE 100 II 393.

72. Bruun, N. (2006), p. 40, and Hopt (2011), p. 476.

73. Hopt (2011), p. 476, and Fleischer (2009), p. 209.

74. Fleischer (2009), p. 209.

75. For details, see Villiers, (2000), pp. 593-614.

76. Villiers (2000), pp. 596-597.

77. Heuschmid (2009), p. 155; Wynn-Evans, C. (2007), pp. 188-193; Villiers (2010), p. 9; and Gower and Davies (2008), p. 518.

company law commissioned by the Department of Trade and Industry which in its final report had recommended the notion of shareholder primacy and rejected the pluralist approach.<sup>78</sup> In this connection, the principle introduced by section 172 of the Companies Act is commonly referred to as the notion of ‘enlightened shareholder value’.<sup>79</sup> This approach is said to combine the shareholder value approach with consideration of stakeholder interests.<sup>80</sup> This means that the board is allowed, at the very least, to have regard to stakeholder concerns.<sup>81</sup> Ultimately, however, under the British notion of corporate governance, the primary focus remains on shareholders.<sup>82</sup> If, prior to the 2006 reforms, the protection afforded to employees as stakeholders was regarded already as weak, the situation under the new regime is even worse.<sup>83</sup> In introducing the Companies Act 2006, the United Kingdom clearly missed an opportunity to create a progressive and sustainable system of company law.<sup>84</sup>

Although company law in the United States generally also follows the shareholder value approach,<sup>85</sup> since the early 1980s various states have introduced provisions (known as ‘other constituency statutes’) allowing management to have regard, in addition to the interests of shareholders, also to the concerns of other stakeholder groups.<sup>86</sup> Section 717 of the New York Business Corporations Law is a model in this respect.<sup>87</sup> Certain states have gone further, for example, imposing an obligation to have regard to stakeholder interests.<sup>88</sup> Sometimes, in order to temper the shareholder value approach, the business judgment rule is invoked,

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78. DTI (2001) *Modern Company Law for a Competitive Economy, Final Report 2001*, London: DTI, paragraph 1.23.

79. Heuschmid (2009), p. 155; Villiers (2010); and Fleischer (2009), p. 209.

80. Villiers (2010), p. 1.

81. Grundmann (2011), § 13, paragraph 462.

82. Villiers (2010), p. 2; and Grundmann (2011), § 13, paragraph 462.

83. Gower and Davies (2008), p. 518; and Villiers (2010), p. 1.

84. Villiers (2010), p. 1.

85. Kuhner (2004), pp. 274-275. The leading case is *Dodge v Ford Motor Co.*, 204 Mich. 459 (1919).

86. Cox, J. and T. Hazen (2003), pp. 210-211.

87. This is worded as follows: ‘... (b) In taking action ... a director shall be entitled to consider without limitation ... (1) both the long-term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation’s actions may have in the short-term or in the long-term upon any of the following: (i) the prospects for potential growth, development, productivity and profitability of the corporation; (ii) the corporation’s current employees; (iii) the corporation’s retired employees ..; (iv) the corporation’s customers and creditors; and (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.’

88. For an overview, see Fleischer, cited above, p. 211.

which accords management considerable discretion in the exercise of its tasks.<sup>89</sup> Nonetheless, company law in the United States continues to reject any presumption that the notions of shareholder value and stakeholder value are converging.<sup>90</sup> The other constituency statutes are said not to be indicative of the legislative philosophy inherent in company law.<sup>91</sup> In addition, as is the case in the United Kingdom, the statutes adopted by the various states lack an enforcement mechanism to ensure that regard is actually had to stakeholder interests.<sup>92</sup> In contrast, shareholders are in a different position. They are afforded legal tools to enforce their interests, more often than not at the expense of other stakeholders.

### OECD level

The stakeholder approach has also had an impact at the level of the OECD (Organisation for Economic Co-operation and Development). A separate chapter on stakeholders (Chapter IV – The Role of Stakeholders in Corporate Governance) was inserted on the 2004 revision of the OECD Principles of Corporate Governance. By means of those rules, the OECD seeks to ensure a balancing of interests between the various groups involved.<sup>93</sup> This is made clear by its call for the corporate governance framework to encourage active cooperation between companies and stakeholders in the interests of the company's own welfare and its long-term performance.<sup>94</sup> In this connection, its recommendation that 'performance-enhancing mechanisms for employee participation should be permitted to develop' can be understood as a reference to instruments such as board-level worker participation.

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89. Von Hein (2008), pp. 861-862.

90. *Ibid.*, p. 862.

91. *Ibid.*

92. Villiers (2000), p. 598.

93. Fleischer (2009), p. 203.

94. This principle is fleshed out in the OECD Principles as follows: 'A. The rights of stakeholders that are established by law or through mutual agreements are to be respected. B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights. C. Performance-enhancing mechanisms for employee participation should be permitted to develop. D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis. E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this. F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.'

## Interim conclusion

As has been demonstrated, a large number of countries, particularly in continental Europe and the OECD, conceive of company law in pluralist terms. It should therefore not be a surprise that the pluralist approach is also the leading perspective from a comparative law point of view.<sup>95</sup> Even common law jurisdictions, which in this connection have traditionally taken a different approach, cannot avoid in their company law systems the recognition of interests going beyond the interests of shareholders alone. However, it remains impossible to speak of a convergence between shareholder value and the stakeholder approach.

If the Commission decides to develop the EU company law *acquis* further, adoption of a pluralist perspective is essential.<sup>96</sup> In this connection, the wording of section 4.1.1 of the German Corporate Governance Code may serve as a useful starting point. The first step would be to insert a clarification of that kind in Article 38 of the SE Regulation and any future SPE Regulation. The next step would be to consider whether the pluralist approach should be inserted in the legal order of all the Member States by means of a coordinating directive adopted on the basis of Article 50(2)(g) TFEU. For most Member States that would simply mean EU-level reinforcement of the national status quo. However, even for the United Kingdom, given the features of its company law regime identified above, a development of that kind would not involve a concept which is entirely foreign.

### 3.2 Development of board-level worker participation at EU level

As was outlined earlier, the legislative establishment of a pluralist (stakeholder) concept of company law will require supplementing with legal enforcement mechanisms. From the perspective of employees, rules on board-level worker participation would appear particularly well-suited in that regard.<sup>97</sup>

The introduction of board-level worker participation by means of EU secondary law has been under discussion since the early 1970s. This ap-

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95. Hansmann H., R. Kraakman (2004), p. 18.

96. For a similar view in relation to environmental concerns, see Sjøfjell, B. (2010).

97. See also demand of the ETUC: Executive Committee Resolution from 28 April 2011.

plies in particular to the Commission's 1972 proposal for a fifth company law directive.<sup>98</sup> On the basis of Article 54(3) EEC (now Article 50(2)(g) TFEU), the proposed directive sought to establish a uniform structure for companies established under national law and to introduce board-level worker representation in companies of that kind.<sup>99</sup> More specifically, the proposal envisaged the introduction of a two-tier board structure (Article 2) and board-level worker participation entailing no fewer than a third of the seats on the supervisory board in all companies having 500 or more employees (Article 4).<sup>100</sup> Quite clearly, this would have fixed company law on the stakeholder track. However, notwithstanding over two decades of efforts, as a result of differences on core issues concerning company structure and board-level worker participation, the directive was never adopted.<sup>101</sup>

The failure of the universal solution proposed in the fifth company law directive should not be seen as a hindrance to the development of EU schemes for worker participation. It is possible that the project to introduce board-level worker participation to the legal order of each Member State was – and still is – somewhat over-ambitious. However, an approach of that kind is unnecessary. Instead, other means are possible. First, the existing corporate forms established under EU law could be enhanced with an independent EU standard for worker participation. Second, those Member States which are well-disposed to the concept of board-level worker participation could make use of the framework for enhanced cooperation established in Article 20 TEU in conjunction with Articles 326 to 334 TFEU to harmonise their systems of company law including the rules on board-level worker participation.

### **Introduction of an independent scheme for board-level worker representation in the corporate forms established under EU law**

A first step towards the enhancement of board-level worker participation could be taken through the introduction of an independent EU standard

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98. COM (72) 887 final (not published in English). See also Habersack, M. (2003), paragraphs 55-56.

99. COM (72) 887 final.

100. In a later proposal, the threshold for participation was raised to 1000 employees: Grundmann (2011), § 11, paragraph 366.

101. Habersack (2003), paragraphs 55-56; and Bröhmer, J. (2011), Article 50 AEUV, paragraph 12. Similar problems arose in relation to the SE. See Kleinsorge (2011), EU-Recht, paragraph 4 et seq.

for board-level worker participation in the corporate forms governed by EU law. This would be an opportunity to reduce or even remove the deficits in the existing SE *acquis* identified above and, as a result, make these corporate forms governed by EU law more attractive from an employee perspective.

The legislative process currently underway in relation to the SPE could be used for this purpose. Consequently, the legislative actors involved should consider the introduction of an independent EU standard for board-level worker participation which goes beyond the existing negotiating procedure. The proposal for the fifth company law directive mentioned earlier could be treated as a starting point for the substance of any such scheme. However, in this connection, it does not appear necessary to require the introduction of a two-tier board structure. It will suffice if each SPE is simply required to adopt a structure compatible with board-level worker participation. This was the approach adopted in the consolidated draft SPE regulation submitted by the Swedish Council Presidency in 2009.<sup>102</sup> As regards the intensity of worker participation, here, too, the draft fifth directive provides a useful starting point. Under that proposal, no less than a third of the seats in the supervisory or management organ must be reserved for worker representatives. At the same time, a special rule will be needed for a Member State whose national law provides for higher levels of worker representation. That State should have the power to apply the higher level of worker representation to SPEs that are registered there. This will ensure that the requirements of Article 151 TFEU are satisfied. On the question of the size of company needed to trigger the introduction of this independent EU notion of board-level worker representation it would appear appropriate, in line with Article 8 of the SCE Directive, to set the threshold at 50 employees.

If agreement cannot be reached on including worker participation of this kind, it would be better to abandon the entire SPE project. Expansion of worker participation as outlined above is needed to remove the deficit which currently exists at EU level. Whereas businesses operating in Europe can take advantage of developments in EU law and adopt a corporate form governed by EU law, employees are, for the most part,

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102. See Koberski and Heuschmid (2010), p. 209.

limited to those rights accorded by national law.<sup>103</sup> If, on the other hand, EU law is developed in the manner suggested above, this could be a model for the other corporate forms governed by EU law.

### **Development through enhanced cooperation**

An alternative approach to extending board-level worker participation at EU level might be to use the procedure for enhanced cooperation provided for in Article 20 TEU in conjunction with Articles 326 to 334 TFEU.<sup>104</sup> In this case, the initiative for such a development would have to come from the Member States.

The conditions for enhanced cooperation are set out in Article 20 TEU in conjunction with Articles 326 to 334 TFEU. Pursuant to Article 20 TEU, Member States may establish enhanced cooperation between themselves within the framework of the Union's non-exclusive competences. It follows from Article 3 TFEU that questions of company law (Article 50(2)(g) TFEU) and worker representation (Article 153(1)(f) TFEU) do not fall within the Union's exclusive competences. Moreover, Article 20(1) TEU provides that enhanced cooperation shall aim to further the objectives of the Union and reinforce its integration process. That would not be difficult in this case as, pursuant to Article 3(3) TEU, the Union shall work for a social market economy and social progress. The same conclusion follows from Article 151 TFEU which establishes that the Union and the Member States shall have as their objectives: 'the promotion of employment, improved living and working conditions, so as to make possible their harmonisation while the improvements is being maintained, proper social protection, dialogue between management and labour, the development of human resources with a view to lasting high employment and the combating of exclusion'. It is clearly evident that the harmonisation of company law with a view to ensuring the effective participation of workers constitutes a measure promoting the integration process. Pursuant to Article 20(2) TEU, enhanced cooperation may only be undertaken as a last resort, that is, when the objectives of enhanced integration cannot be attained by the Union as a whole. This is the case, as discussed earlier, in relation to the fifth company law directive. The final requirement, pursuant to Article 20(2) TEU, is that

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103. Kluge (2011), p. 167.

104. A similar view is taken in the chapter by Malmberg, Sjödin and Bruun.

at least nine Member States participate in the enhanced cooperation. Given that legislation on board-level worker representation exists in 14 Member States,<sup>105</sup> it wouldn't seem impossible to achieve that quorum. In particular Germany, with both a healthy economy and widespread participation rights, could use its influence to convince other member states to follow the participation path. The procedure to establish enhanced cooperation is set out in Articles 329 to 334 TFEU. According to those provisions, the Member States which wish to establish this must address a request to the Commission. Authorisation to proceed will be granted by the Council on a proposal from the Commission and after obtaining the consent of the European Parliament. In the framework of enhanced cooperation, the participating Member States may make use of the Union's institutions and exercise those competences by applying the relevant provisions of the Treaties. Moreover, pursuant to Article 328(1) TFEU, the Commission is required to promote the participation in enhanced cooperation by as many Member States as possible.

#### **4. Conclusion**

Given the seriousness of current problems such as increasing social inequalities and the precarious state of the environment, the demands placed on EU company law are considerable. What is needed for the future is a system which with ingenuity and the careful harnessing of resources achieves greater qualitative rewards and improved output of benefit to society and does not simply conquer markets as rapidly as possible with a view to making shareholders richer.<sup>106</sup> The fact that good corporate governance requires consideration of employee interests has now been recognised even by supporters of the shareholder value approach. For example, Hopt writes in a recent article: 'good corporate governance includes the interests of other groups involved with the company, in particular, its employees'. This is something which must be put in practice at EU level. A first step in that direction would be to establish the pluralist notion of the company as a principle of EU company law. To do so would reflect a model in which a company is seen as a social association of cooperating stakeholders who contribute to that organisation's success through the provision of their capital or labour. In order

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105. For an overview, see Conchon, cited above, p. 10.

106. Kluge, cited above, pp. 156-157.

to ensure – from an employee perspective – that this pluralist approach is actually put into effect, flanking measures are required which establish board-level worker participation. The shape that measures of that kind could take has been identified in this chapter. Consequently, the ball is now in the court of the EU legislature and the Member States. As long as the relevant actors do not take action in this field, employees have to access to more conventional measures to safeguard their interest in company decision making. How this could work on the basis of collective bargaining or investor agreements is described by the contribution to this book by Däubler.

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107. Hopt, cited above, p. 524.

108. Heuschmid (2009), p. 263.

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# Chapter 6

## EU company law and employee involvement – some perspectives on future developments

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### 1. Introduction\*

A long-standing conflict in the European integration project is between advocates of greater market integration and those who believe that market integration will inevitably lead to the dismantling of social rights at national level. In the 1970s a social action programme was adopted in order to try to overcome this conflict. Policymakers took the view that action in the area of social policy was needed in order to avoid the perception that the European Union (EU) was only an instrument for capital. The EU was said to be in need of a more human face in order to gain the support of the working population.<sup>1</sup>

In his 2010 report on a new strategy for the single market, Professor Monti states that this conflict has been revived after some controversial judgments of European Court of Justice (ECJ). According to Professor Monti, a potential effect of this divide may be the alienation of previous key supporters of the single market within the workers' movement and the public at large (Monti 2010: 68). This reasoning bears a resemblance to that used on the adoption of the social action programme in the 1970s. Another common feature to contemporary developments and the situation in the 1970s is the prevailing economic crisis.

In light of the recent report of the Reflection Group, we will analyse in the present chapter the current discussion on the modernisation of

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1. 'The Community has to be seen as more than a device to enable capitalists to exploit the common market; otherwise it might not be possible to persuade the people of the Community to accept the discipline of the market,' Michael Shanks quoted in Bercusson (1996: 50).

company law and the implications for employee involvement. We propose two different routes which could be used to protect and enhance employee involvement in the EU. The first is to adopt legislation at EU level establishing a European minimum standard for employee involvement intended to complement existing national and European regulations on this subject. The second route is to pursue enhanced cooperation between EU States that wish to promote both social and economic integration.

## **2. Harmonisation of company law**

In the early 2000s, the European Commission introduced an action plan in order to modernise company law and enhance corporate governance in the EU (European Commission 2003). The action plan was seen as an impetus to harmonising EU company law in order to make the most of the internal market by facilitating the freedom of establishment, cross-border restructuring and to promote the integration of capital markets. The aim was also to minimise the damaging impact of a number of financial scandals that had recently occurred.

The Commission has recently taken an initiative to relaunch the process of harmonisation of company law. In 2010 the Commission established the Reflection Group on the Future of EU Company Law. The report of the Group (Reflection Group 2011) was discussed in May 2011 at a conference organised by the Commission.

The starting point for the Reflection Group report is the economic and financial crisis. The aim of the report is, in part, to assess whether imperfections in company law might have played a role in the economic crisis and to propose improvements in regulatory regimes in order to prevent future crises. The Group stresses excessive risk-taking and myopic management decisions as major causes of the crisis. At the same time, the Group emphasises that the financial crisis highlighted how important it is 'for businesses to operate in a flexible environment allowing for adaptation to new circumstances and for experimentation of innovative financial, organisational or industrial ideas'.

The Group thus wants to strike a balance between the need for rules discouraging harmful short-termism and excessive risk-taking, on the one hand, and the goal of preserving a flexible legal framework, on the other.

The Reflection Group puts forward a long list of recommendations concerning cross-border mobility, the contribution of corporate governance and investors to long-term viability of companies and concerning groups of companies. Against this background, the Reflection Group also addresses employee participation at board level.

Before considering the views expressed by the Reflection Group on the aim and function of employee participation, we will briefly sketch the EU law framework on employee involvement.

### 3. The EU employee involvement acquis in a nutshell

The law which provides for worker representatives to influence decision making in companies is an area where legal concepts and their translations tend to confuse discussions (Weiss 2004). The term employee involvement is used here in the widest sense, indicating any mechanisms through which employee representatives – these may be trade unions or works councils – may exercise influence on decisions to be taken within a company.<sup>2</sup> The mechanisms could be information (one-way communication from management/employer), consultation (two-way communication between management and worker representatives) or participation. The latter refers to the right of employee representatives to elect, appoint, recommend or oppose appointment of members in the supervisory or administrative organ (board-level representation).<sup>3</sup>

Workers' rights to information and consultation within the undertaking are considered fundamental rights for the purposes of the EU Charter of Fundamental Rights (Article 27), which is inspired by the revised European Social Charter (Article 21) and the Community Charter on the social rights of workers (points 17 and 18).<sup>4</sup> The latter states that information, consultation and participation rights must be developed along appropriate lines within the EU.

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2. See the definition in Article 2(h) of Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, OJ L 294, 10.11.2001, p. 22.

3. See the definition in Article 2(k) of Directive 2001/86.

4. See the explanations relating to the Charter of Fundamental Rights, OJ C 303, 14.12.2007, p. 17, at p. 26.

The original Treaty of Rome did not include any explicit competence to adopt directives on employee involvement. However, different articles have been invoked as the basis for directives on employee involvement. The first directives were adopted on the basis of Article 100 of the Treaty of Rome (now Article 115 of the Treaty on the Functioning of the European Union (TFEU)). This article provided the EU with the competence to adopt directives for the approximation of national laws directly affecting the establishment or functioning of the common market.

Today, employee involvement is covered by the EU competence on social policy. Article 153 TFEU requires the Union to support and complement the activities of the Member States in this field and authorises it to adopt minimum directives to that end. This competence covers both information and consultation (Article 153(1)(e) TFEU) and participation (Article 153(1)(f) TFEU). However, the latter power requires unanimity in the Council and has to our knowledge never been used. The use of Article 153 TFEU as a legal basis also presupposes the involvement of the social partners at European level (see Article 154 TFEU). Within the scope of the social dialogue, the social partners may conclude an agreement that can be turned into a directive (see Article 155 TFEU).

The European Union has over the years adopted a wide but rather disjointed *acquis* concerning employee involvement. This secondary EU law presupposes existing national systems of employee involvement.

The first kind of directive addressed issues of employee involvement in relation to certain matters or incidents, which often are an effect of the internal market. The first two directives – adopted in the 1970s – concerned information and consultation in relation to the restructuring of companies.<sup>5</sup> The need for restructuring of companies was considered a necessary and desirable effect of the increased competition on markets for goods and services following the establishment of an internal market.<sup>6</sup>

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5. Both directives have been revised and consolidated. The latest versions are: Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies, OJ L 225, 12.8.1998, p. 16, and Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, OJ L 82, 22.3.2001, p. 16.

6. In the same vein, the directive on takeover bids also contains provisions on information and consultation. See Directive 2004/25/EC of the European Parliament and the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12.

The second kind of directive in the employee involvement *acquis* addresses different issues related to companies operating across national borders. The Directive on European Works Councils regulates employee involvement in Community-scale undertakings.<sup>7</sup> The Directive provides for the establishment of permanent employee representation bodies at transnational level for the purpose of informing and consulting on transnational matters. The Directive does not regulate participation. Further, there are three directives concerning other aspects of the cross-border organisation of companies. These directives aim at establishing participation – board-level representation – in undertakings which have adopted the legal form of the European company (SE) or the European cooperative society (SCE), and following cross-border mergers.<sup>8</sup> Further, there is a proposal that a future European private company (SPE) should also include a system for worker participation. However, the SPE proposals (European Commission 2008) are currently on hold.<sup>9</sup>

The third kind of directive is the 2002 Information and Consultation Directive, which provides a general framework for information and consultation in national companies.<sup>10</sup> The Framework Health and Safety Directive also includes obligations for information and consultation.<sup>11</sup>

A general observation is that directives on information and consultation lay down substantive standards, which are to be applied in different situations. These standards are considered minimum requirements, reflecting the idea of upward harmonisation expressed in Article 151 TFEU ('harmonisation, while the improvement is being maintained'). The directives concerning participation mainly regulate the applicable law and procedures aimed at reaching agreements on how participation is to be

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7. Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees (recast), OJ L 122, 16.5.2009, p. 28.
  8. Directive 2001/86, cited above, Council Directive 2003/72/EC of 22 July 2003 supplementing the Statute for a European Cooperative Society with regard to the involvement of employees, OJ L 207, 18.8.2003, p. 25, and Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJ L 310, 25.11.2005, p. 1.
  9. For the amendments proposed by the Parliament see OJ C 87E, 1.4.2010, p. 300.
  10. Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community, OJ L 80, 22.3.2002, p. 29.
  11. Council Directive 89/391/EEC of 12 June 1989 on the introduction of measures to encourage improvements in the safety and health of workers at work, OJ L 183, 29.6.1989, p. 1.

organised. In addition, they also contain default requirements if such agreements cannot be concluded. The main aim of these directives is to avoid dilution of existing national systems for participation as a result of cross-border business activities.

## **4. Employee participation according to the Reflection Group**

### 4.1 Aim and function of employee participation

The Reflection Group evaluates employee participation at board level from the perspective of how it affects the performance of companies, presumably defined as the return provided by the company to its shareholders or the increase in value of the company's shares. The point of reference for evaluating employee board representation thus appears to be that of shareholder value. According to the Group, the empirical econometric studies available do not indicate any clear evidence of a correlation between employee participation at board level and the performance of the companies. Companies with employee participation at board level or countries with such systems do not perform either better or worse than they would have been expected to have done without any such board representation.

The Reflection Group thus takes the view that employee participation at board level is neither good nor bad for the performance of the companies. And since the existence of systems of employee board-level representation is based on consciously taken political choices, these systems must be respected (even though the Group suspects that there might be vested interests in keeping such systems once they are established).

### 4.2 Implications

The policy implications of this view are, according to the Group, that there is no need to enhance EU rules on board-level representation. Likewise, there is no need for the EU to interfere with existing national systems for employee participation, unless they are discriminatory. The 'appropriate attitude' for the EU legislative bodies is thus to abstain from both deregulation and introduction of legislation on worker participation (Reflection Group 2011: 53).

In practice, this formally neutral position risks undermining the employee involvement systems in Germany, Austria and the Nordic countries (especially Sweden), which are the countries with the most developed systems for employee participation at board level. The Reflection Group appears to propose that those Member States that have weak or no employee participation systems in place should deepen their cooperation in order to introduce a regulation for a European private company (SPE). The Reflection Group has suggested using the possibility of enhanced cooperation, which gives Member States willing to commit to such cooperation the ability to do so (see the provisions of Article 20 of the Treaty on European Union (TEU) and Articles 326 to 334 TFEU).<sup>12</sup> In doing so, the Group indirectly defines employee participation as something odd, which should not form a part of the common EU solution.

The Reflection Group further states that employees in the EU might suffer unequal treatment with respect to co-determination due to the fact that subsidiaries may be in a different jurisdiction to the parent company, for instance, a German Aktiengesellschaft. The Group highlights here an important structural problem in the internal market. The Group's proposal is that the Commission should challenge such situations before the ECJ. However, that course of action would hardly provide any solution to the discrimination of employees regarding their participatory rights. Instead, it would risk undermining the existing system for employee participation. The proper solution would, in our opinion, require legislation at national or European level.

The attitude within the Reflection Group towards worker participation is also reflected in the fact that the Group does not see any need for further comparative studies on employee representation. Nor does it call for any other studies in this field. In this respect, the position of the Group is not fully consistent with its own observation that there are different views on the impact of employee participation on the performance of companies. The position is also in sharp contrast with the general approach of the Group, which favours further studies on different aspects of EU company law.

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12. Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees (recast), OJ L 122, 16.5.2009, p. 28.

### 4.3 Employee involvement according to the Treaty

The understanding of the aims and function of employee participation as limited to its ability to enhance the performance of the companies is not fully compatible with the aims and functions attributed to employee involvement (of which participation is one part) in the political and legal debate. This point is clearly illustrated if we consider the functions and aims of employee involvement as expressed in the Treaty, which is intended to guide the actions of the European Commission.

According to the Treaty, employee involvement forms part of the social policy of the Union. The aim of social policy, as set out in the Treaty, includes improvement of the dialogue between management and labour (Article 151 TFEU). One of the directives in the EU employee involvement acquis states in its recitals that the strengthening of social dialogue is needed to promote mutual trust within undertakings in order to, for instance, improve risk anticipation, make work organisation more flexible and facilitate employee access to training within the undertaking etc.<sup>13</sup> It is obvious that the Treaty, as well as secondary EU legislation concerning employee involvement, is, on the one hand, based on the assumption that employee involvement might increase shareholder value. It is, on the other hand, equally evident that the EU employee involvement acquis ascribes to social dialogue a value of its own, which does not have to be justified in terms of improving shareholder values.

When adopting measures to implement social policy objectives, the Union and the Member States should, according to the Treaty, take account of ‘the need to maintain the competitiveness of the Unions economy’ (second paragraph of Article 151 TFEU). This indicates a different order of structuring the arguments compared to the reasoning of the Reflection Group. The argument of the Reflection Group, somewhat oversimplified, is that there is no need to eliminate national regulations on participation since it is not proven that these regulations are bad for shareholder value. The argument of Treaty is different. It identifies as an aim the strengthening of the social dialogue. While doing this, the EU and the Member States should ensure that the function of the market is not distorted, or at least not more than is necessary.

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13. See recital 7 in the preamble to Directive 2002/14.

Further, it is expressly stated in the Treaty that the objectives of social policy will not follow only from the functioning of the internal market, but require action from the EU, including harmonisation of national laws (third paragraph of Article 151 TFEU). This view clearly rejects the argument sometimes put forward in the debate that employee participation is detrimental because, if it were not, it would have been developed by the market and hence co-determination need not and should not be introduced as a matter of law (contrast Reflection Group 2011: 53).

Further, the point of view expressed in the Treaty is that the Union should support and complement the activities of the Member States in the field of employee involvement, including the provision of information to and consultation with workers, and the representation of workers, including co-determination<sup>14</sup> (Article 153(1)(e) and (f) TFEU).<sup>15</sup>

The policy implications of the Treaty are thus different from those put forward by the Reflection Group. In light of the Treaty, the question must be whether there is any need for the Union to support and complement the activities of the Member States in order to promote dialogue between management and labour. If this is done, the Treaty requires that it should be in a way that does not interfere with the functioning of the market more than is necessary.

## **5. Is there a need for a European minimum standard on employee involvement?**

Is there a need today for the Union to complement the actions of the Member States in the field of employee involvement?

We believe that the answer is yes. The main argument for such actions is the increase in cross-border activities of companies. This increase is partly related to the evolution of EU company law, for instance the case-law concerning cross-border mobility of companies, the establishment of the European company (SE), and now the proposed European private

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14. In German the term is *Mitbestimmung*, which refers, inter alia, to systems for board-level representation. See, inter alia, Preis (2003: 377 et seq.).

15. Different legislative procedures apply if the proposed legislation concerns the representation of workers including co-determination, see Article 153(2) TFEU.

company (SPE). The development of genuine cross-border companies has put, and will continue to put, severe constraints on national systems of employee involvement. Thus, there is a need to complement the activities of the Member States. An EU intervention would have added value in the promotion of dialogue between management and labour.

This has also traditionally been one of the main arguments for adopting the EU employee involvement *acquis*, starting from the Collective Redundancies Directive in the 1970s, via the European Works Councils Directive in the 1990s, to the Directive on Cross-border Mergers in 2005.<sup>16</sup> Further, the existing *acquis* is rather disjointed and highly complicated. This is particularly true for regulation on employee participation at board level.

There are, in our opinion, reasons to consider a new framework directive covering all types of European companies and other European legal entities (i.e. undertakings which have adopted the legal form of SE, SCE or SPE). The objective of such a directive would be both to enhance employee involvement and thereby promote the dialogue between management and labour and to promote the functioning of the internal market, in particular to implement the freedom of establishment. The directive could give each Member State an option to choose between different methods of safeguarding employee involvement, that is, either participation or information and consultation.

By introducing a common European minimum standard of employee involvement, such a directive would stress that companies and other actors taking advantage of the European internal market must respect and promote workers' participation in decision making. This standard should help to prevent the registration and localisation of the seat of such companies being done solely or mainly with a view to avoid worker participation. Furthermore, it is necessary to guarantee the existing or established best practices when companies from different jurisdictions merge or when the restructuring processes of existing entities result in the establishment of a European legal entity. Such a directive would further provide an opportunity to simplify the rules on employee par-

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16. Part of the EU employee involvement *acquis*, namely, Directives 98/59, 2001/23 and 2002/14, is currently subject to evaluation by the European Commission to determine whether the legislation is fit for purpose.

ticipation for undertakings adopting the SE or SCE form and would also solve some of the legislative problems related to the adoption of an SPE regulation.

## 6. Enhanced cooperation – a possible way ahead?

The proposal for a European private company (SPE) has, as was already mentioned, been put on hold. This is mainly due to disagreements on how to regulate employee participation. Against that background, the Reflection Group has suggested using the possibility of enhanced cooperation. The idea, as indicated above, is to adopt a regulation on an SPE which would not cover all Member States. According to the Group, a Member State wishing to impose its national system of workers' participation should not be able to block others wishing to progress on the SPE.

If we assume that market integration and social policy are on an equal footing – which arguably is the position of the Treaty – the idea of enhanced cooperation in the field of company law without addressing the issue of employee involvement is not the only or, indeed, the obvious choice. Considering social policy and market integration as equally important to establish a highly competitive social market economy (Article 3(3) TEU), a possible route for enhanced cooperation between progressive Member States is to develop a cooperation addressing both social and economic integration i.e. adopting both an SPE regulation and a framework directive on employee involvement of the kind just proposed. This would better serve the aims of the Treaty, by both promoting dialogue between management and labour and facilitating the internal market. Therefore – in its role as guardian of the treaties – the Commission should try to promote enhanced cooperation between those Member States that want to take on board employee involvement as a part of the SPE package and not between those wishing to exclude it.

The possibility of enhanced cooperation might in this way provide an opportunity to reinvigorate the idea of Jacques Delors for *un espace social européen*, which promotes both social and economic integration. In 1986 Delors stated:

‘Our ultimate aim must be the creation of a European social area. This idea, may I remind you, was rejected as Utopian, dangerous, and irrelevant to the Community venture a few years ago. Today its purpose is

clear: to ensure that economic and social progress go hand in hand.’ (European Commission 1986)

The idea of coupling social and economic integration is, as has been illustrated, clearly in line with the ambitions of the Treaties and need not be Utopian.

## 7. Conclusion

Recent decisions by the ECJ have rekindled the long-standing conflict between supporters of market integration and those that fear that such integration threatens social rights embedded in national systems. In 2011, the Reflection Group on the Future of EU Company Law, appointed by the European Commission, published a report outlining recommendations and options for future actions in this area. However, this report suffers from a number of deficiencies, particularly with regard to employee involvement rights in the EU.

This chapter has discussed the deficiencies of that report and suggested alternative ways forward. One route could be to adopt legislation at the EU level on a minimum standard of employee involvement. This standard would supplement and protect existing national systems of employee involvement, which are particularly threatened in cases of cross-border activities by companies. A second route would be to use the mechanism to pursue enhanced cooperation between certain Member States. In this way, countries wishing to give equal footing to both economic and social integration in the EU could pursue an agenda more supportive of employee rights. Both of these mechanisms are compatible with EU law, and could help to retain much-needed support for the European project among trade unions and the public at large.

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# **Chapter 7**

## **Worker participation as an element of the democratic principle in Europe – A critique of the co-determination relevant aspects in the Reflection Group report**

**Marie Seyboth**

### **1. Introduction\***

In December 2010, the European Commission established a Reflection Group on the future of EU company law. This group of 13 international experts was asked to report on EU company law and corporate governance issues.<sup>1</sup> In light of the financial and economic crisis the experts considered whether imperfections in company law may have played a role in the crisis and prevented the adoption of a more long-term perspective. The Reflection Group published its report in April 2011 and presented the findings at a conference on the future of EU company law held in Brussels the following month. The Report is divided into three main chapters and contains numerous recommendations for the European legislative bodies.

The Commission published a Green Paper on company law early in 2012. It then embarked on an extensive consultation with all stakeholders concerning the future development of EU company law. Following the consultation, the Commission has said that it will present specific legislative proposals.

Chapter 3 of the report entitled ‘The contribution of governance and investors to long term viability of companies’ contains a subsection on worker participation at the board level. It includes an assessment of worker participation in board-level decisions in the Member States. On the basis of numerous existing studies, the Reflection Group concludes

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\* Chapter 7 was translated from German by Paul Skidmore.

1. This report is available on the Commission’s website [http://ec.europa.eu/internal\\_market/company/docs/modern/reflectiongroup\\_report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf)

that board-level worker participation has proven neither detrimental nor advantageous to the interests of shareholders.

However, this perspective is very superficial. The broad range of existing empirical econometric studies on worker participation both at board level and at plant level reveals an increasingly differentiated picture. The sheer diversity of recent studies using different methods, different panel data and leading to different results makes it increasingly impossible to deliver a generalised broad-brush assessment of the economic effects of worker participation.<sup>2</sup>

Looking at these studies in total, one can say with a clear conscience that, taken together, they are unable to prove any adverse economic effect of worker participation. Quite the reverse is true. Contrary to the conclusion reached by the Reflection Group, there are clear indications that worker participation can facilitate productivity (with stronger evidence for plant level rather than board level participation). Naturally, the extent of that positive effect will depend on local variables such as the functional efficiency of the social partners, the quality of the working environment and other economic factors.<sup>3</sup>

University of Trier Economics Professor Uwe Jirjahn (2011) observes convincingly in his excellent recent literature review that, specifically taking account of the most recent studies, it may be concluded ‘that worker participation has indeed the potential to enhance economic performance’. In addition, from a trade union perspective, it must be added that worker participation constitutes both a protective right of workers and a right to have an active say and, thus, an essential component of the democratic social order which cannot be assessed simply by reference to economic criteria.<sup>4</sup>

Moreover, an assessment simply from the shareholder perspective overlooks the social policy dimension to worker participation which, follow-

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2. For an overview of the latest research on the economic effects of worker participation see the various articles devoted to this theme in *Schmollers Jahrbuch* (2011). See also Bermig and Frick (2011).

3. For example, in his comparison of the economic effects of different typologies of works councils, Pfeiffer (2011) concludes that the greatest increase in productivity can be achieved where members of the works council adopt a different position to management but, ultimately, a compromise is reached.

4. For a more detailed analysis of this aspect, see Heuschmid (2008).

ing the Treaty of Lisbon, the Commission is obliged to respect (Article 153(1)(f) TFEU, formerly Article 137 EC).<sup>5</sup>

In relation to existing systems of worker participation at Member State level, the Reflection Group recommends that, in general, the Commission should take a neutral approach, neither encouraging nor discouraging worker participation unless those schemes are considered to discriminate. In those cases, the Commission should take action and commence Treaty infringement proceedings.

The Report regards discrimination of that kind to exist under the German system of board-level worker representation where workers in foreign plants or subsidiaries are excluded for the purposes of electing worker representatives. It states:

The other area where the Commission in particular as the guardian of the EU Treaties should act is where a co-determination system discriminates against employees from other EU states. This is for example the case in the German regulations regarding the codetermination of the Aktiengesellschaft and the GmbH (Reflection Group 2011: 53).

In order to end this supposed discrimination, the Reflection Group proposes that the worker participation system established in relation to the European company (SE)<sup>6</sup> should be applied in relation to companies under national law and that the scheme of worker participation be determined by agreement at company level.

This chapter focuses on this discrimination thesis and the solution proposed by the Reflection Group and underlines the position of German trade unions in relation to the thesis and proposed solution.

## **2. Debates on worker participation**

In Germany, debates concerning worker participation are sometimes highly fuelled and intense, at other times, calm and rational. Worker

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5. Treaty on the Functioning of the European Union.

6. Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, OJ L 294, 10.11.2001, p. 22. On this, see Köstler (2011).

participation is acclaimed and celebrated, condemned and cursed. Only one thing appears certain, the debates on worker participation will continue.

Worker participation is characterised as something unique. It is said to exist only in Germany and nowhere else in the European Union:

One reason why Germany is very often erroneously considered as the main, if not the only, country granting employees the right to be represented on boardrooms is that it was the first country to legislate on this issue. Indeed, the 1951 Act regulating board level employee representation in the German coal, iron and steel industries marks an historic step as 20 more years had to be waited until the enactment of the next board level employee representation legislation in Europe. The 1970s were a decade of lively legal action in this regard, as laws regulating board level employee representation were enacted in 7 other countries (the Netherlands, Austria, Ireland, Denmark, Luxembourg, Sweden and Portugal), while the German legislator has also introduced in 1976 an Act implementing parity board level employee representation in all companies with more than 2,000 employees. In the 1980s, 4 countries passed a similar law (Poland, France, Greece and Hungary) and 4 more did the same in the 1990s (Finland, the Czech Republic, Slovakia and Slovenia). However, since then no new country has joined this group of the most advanced countries in terms of industrial democracy (Conchon 2011).

In addition, assessment of worker participation often focuses simply on the number of worker representatives on the supervisory or administrative board and, given the rule establishing parity between the representatives of shareholders and workers, this number is higher in Germany than in many other Member States. However, such assessment ignores other factors.

The law on board-level worker representation is triggered in Sweden with 25 employees, in Denmark with 35, in the Czech Republic with 50, in Finland with 150 and in Hungary with 200. By contrast, in Germany, 500 employees are required to trigger worker representation involving only a third of the seats on the board and 2 000 employees for parity representation.

This aspect was emphasised by the academic experts on the commission appointed by the Government of Gerhard Schroeder in 2005 to develop recommendations for the modernisation of the German system of board-level worker representation. In their final report, they conclude:

Taking account of all these elements, what characterises the German system of board-level worker participation is, above all, the fact that numerical parity applies in companies with 2 000 or more employees and, in general, the very high thresholds and not the mere existence of worker participation as such (Kommission zur Modernisierung der deutschen Unternehmensmitbestimmung 2006: 30).

Another criticism often levelled against board-level worker participation is the supposed absence of democratic legitimacy for the worker representatives on the supervisory board. Speaking at the biennial congress of German lawyers (Deutscher Juristentag) held in 2006, former member of the board at Mercedes-Benz Manfred Genz put it in the following terms:

In today's world, a significant proportion if not the majority of the workforce employed many German companies subject to the regime of board-level worker representation are employed abroad and not in Germany. However, as only workers in Germany may stand as candidates and vote in elections to the board, worker representatives on the supervisory board lack in many cases the democratic legitimacy on which so much store is set (Genz 2006: M43).

The members of the Reflection Group go one step further and do not limit their criticism to a supposed lack of democratic legitimacy for worker representatives but contend that the German system of board-level worker representation discriminates against workers from other Member States. They propose that the foreign workforce should be included in the national system of board-level worker representation by means of negotiations similar to those provided for in Directive 2001/86/EC on employee involvement in the European company.

### **3. Negotiated forms of worker representation in Germany**

The Reflection Group proposes that where companies that are using a domestic legal form have cross-border operations board-level worker

representation should be determined by negotiations. The report states that:

There is an easy way to end this discrimination by simply introducing the codetermination system provided for by the EU Directive for the SE and the SCE ... also for the domestic forms of company (Reflection Group 2011: 53).

In Germany, certain interested parties have long proposed that the statutory rules on board-level worker representation should be replaced by rules establishing a negotiating framework. Employer organisations started the ball rolling in 2004 with their proposal to modernise worker representation (BDA and BDI 2004). This was followed in 2006 by discussions at the 66th biennial congress of German lawyers and in the Government commission on the Modernisation of Worker Representation chaired by Professor Biedenkopf (Kommission zur Modernisierung der deutschen Unternehmensmitbestimmung 2006).

The latest initiative in this connection at national level came in May 2009 from a working group on board-level worker representation composed of seven academic experts and which resulted in proposals for a negotiating framework to establish board-level worker representation and concerning the size of the supervisory board in such companies (Arbeitskreis Unternehmerische Mitbestimmung 2009: 885). One of the academics on that working group, Professor Baums, was also a member of the Reflection Group.

The German Confederation of Trade Unions (DGB) rejects the proposals of the working group. Its opposition centres on the fact that, under the proposals, the right to negotiate on behalf of workers is not accorded to trade unions and, in addition, many of the matters identified for negotiations aim to reduce the scope of worker influence.

All these national initiatives to introduce negotiated forms of board-level worker representation have not met with any success. Now it would appear that efforts are under way to achieve at European level what has failed at national level.

Moreover, this whole approach is flawed because of the fact that it rests on an incorrect presumption. The negotiation-based solutions for employee involvement established in relation to the European company

(SE),<sup>7</sup> the European cooperative society<sup>8</sup> and in the case of cross-border mergers<sup>9</sup> constitute a successful compromise between different European systems of worker participation. They are not intended as a model for national systems. The EU law requirements apply to undertakings operating on a cross-border basis and have to resolve the tensions between different national approaches to industrial relations. However, at a national level, the need to unify different approaches to industrial relations does not exist. Thus, there is no reason why, as a matter of EU law, fundamental changes should be made to the successful instruments of board-level worker representation established in Germany. For more details on this point, see DGB (2009).

In addition, the Directives on the European Company and the European Cooperative Society both make specific reference to national law which must establish fall-back solutions applicable where negotiations fail. Moreover, Article 16(1) of Directive 2005/56 on Cross-Border Mergers provides that the company resulting from such merger shall be subject to the rules in force concerning employee participation, if any, in the Member State where it has its registered office.

These provisions make it clear that the European legislative bodies regard the different rules on worker participation in the Member States as consistent with EU law. Quite specifically, the fundamental premise of these directives is to accept the diversity of the worker participation systems within the European Union. Thus, it is already clear at a legislative level that national systems of worker participation are not regarded as operating contrary to EU law.

#### **4. Worker participation as an element of the democratic principle in Europe**

The European social model and its values and visions have become part of a lively debate on the shape of European society. The discussion and analysis of the values implicit in social Europe is very much to be wel-

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7. Council Directive 2001/86/EC, cited above.

8. Council Directive 2003/72/EC of 22 July 2003 Supplementing the Statute for a European Cooperative Society with regard to the involvement of employees, OJL 207, 18.8.2003, p. 25.

9. Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJL 310, 25.11.2005, p. 1.

comed and something which is long overdue. For too long, the debate has focused simply on Europe's economic relevance.

Member States of the European Union are characterised by national social models with robust systems of employee representation and participation in company decision making. In 17 of the 27 EU Member States and in Norway, employee participation at board-level is a reality.<sup>10</sup> This system of participation is underpinned by a notion of active involvement in the decision making processes of the company.

Although, in light of the different traditions, culture and history of the Member States, these national systems are differently structured, they share many common features and, above all, the objectives of solidarity and social justice.<sup>11</sup> Worker participation is recognised as an element of the democratic principle in Europe and puts into practice workers' legitimate right of involvement. To restrict participation would undermine the objectives of the Lisbon Treaty and the notion of European social policy.

A recent ETUC resolution put the matter in the following terms:

The Treaty is clear on this issue and explicitly asks [the EU] to 'support and complement' and thus prevent circumvention of co-determination and other forms of workers participation: 'With a view to achieving the objectives of Article 151, the Union shall support and complement the activities of the Member States in the following fields: (e) the information and consultation of workers; (f) representation and collective defence of the interests of workers and employers, including co-determination' (Article 153).

These basic principles must be recognised by the members of the Reflection Group and, above all, by the European Commission. For many years, the European Union has been losing support and approval amongst its citizens. According to a recent Eurobarometer survey on the internal market, 62% of people believe that the internal market only benefits big companies and 58% think that it has flooded the Member States with cheap labour (Special Eurobarometer 2011). These figures suggest that European politics pays too little attention to the social dimension and

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10. For a good overview, see Conchon (2011).

11. For a comparative law analysis, see Heuschmid (2008).

that disregard for this aspect has increased considerably in recent years. Improvements in the opportunities for competition, freedom of establishment for companies, deregulation and harmonisation: these are the notions which Europe's citizens associate with EU policies. The Commission's decision to bring a further action before the European Court of Justice (ECJ) challenging the terms of Germany's Volkswagen Act has enraged workers' leaders. Addressing 18 000 workers at VW's main plant in Wolfsburg on 7 December 2011, the head of the group's works council Bernd Osterloh condemned the Commission's cold-heartedness (Osterloh 2011: 14).

The latest EU initiatives to harmonise company law also bring with them fewer opportunities for employee involvement. For example, mention should be made here of the proposal for a European private company (SPE),<sup>12</sup> which would allow Member States to restrict the proportion of worker representatives on the supervisory or administrative board of the company to a maximum of one third. This is clearly a proposal which undermines the system of parity of representation, a system which is valued in Germany and has helped the country overcome the financial crisis. It is reported that other Member States, for example, Austria, the Netherlands and Finland are also concerned about the threat to their system of worker participation (Sick and Thannisch 2011). In addition, the proposal to allow the cross-border transfer of the registered office of limited companies,<sup>13</sup> thereby allowing companies to have their registered office and administrative headquarters in different Member States, would pave the way for the spread of shell companies (also known as letterbox companies) to the detriment of workers, creditors and consumers.

These examples demonstrate that Europe is not on the correct path. Worker participation must not be seen as a barrier, as a necessary evil, something which must be tolerated in establishing the internal market. It has to be understood that companies do not simply constitute a private

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12. Proposal for a Council Regulation on the statute for a European private company, COM(2008) 396 final. The latest compromise proposal was presented by the Hungarian presidency in May 2011. See Council document 10611/11.

13. Planned proposal for a 14th company law directive on the cross-border transfer of the registered office of limited companies. The Commission has not published any formal proposal for this directive. For details of this project, see the Commission's website [www.ec.europa.eu/internal\\_market/company/index\\_en.htm](http://www.ec.europa.eu/internal_market/company/index_en.htm)

affair but are institutions which have social responsibilities. Europe does not need fewer opportunities for worker participation. Instead, more opportunities are needed in order to establish transparent and controllable business structures and to ensure respect for the interests of workers and society at large. The Occupy Wall Street movement together with its slogan ‘This is what democracy looks like’ currently bringing people onto the streets worldwide is specific evidence of the fact that people want to exercise more democracy and to claim ownership of it. Direct democracy in the form of worker participation is part of that project.

One of the first steps towards more democracy can be seen in the European Works Council Directive,<sup>14</sup> one of the first common instruments to advance worker participation within the EU. Likewise, mention must be made of the Information and Consultation Directive<sup>15</sup> and of the directive on employee involvement in the European Company.<sup>16</sup> These are signs of the increased European commitment to worker participation:

There is no longer any doubt that the promotion of workers’ participation in a company’s decision making has become an essential part of the Community’s mainstreaming strategy in its social policy agenda. It has definitely crossed the ‘point of no return’ (Weiss 2004: 229).

We have to follow this path further.

## **5. Worker participation and the prohibition on discrimination**

In its assessment of worker participation as a stumbling block to the harmonisation of company law, the Reflection Group has adopted a diametrically opposed path. In that regard, it has concluded that the German legislation on worker participation (and seemingly that of other Mem-

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14. Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees (recast), OJ L 122, 16.5.2009, p. 28.

15. Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community, OJ 2002 L 80, 23.3.2002, p. 29.

16. Council Directive 2001/86/EC of 8 October 2001, cited above.

ber States too) cannot continue in its present form as it (supposedly) infringes EU law.

Its report states: ‘The discrimination against employees in other Member States is in clear conflict with basic principles of the common market’ (Reflection Group 2011: 53).

For several years, various authors in the German legal literature have considered whether the German rules on worker participation are compliant with EU law. For example, Hellwig and Behme conclude that, as the legislation completely excludes the foreign workforce of German companies from all participation on the supervisory board, the rules on the composition of the supervisory board in their current form infringe the prohibition on discrimination and the principle of free movement for workers established by Community law (Hellwig and Behme 2009). Therefore, according to the authors, the German rules cannot be applied and, as a consequence, the supervisory board of German companies must remain free of worker participation.

The complaint levelled is that the rule established in the German legislation on worker participation restricting the electorate and possible candidates for elections to the supervisory board to the workforce based in Germany contravenes EU law.

It is said that these rules restrict the freedom of movement for workers (contrary to Article 45(2) TFEU) and infringe the general prohibition on discrimination on grounds of nationality (established by Article 18(1) TFEU). However, as the following sections will demonstrate, those arguments are unconvincing.

## 5.1 Restriction on the freedom of movement for workers

It is correct to assert that the ECJ has extended the prohibition on discrimination established in Article 45 TFEU to become a prohibition on restrictions.<sup>17</sup> As a result, that article applies to national legislation which in law or in fact restricts the ability of domestic workers to exercise their

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17. Case C-415/93 *Bosman* [1995] ECR I 4921. For a critical assessment of this judgment see Heuschmid (2011).

right to free movement (Franzen 2012). For example, if, as a result of German legislation, a worker in Germany is prevented from taking up employment in another Member State, this constitutes a restriction on the freedom of movement for workers.

The fact that workers employed in Germany lose both their right to vote and to be a candidate in elections to the supervisory board once they move to work at a foreign plant or subsidiary of their company is regarded in this context as a restriction on the freedom of movement for workers.

The same argument applies in relation to the loss of any seat on the supervisory board consequent on a move to another Member State.

This loss of voting and candidature rights is said to make the move from Germany to another EU Member State so unattractive that workers are restricted in their ability to participate in the European labour market. According to this argument, workers would rather reject lucrative and interesting job offers abroad in order to retain their voting and candidature rights in elections to the supervisory board and, in a relevant case, their seat on the supervisory board.

This argument is divorced completely from reality. There is no worker in Germany whose decision whether or not to take up work in another Member State depends solely on his voting and candidature rights in elections to the supervisory board. The decision to take up work abroad is influenced by a mixture of factors. Better quality of life, better working conditions and better career opportunities are the reasons most commonly cited by European citizens for wanting to work abroad (European Commission 2010: 105).

The increasing number of workers in the European Union exercising rights to mobility (Franzen 2012) further disproves the argument. It cannot be said that the possibility to participate in elections to the supervisory board restricts workers from leaving Germany or that workers from other Member States choose to work in Germany in order to participate in elections to the supervisory board. The factors which are decisive for migration always concern living and working conditions.

Moreover, this argument (which, in any event, is somewhat absurd) ignores the fact that the loss of rights connected with board-level employee representation is counterbalanced by the acquisition of new rights in the

new country of employment, for example, the more generous right to strike provided for under French or Italian law.<sup>18</sup>

Similar arguments apply in the case where a worker from Germany loses his seat on the supervisory board as result of moving to a job in another Member State. This is, in practice, an extremely remote possibility. There are only 3 448 worker representatives on the supervisory boards of German companies.<sup>19</sup> Although this figure is not relevant for the legal assessment of any alleged discrimination, it is important that the reader is aware of the dimensions of this issue. Moreover, not every move to work at one of the employer's foreign plants necessarily involves the loss of that worker's seat on the supervisory board. The worker will retain his seat if he continues to perform activities which are within the organisational structure of the German plant.

In order to round off this picture, it must be emphasised that any restriction on the freedom of movement will in all cases be justified.

Germany cannot adopt legislation providing for worker participation in other Member States (Teichmann 2009). German laws can only apply to German matters. National laws can only go as far as a country's borders. This principle of territoriality applies in all European States which have legislation on worker participation. For that reason, German legislation on worker participation does not apply in Austria and the Austrian legislation on worker participation does not apply to workplaces in Germany.

## 5.2 Infringement of the general prohibition on discrimination on grounds of nationality

One of the fundamental principles of EU law is the general prohibition on discrimination on grounds of nationality (Article 18(1) TFEU). Consequently, the question which needs to be answered is whether exclusion of the workforce in another country from participation in elections to a German supervisory board constitutes discrimination on grounds of nationality. The answer is quite clearly 'no'.

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18. See also the discussion in ZIP – Zeitschrift für Wirtschaftsrecht (2009).

19. See the data on supervisory boards compiled by the Böckler Foundation available on its website [www.boeckler.de/38347.htm](http://www.boeckler.de/38347.htm).

In Germany, the right to participate in the system of worker participation is accorded to workers without any distinction between German nationals and nationals of other Member States. Instead, under the 1976 Worker Participation Act, the crucial requirement is an employment relationship with a domestic company. The nationality of the worker is irrelevant.

However, as Iliopoulos-Strangas points out, Article 18 TFEU covers not only overt discrimination based on nationality but also all covert forms of discrimination which, by applying other distinguishing criteria, such as a residence requirement, lead in fact to the same result, as is the case, for example, where a national provision appears to apply generally but in fact predominantly impacts on nationals of other Member States because the distinguishing criteria used typically only place obstacles in the path of nationals of other Member States (Iliopoulos-Strangas 2010: 1120).

In the present case, however, there is no indirect discrimination of that kind, as the adverse treatment of the foreign workers results specifically, as Wißmann correctly observes, from the fact that they remain in their home country and do not take advantage of their right to freedom of movement (Wißmann 2011: Vorbem. par. 63b).

The same conclusion is reached by Teichmann. He observes:

The suggestion that persons living outside a Member State and who do not even wish to enter it should be accorded the benefits of domestic law would appear, to put it mildly, a borderline case as regards the EU principle of non-discrimination. Namely, there are many instances of a difference in treatment based on the place of employment. Are workers employed in Spain by [the German company] Siemens now to be regarded as protected under the German law of dismissal protection? Can Lufthansa continue to accord to its pilots employed in other European countries terms and conditions less favourable than those enjoyed by its pilots whose contract is with the German parent company? If cross-border group management of a German holding company is regarded as sufficient to trigger the comparability of two fact situations, the ECJ is going to be very busy in the near future (Teichmann 2010: 874-875).

Nothing further needs to be added to this argument.

In addition, the contention advanced by supporters of the discrimination thesis, that is, that German worker representatives are only interested in the fortunes of German plants and are ‘more likely than not to vote against the establishment or expansion of foreign plants and subsidiaries’ (Hellwig and Behme 2009: 269), fails to acknowledge corporate realities and turns the task of codetermination on its head. Foreign workforces have no reason to fear German worker representatives on the supervisory board. These are not the individuals responsible for closing plants and restructuring measures. Those matters are still decided by a company’s management. The fact that, in this context, the supervisory board has a right of codetermination serves to protect the German and foreign workforces and constitutes an element of the carefully balanced system of German industrial relations. In common with the (European) trade unions and the works councils at national and European level, the worker representatives on the supervisory board aim to safeguard the interests of all the workforce specifically by reason of the fact that they do not regard redundancies as a cure-all and, instead, seek to develop innovative solutions and do not adhere to the principle of shareholder value. A good example of this approach can be seen in the successful opposition to the closure of the Bosch plant in Vénisieux (France) in 2011.

To presume in all seriousness that foreign workforces would be better protected against redundancies if the German rules on worker participation did not apply and only shareholder representatives were to be present on the supervisory board (a legal consequence of the supposed infringement of EU law) is nothing but an ideological construction.

Although the previous discussion has already disproved the thesis that discrimination results from national rules on worker participation, the following section will consider the legal consequences arising. This examination of the legal consequences of that supposed discrimination will further underline the absurdity of the debate.

### 5.3 Legal consequences of the supposed discrimination

A further issue which deserves consideration concerns the possible consequences of a finding that the rules on board-level worker representation infringe EU law. Three possibilities are conceivable.

- (a) There is no requirement on German companies to have board-level worker representation. ‘As the legislation completely excludes the foreign workforce of German companies from all participation on the supervisory board, the rules on the composition of the supervisory board in their current form infringe the prohibition on discrimination and the principle of free movement for workers established by Community law. Therefore, those rules cannot be applied and, as a consequence, the supervisory board of German companies must remain free of worker participation’ (Hellwig and Behme 2009: 261).

To afford the principle of equality established under EU law such a wide interpretation would constitute a new development. Usually, the order not to apply a certain section of the law relates to the provision which discriminates, not the provision conferring a benefit (Teichmann 2010). In addition, a consequence of this kind would not affect not only the German legislation on board-level worker representation but the legal framework for board-level worker representation across Europe. With the exception of Denmark and Sweden, all remaining EU Member States do not include foreign workforces within the scope of their legislation on board-level worker representation. In Denmark, following the entry into force of the new Companies Act in 2010, ‘employees in foreign subsidiaries [have the possibility] to vote and be eligible as board-level employee representatives on the board at group level. This right is not, however, automatic and depends on the decision of the general meeting of shareholders’ (Conchon 2011: 29). In Sweden, ‘the right for employees working in foreign subsidiaries to be represented on the board of a .. Swedish parent company is not enshrined as such in dedicated legal provisions, but results from the interpretation of the legal definition of a “group” of companies’ (ibid). Thus, in both of those Member States, under certain conditions, workers in foreign subsidiaries have the possibility to participate in the election of board-level worker representatives at group level. In all other Member States, no such possibility exists. Thus, under this interpretation, throughout Europe, at a stroke, board-level worker representation would disappear. However, an outcome of that kind touches a core element of the national legal order in the Member States. In Germany, worker participation has become an important pillar of economic, legal and social stability. In the German system, it constitutes a uniform concept operating on multiple levels and something which addresses the employment relationship from multiple angles. Those who wish to disturb the overall system of worker participation must be capable of

justifying an interference with the freedom of association and freedom of occupation of workers. In particular, they must recognise that such interference will undermine the finely balanced symmetry which ensures a coherent order and settlement in the workplace (Hexel 2006: M70).

In addition, the repercussions of this solution for the European company (SE) may not be ignored. In relation to employee involvement in the European company, the 'before and after' principle applies, that is, if worker participation rights were in force prior to the company's establishment, these must be retained.

Therefore, should worker participation no longer apply to national companies, worker participation would not be triggered on their conversion to a European company.

In my view, this solution is the most absurd.

- (b) A further possibility is interpretation of the rules on worker participation in conformity with EU law in a manner which involves levelling up. This means that the disadvantaged group is henceforth treated in the same way as the group which was previously advantaged (Teichmann 2010: 875).

In my view, this approach is impractical and infringes the principle of territoriality.

Specifically, this would mean that the German legislation on worker participation (and logically also the legislation on worker participation in other Member States) must be interpreted as requiring the national rules on election of worker representatives to include foreign workforces. The strict limitation of such rights to domestic workforces would thereby be removed. In my view, that is not only extremely difficult but also quite simply impractical. Under that solution, the electoral rules governing the election of worker representatives to the supervisory board would apply to all the plants within the company or group regardless of whether those plants are located in Germany or another Member State. This presupposes, however, that the German electoral rules are regarded as binding in all the relevant States. Naturally, this requirement for the rules to be regarded as binding applies likewise to the rules of other Member States governing the election of worker representatives to the relevant company organ.

To that extent, the principle of territoriality would no longer apply and national law would apply on the territory of a foreign State. In this connection, the argument is advanced that only the territorial aspect of board-level worker participation infringes EU law and, as a consequence, only this aspect need not be applied. Inclusion of foreign workforces, whose participation might require, in certain circumstances, underpinning with legal rights to challenge election results and the composition of the supervisory board, would allow the worker participation legislation to be interpreted in a manner in which discrimination is absent and, hence, in conformity with EU law (Rieble and Latzel 2011: 166).

- (c) Finally, the Reflection Group proposes that in relation to worker participation in Germany a negotiating model should be established in line with the rules governing the European company (SE) (Reflection Group 2011: 53).

In my view, this approach is only possible for companies established under the rules of EU law.

Nonetheless, this raises the interesting question of which default rules should apply if the negotiations on worker participation fail. If, as has been suggested, in the event of a failure of negotiations, recourse should had to the rules of national law, for example, the law of the State where the company has its registered office, a further series of legal problems is raised casting doubts on the proposal's logic.

Namely, if in such a case the company had its registered office in Germany, the German legislation on worker participation would apply by default. However, according to the Reflection Group, this legislation infringes EU law and the mere fact of prior negotiations is incapable of curing such an infringement.

It is clear that the default rules applicable to a European company (SE) cannot apply as they govern a different fact situation. That is why the Reflection Group suggests that they apply only by analogy (although it is unclear exactly how).

Finally, I should like to observe that this Reflection Group proposal does not stand any realistic chance of adoption in the near future as unanimity is required for legislation on worker participation.

It would be more sensible, therefore, for the European legislative bodies to concentrate on worker participation rules in relation to corporate forms established under EU law.

## **6. Foreign companies with administrative headquarters in Germany**

From the non-discrimination perspective, it would appear more productive to address the fact that foreign companies with administrative headquarters in Germany are excluded from the system of board-level worker representation.

During the period 2006 to 2010, a further 26 cases were recorded in Germany in which companies adopted a foreign legal form not subject to German rules on board-level worker representation. This increases the total number of companies that have adopted this approach to 43 confirming that this phenomenon has more than doubled in under five years (Sick and Pütz 2011: 35-36). These facts all suggest that the legislation on board-level worker representation should be extended to include foreign companies operating in Germany thereby counteracting the disadvantage experienced by the workforce in those companies. As a result of the increasing number of companies with a foreign legal form but administrative headquarters in Germany sections of the labour market have emerged in which board-level worker representation is absent. However, it is by no means evident why the workforce in such companies, unlike those in German companies, should not have the right to participate at board level. That distinction is illogical, unjust and undemocratic.

For that reason, trade union demands for legislation to include foreign companies with administrative headquarters in Germany within the scope of German rules on board-level worker representation are logically consistent and do not involve any infringement of EU law. According to Weiss and Seifert, 'ensuring the continued existence of a national system of worker participation constitutes .. an overriding reason in the public interest which can justify a restriction on the freedom of establishment for companies from other Member States with administrative headquarters on the national territory' (Weiss and Seifert 2009; see also Sick 2011). Likewise, the academic experts on the commission appointed to develop recommendations for the modernisation of the German

system of board-level worker representation point out that ‘Community law does not preclude the German legislature from subjecting such companies [foreign companies with an administrative headquarters in Germany] to the rules on board-level worker representation in such cases, at any rate, where the substance of that company’s organisation including its workforce are to be found in Germany and, under the law of the country in which that company is incorporated, those workers do not have any worker participation rights’ (Kommission zur Modernisierung der deutschen Unternehmensmitbestimmung 2006: 35). For that reason, the academic experts recommend that ‘the establishment of such companies should be closely observed and, in the event that they appear in appreciable numbers in a size relevant for the purposes of board-level worker representation, appropriate measures compatible with the requirements of EU law should be taken in order to maintain the integrity of the system of board-level worker representation’ (ibid).<sup>20</sup>

## 7. Outlook for the future

The future of worker participation in Europe and the development of this instrument must be viewed increasingly in light of the demands of society for greater democracy in economic affairs. In this area, Europe must have the confidence to adopt its own path and create a regulatory framework which strengthens worker participation.

There must be more focus on the connections between worker participation and the system of political democracy. In Kluge’s view, today’s Europe would be more ‘social’ if the political intentions of the 1960s and 1970s had been realised. If the institutions of industrial democracy had been inserted across the board throughout the European Economic Community, from the outset, the economy would have been subject to greater social control. The idea of board-level worker participation was central to that approach. The Commission’s 1972 proposal for a Fifth Company Law Directive envisaged that in all companies of 500 or more employees operating on a cross-border basis day-to-day management should be separated systematically from the task of controlling company management by a supervisory board. Half of the seats on such a body were to be filled by worker representatives (Kluge 2009: 111).

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20. See on this Seyboth (2007).

Trade unions must have a role in shaping future social policy at the European level. The question to be answered, however, is how trade unions can exercise an influence at the European level in order to facilitate a constitutive social policy. The underlying objective of European social policy, that is, to maintain and develop national welfare state models through the adoption of political initiatives and minimum standards at a European level is currently far from being achieved; more accurately, it has been turned on its head. This is all the more critical following the Treaty of Lisbon as a result of which fundamental social rights are now binding and intended to guide the Union in its social policy actions. In the area of worker participation, this means the implementation of a minimum standard of board-level worker representation in all companies incorporated under EU law. ‘Whenever a company takes on a European corporate form or exercise its EU law right to cross-border mobility, the workforce must have the opportunity to be present in the governing bodies of that company’ (DGB 2010: 4).

However, it is important to counsel against unrealistic expectations. From the outset, European social policy has always been the snail which has advanced very slowly on the tails of integration in the internal market, heavily dependent on the political complexions in the Member States. Ultimately, European social policy is determined by the Council in which, at present, conservative governments are in the majority. This does not make the matter any easier. At the same time, discussions must be continued and taken forward with a view to ensuring minimum standards for worker participation in companies which have adopted a European legal form. This is a demand which the ETUC has advanced repeatedly. Its Executive Committee resolution of December 2011 put it as follows: ‘Furthermore, the ETUC Congress demanded European minimum standards for worker participation in order to strengthen the implementation of worker information and consultation rights in the EU and to confirm that the EU respects and promotes different forms of board-level representation in European legal entities like SE, SCE and SPE and in the Member States where such systems exist’ (ETUC 2011: par. 3).

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# Chapter 8

## Investor agreements and collective labour law

Wolfgang Däubler

### 1. Introduction\*

Board level employee representation (BLER) is considered to be an important tool for helping safeguard employee interests and promoting sustainable companies. However, this mechanism has important limitations. First of all, some countries in the EU and many countries outside of it have no tradition of codetermination and no legal framework for BLER. Secondly, there are limits to what worker representatives can achieve through BLER alone. Therefore it is important to identify instruments that can supplement BLER or that can be used in countries without a tradition of codetermination.

One such instrument is an agreement between trade unions and investors. These investor agreements are especially useful for supporting labour interests in takeover situations, where a controlling ownership stake is transferred from one shareholder (or group of investors) to another. One such example where this relatively new instrument was used is the takeover of the German construction company Hochtief by its Spanish competitor ACS in 2010/11. The German trade union IG BAU was able to negotiate an investment agreement with the new owner regulating investment after the takeover. Based on the case of the German legal framework, the Hochtief-ACS example shows how investor

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\* Chapter 8 was translated from German by Paul Skidmore.

1. For an analysis, see C. Seibt and O. Wunsch 'Investorenvereinbarungen bei öffentlichen Übernahmen', *Der Konzern* 2009, pp. 195-213; R. Kiem 'Investorenvereinbarungen im Lichte des Aktien- und Übernahmerechts', *Die Aktiengesellschaft* 2009, pp. 301-312; and J. Reichert and N. Ott 'Investorenvereinbarung mit der Zielgesellschaft – Möglichkeiten und Grenzen der Einflussnahme auf Gesellschaftsorgane', in M. Habersack and P. Hommelhoff (eds) *Festschrift für Wulf Goette*, Munich 2011, pp. 397-412.

agreements can be designed and incorporated into a national context of labour and company law without difficulties.

## 2. Takeovers and investor agreements

Where an investor buys up the shares of a listed company, this can have serious implications not only for the company's future direction but also for its directors and members of the supervisory board. If these actors do not consent to this development, the transaction is generally referred to as a hostile takeover and, as such, cannot usually be prevented simply by legal means. However, if there are forces within the target company resistant to the takeover, such as minority shareholders holding a veto, it may both be possible and opportune to establish certain limits which will restrain the investor following the takeover. For these purposes, investor agreements have been developed. The target company, represented by its board, and the investor agree on certain terms.<sup>1</sup> For example, it is conceivable that the investor agrees to retain the existing members of the supervisory board for the next three years or, as was the case in the agreement between the Schaeffler group and the tyre and motor vehicle parts manufacturer Continental AG,<sup>2</sup> not to acquire a holding of more than 49.9% and thus not to become the majority shareholder. It may also commit not to question the future of a particular plant or to retain certain production lines. Analysis from the company law perspective has tended to focus on the extent to which company law permits agreements of this kind. In particular, questions have been raised in light of the rules on the independence of both the management and the supervisory boards.<sup>3</sup>

Labour law appeared not have become involved in this new anticipatory instrument emerging within the sphere of company law. This all changed at the latest on 21 December 2010 when the German trade union IG BAU reached an accord with the leading Spanish construction company ACS<sup>4</sup> that was in the process of establishing a controlling stake in the German construction firm Hochtief AG.<sup>5</sup> This accord provides for Hochtief to re-

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2. The investor agreement of 21 August 2008 is available online: [www.handelsblatt.com/unternehmen/industrie/investorenvereinbarung](http://www.handelsblatt.com/unternehmen/industrie/investorenvereinbarung) [accessed 24 August 2011].

3. On this point, see Reichert and Ott, cited above.

4. Actividades de Construcción y Servicios S.A.

5. The wording of the accord is available online: [www.igbau.de/Binaries/Binary83348/Vereinbarung\\_IGBAU\\_ACS\\_Wortlaut.pdf](http://www.igbau.de/Binaries/Binary83348/Vereinbarung_IGBAU_ACS_Wortlaut.pdf) [accessed 27 December 2011].

main an independent company subject to the rules on worker participation at board level operative either in its own right or through the activities of subsidiaries. Conversion of the company to a European company (SE) is expressly excluded. The company's administrative headquarters are to remain in the city of Essen. In addition, ACS agrees not to intervene in operational decisions taken by Hochtief's management and indicates that it does not plan to make changes to working conditions or to the arrangements for worker participation at plant and company level. ACS also indicates that the board of Hochtief can count on its support if it decides to offer employees a guarantee of continued employment. Under the accord, IG BAU will remain the sole negotiating partner within the Hochtief group. In addition, ACS agrees that in those companies within the group subject to worker participation at board level candidates will only be proposed as board of directors' member responsible for human resources (Arbeitsdirektor) following negotiations with the trade union representatives on the relevant supervisory board. This degree of worker influence comes close to the regime operating in the coal and steel industries. These provisions will all take effect as soon as ACS acquires a majority shareholding. Until it has acquired the necessary 50% (and provided that its holding does not fall below 30%), ACS agrees to act within the spirit of this accord.

The accord is silent on the law applicable to this agreement. As the obligations (whether legal or moral) all have to be satisfied in Germany, there is manifestly a closer link to that country than to Spanish law and, as a consequence, in light of the principle set out in Article 4(3) of the Rome I Regulation (Regulation (EC) No 593/2008), German law must apply.

The accord raises some unusual questions. Does the law permit a company's conduct to be fixed in advance by means of such an accord? Is the accord governed by the rules of collective labour law? Or, instead, should it be considered nothing more than a regular contract which an investor has agreed not with the target company but with a trade union? What are the limits governing each type of agreement? Is it lawful to take strike action with a view to reaching such an accord? To begin to answer these questions we must first remind ourselves of the legal forms which are generally open to trade unions in German labour law.

### 3. The legal instruments available

#### 3.1 Collective agreements

The predominant instrument used in structuring a consent reached between trade unions and employers is the collective agreement (*Tarifvertrag*). In the context of this book, a detailed examination of that instrument would be as helpful as carrying coals to Newcastle. Suffice it to say that if an agreement is not reached, workers may strike with a view to persuading employers to conclude an agreement of that kind. This also applies in relation to collective agreements which do not lay down terms and conditions for workers (i.e. do not have a normative or regulatory function) but are simply limited to defining relations between employers and trade unions.<sup>6</sup> Existing law does not distinguish at any point between elements of a collective agreement for which workers may lawfully strike and elements in respect of which strikes are not permitted. On the contrary, the Collective Agreements Act (*Tarifvertragsgesetz*) treats the contractual part of the collective agreement (governing relations between employers and trade unions) on a par with the normative part. Moreover, there is nothing to suggest that the legislation envisages any difference in the process by which an agreement is reached on each of these parts. In addition, many substantive issues are equally as susceptible to regulation in the normative part of a collective agreement as in its contractual part. Furthermore, at the start of industrial action it is in many cases unclear what legal form will be given to the final outcome of the negotiations. What is clear, however, is that it would be incompatible with Article 9(3) of the Basic Law (*Grundgesetz*) to remove the contractual part of a collective agreement from the range of objectives for which workers may lawfully strike. From the traditional perspective, such a restriction would be tantamount to declaring certain working and economic conditions, more specifically, anything that cannot be expressed in normative provisions, as beyond the purview of a strike and, consequently, would render it impossible to achieve a balance between the two opposing interests. For that reason, the overwhelming majority of legal writers share the view taken by the Federal Labour Court (*Bundesarbe-*

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6. To the same effect, see the judgment of the Federal Labour Court of 12 September 1984 in Case 1 AZR 342/83, reported in *Der Betrieb* 1984, p. 2563.

*itsgericht*),<sup>7</sup> namely, that it is lawful to strike with a view to obtaining the contractual part of a collective agreement.<sup>8</sup>

### 3.2 Collective accords

The Federal Labour Court has held consistently<sup>9</sup> that trade unions and employers are also entitled to conclude collective accords (*sonstiger Kollektivvertrag*), that is, a form of collective agreement to which the Collective Agreements Act does not apply. These accords are commonly used by trade unions when agreeing with companies threatened with a strike a framework for emergency service provision. As a rule, both parties presume that the accord does not constitute a collective agreement within the meaning of the legislation. The parties do not observe the requirements for writing,<sup>10</sup> nor do they follow the involved procedures generally required under their own rules in order to conclude a collective agreement.<sup>11</sup> Moreover, practice also demonstrates that an individual member of an employers' association may prefer to agree an accord (and not a collective agreement) since conclusion of a formal company-level collective agreement could provoke major repercussions within that as-

7. *Ib id.*

8. P. Berg, H. Platow, C. Schoof and H. Unterhinninghofen *Tarifvertragsgesetz und Arbeitskampfrecht*. Kompaktkommentar, 3rd edition, Frankfurt 2010, AKR paragraph 24; W. Däubler in W. Däubler (ed.) *Tarifvertragsgesetz. Kommentar*, 3rd edition, Baden-Baden 2012, Introduction, paragraph 872; T. Dieterich in R. Müller-Glöge, U. Preis and I. Schmidt (eds) *Erfurter Kommentar zum Arbeitsrecht*, 12nd edition, Munich 2012, Art. 9 Abs. 3 GG paragraph 114; F. Gamillscheg *Kollektives Arbeitsrecht*, Volume I, Munich 1997, § 22 I 3 b (p. 1070); M. Jacobs 'Die Erkämpfbarkeit von firmenbezogenen Tarifverträgen mit verbandsangehörigen Arbeitgebern', *Zeitschrift für Tarifrecht* 2001, pp. 249-257, at p. 252; M. Löwisch and V. Rieble *Tarifvertragsgesetz*, 2nd edition, Munich 2004, § 1 paragraph 422; H. Otto, *Arbeitskampf- und Schlichtungsrecht*, Munich 2006, § 5 paragraph 19 et seq.; U. Zachert in E. Kempen and U. Zachert (eds) *Tarifvertragsgesetz*, 4th edition, Frankfurt 2006, § 1 paragraph 761. For a different view, see T. Mayer-Maly 'Gemeinsame Einrichtungen im Spannungsfeld von Tarifmacht und Organisationspolitik', *Betriebs-Berater* 1965, pp. 829-834, and recently to the same effect S. Greiner "'Tarifsozialplan" bei Betriebsübergang?' *Neue Zeitschrift für Arbeitsrecht* 2008, pp. 1274-1281, at p. 1277 with further references.

9. See judgments of 28 September 1983 in Case 4 AZR 313/82, reported as AP Nr. 2 zu § 1 TVG Tarifverträge: Seniorität; 28 July 1988 in Case 6 AZR 249/87, reported as AP Nr. 1 zu § 5 TVArb Bundespost and in *Betriebs-Berater* 1988, p. 2111; 5 November 1997 in Case 4 AZR 872/95, reported as AP Nr. 29 zu § 1 TVG; and 14 April 2004 in Case 4 AZR 232/03, reported in *Neue Zeitschrift für Arbeitsrecht* 2005, p. 178.

10. See, for example, the facts in Case 1 AZR 676/92, judgment of the Federal Labour Court of 13 July 1993, reported as AP Nr. 127 zu Art. 9 GG Arbeitskampf.

11. A similar conclusion is reached by G. Thüsing in H. Wiedemann (ed.) *Tarifvertragsgesetz*, 7th edition, Munich 2007, § 1 paragraph 24.

sociation.<sup>12</sup> In addition, accords have been reached on any number of issues from the modernisation of the public administration<sup>13</sup> to the retention of worker participation at company level.<sup>14</sup> These are all situations in which it is doubtful whether a collective agreement (as defined in legislation) would be permitted.

The conclusion of collective accords constitutes an activity specific to the collective actors of labour and management and hence derives its legitimacy from Article 9(3) of the Basic Law.<sup>15</sup> In turn, this constitutional foundation means that these accords must relate to ‘working and economic conditions’, as specified in that provision. Outside of this area, the parties enter a terrain beyond the scope of their specific competence. Whether or not strikes may be used to persuade an employer to sign a collective accord remains undecided by the courts. Different views are possible on this question.

If one takes the view that strikes are permissible even if they are not directed towards the conclusion of a collective agreement, the situation at issue here does not pose any problems. Strikes in pursuit of a collective accord are evidently much more closely aligned with the traditional model (pursuit of a collective agreement) than those intended as a means of (political) protest or concerning terms and conditions included in individual employment contracts.<sup>16</sup> The question whether the legality of a strike is contingent on the pursuit of an objective capable of regulation by means of collective agreement was expressly left open by the Federal

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12. For an example of this practice, see the accords concluded in Eastern Germany according to which teachers agreed to a reduction of 10% or 15% in working hours and in return employers made a commitment not to introduce compulsory redundancies.
  13. On this point, see T. Blanke *Verwaltungsmodernisierung. Direktionsrecht des Arbeitgebers, Mitwirkungsrechte des Personalrats und Tarifautonomie*, Baden-Baden 1998, p. 79 et seq.; H. Plander ‘Nichttarifliche Übereinkünfte zwischen Gewerkschaften und Trägern öffentlicher Gewalt’, in U. Engelen-Kefer, M. Schoden and U. Zachert (eds) *Arbeitsrecht in der Bewährung: Festschrift für Karl Kehrmann*, Cologne 1997, pp. 295-320; K. Lörcher and R. Armbruster ‘Die Vereinbarung über die Rahmenbedingungen des Wechsels von Beamten der Deutschen Postbank AG zur Deutschen Post vom 9. September 1999’, *Zeitschrift für Tarifrecht* 2000, pp. 483-489.
  14. See, for example, accords made in the 1950s with a view to retaining special forms of worker participation in the coal and steel industries. On this, see W. Spieker ‘Tarifautonomie und Mitbestimmung’, *Mitbestimmungsgespräch* 1962, p. 182. On current practice, see C. Seibt ‘Privatautonome Mitbestimmungsvereinbarungen. Rechtliche Grundlagen und Prozesshinweise’, *Die Aktiengesellschaft* 2005, pp. 413-429.
  15. This is the view taken by the Federal Labour Court. See the case-law cited in footnote 10.
  16. On this point, see W. Däubler in W. Däubler (ed.) *Arbeitskampfrecht*, 3rd edition, Baden-Baden 2011, § 13 paragraph 17 et seq.

Labour Court in judgments of 2002<sup>17</sup> and in 2007.<sup>18</sup> However, having regard to the interpretation generally accorded to the strike guarantee enshrined in Article 6(4) of the European Social Charter,<sup>19</sup> relevant also in defining the scope of the right guaranteed by Article 11 of the European Convention on Human Rights,<sup>20</sup> the Federal Labour Court would be well advised to abandon its traditional approach. This would avoid further defeats at the hands of the European Court of Human Rights in Strasbourg and ongoing conflict with the various European courts and supervisory bodies. If, on the other hand, one continues to take the traditional approach, that is, that strikes constitute a means to facilitate free collective bargaining as only where strikes are permitted can negotiations take place on an equal footing, the same logic must apply in the case of collective accords. These, too, cannot be achieved simply by appealing to employers or, in the well-known words of the Federal Labour Court, by engaging in ‘collective begging’.

### 3.3 Contracts under the law of obligations

Finally, it is open to the collective organisations of labour and management to regulate their relations using regular contracts governed by the law of obligations. To the extent that their agreement covers issues which cannot be classified as ‘working and economic conditions’ this is the only option available. A trade union has the legal capacity to conclude such contracts even if it has not been entered in the register of associations. In this case, pursuant to section 54 of the Civil Code (*Bürgerliches Gesetzbuch*), the law governing partnerships applies. According to recent case-law of the Federal Court of Justice (*Bundesgerichtshof*),<sup>21</sup> a partnership acquires legal capacity as soon as it assumes the appearance of a partnership in dealings with third parties. For the purposes of persuading an employer to conclude such a contract, industrial action may not be used.

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17. Judgment of 10 December 2002 in Case 1 AZR 96/02, reported in *Neue Zeitschrift für Arbeitsrecht* 2003, p. 735, at p. 740.

18. Judgment of 24 April 2007 in Case 1 AZR 252/06, reported in *Neue Zeitschrift für Arbeitsrecht* 2007, p. 987, at p. 994 point 79.

19. On this, see K. Lörcher in W. Däubler (ed.) *Arbeitskampfrecht*, § 10 paragraph 34.

20. *Ibid.*, § 10 paragraph 42.

21. Judgment of 29 January 2001 in Case II ZR 331/00, reported in *Juristenzeitung* 2001, p. 655 et seq.

### 3.4 Freedom to choose the appropriate legal instrument

The collective organisations of labour and management are free to choose whether to conclude a collective agreement, a collective accord or a contract under the law of obligations.<sup>22</sup> There is no compelling reason why, as a matter of law, a collective agreement should take precedence. Although only collective agreements are endowed with a normative function pursuant to section 4(1) of the Collective Agreements Act, the parties should not be obliged to use this legal instrument. They are entitled to restrict themselves to instruments with fewer capabilities. In these circumstances, there will not be any risk that the requirement for the written form established in section 1(2) of the Collective Agreements Act will be circumvented or deprived of its meaning through the conclusion of a collective accord not subject to any requirements as to form. If a trade union wishes to enter the terrain of collective accords or contractual agreements in pursuit of which strikes are not permitted and, consequently, foregoes the opportunity to conclude an agreement with normative effect, it is entitled to benefit from this absence of requirements as to form. Moreover, given that such agreements do not automatically establish individual terms and conditions of employment, there is no comparable requirement for transparency.

Whether or not an agreement must be regarded as collective agreement, a collective accord or a contract under the law of obligations depends on the wishes of the parties.<sup>23</sup> Sometimes it is expressly stated in an agreement (or made clear in some other manner) that the accord is not to be regarded as a collective agreement. Naturally, this is then binding. The most important agreements of this kind are the social partner agreements in the German chemicals industry.<sup>24</sup> The same applies if an agreement is specified as merely preliminary to the conclusion of a collective agreement.

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22. This view is also taken by R. Krause in M. Jacobs, R. Krause and H. Oetker *Tarifvertragsrecht*, Munich 2007, § 1 paragraph 140.

23. See the judgments of the Federal Labour Court of 5 November 1997 in Case 4 AZR 872/95, reported as AP Nr. 29 zu § 1 TVG Bl. 4 R; and 14 April 2004 in Case 4 AZR 232/03, reported in *Neue Zeitschrift für Arbeitsrecht* 2005, p. 178. To the same effect, see F. Gamillscheg *Kollektives Arbeitsrecht*, Volume I, § 12, 9c (p. 510); H. Plander, cited above, p. 307; G. Thüsing in H. Wiedemann (ed.) *Tarifvertragsgesetz*, § 1 paragraph 25; U. Zachert 'Sozialpartnervereinbarungen – ein Modell für die Zukunft?', in U. Isenhardt and U. Preis (eds) *Arbeitsrecht und Sozialpartnerschaft Festschrift für Peter Hanau*, Cologne 1999, pp. 137-148, at p. 141.

24. On this point, see U. Zachert (footnote 23) and for a more recent assessment W. Däubler 'Soft law und kollektives Arbeitsrecht', Supplement 1/2011 to the *Neue Zeitschrift für Arbeitsrecht*, pp. 42-47.

If, however, the agreement is silent on this point, interpretation will be required. As the issue to be resolved is the nature of the legal instrument chosen by the parties, the principles of contractual interpretation established in sections 133 and 157 of the Civil Code apply.<sup>25</sup> Inclusion of provisions clearly intended to govern individual employment relationships points in favour of a collective agreement. On the other hand, a collective accord may be presumed if the agreement establishes only objectives requiring further implementation or concerns matters unconnected to the individual employment relationship, for example, on worker participation at company level. A further aspect to be considered is the previous conduct of the parties. A sudden switch from one legal instrument to another may only be presumed if there is compelling evidence to support this. Where there is considerable uncertainty over the parties' competence to conclude a collective agreement in the matter at hand, this may well suggest that the parties, wishing to avoid a dispute, opted, instead, not to use a collective agreement. Hence, it must be presumed a fortiori that the parties did not intend to adopt a legal instrument which would result in the failure of their agreement. In certain circumstances, this may point in favour of a purely contractual arrangement.

### 3.5 Mixed forms

It is conceivable that the parties may adopt hybrid or mixed agreements in which certain provisions are intended to have the characteristics of a collective agreement, others have the quality of a collective accord and the remainder are of a purely contractual nature. There is nothing objectionable to this approach as long as the legal character assigned to each provision can be determined through interpretation. In substance, this is nothing other than a special form of a mixed contract in which certain elements of various contractual forms are brought together under one roof.<sup>26</sup> This possibility to make use of a mixed contract has not been called into question by the case-law of the Federal Labour Court.<sup>27</sup> In the case of company agreements involving both trade unions and works councils, it requires simply that the agreement is clear on which part

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25. See the case-law cited in footnote 23.

26. On this point, see W. Däubler *BGB kompakt*, 3rd edition, Munich 2008, Chapter 13, paragraph 16 et seq.

27. Judgment of 15 April 2008 in Case 1 AZR 86/07, reported in *Neue Zeitschrift für Arbeitsrecht* 2008, p. 1074.

constitutes a workplace agreement (*Betriebsvereinbarung*) and which part must be characterised as a collective agreement. This need to categorise provisions according to their legal character does not pose any problems of principle in the situation being examined in this chapter. A dual legal base,<sup>28</sup> something which may be useful in the case of a social plan or an ‘alliance for jobs’, is not essential here.

#### **4. Does an investor in a company have the legal capacity to conclude a collective agreement?**

The uniform view taken by the authors of the leading commentaries on the Collective Agreements Act is that a business cannot conclude a collective agreement unless it is the employer of one or more employees.<sup>29</sup> It suffices for these purposes that a business intends to conclude contracts of employment; the contracts do not need to have been signed.<sup>30</sup> For that reason, if a parent company in a group or a holding company does not have any employees of its own it will be regarded as lacking the capacity to conclude a collective agreement. To this extent, only contractual agreements under the law of obligations are possible.<sup>31</sup> This is consistent with the wording of section 2(1) of the Collective Agreements Act which specifies as possible parties to a collective agreement, in addition to trade unions and employers’ associations, only individual employers.

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28. Previous case-law of the Federal Labour Court regarded it as self-evident that an agreement may constitute both a workplace agreement and a collective agreement. See its judgment of 24 November 1993 in Case 4 AZR 225/93, reported in *Der Betrieb* 1993, p. 2436. In support of this approach, see C. Meyer ‘Der Firmentarif-Sozialplan als Kombinationsvertrag’, *Der Betrieb* 2005, pp. 830-833. However, in passing, it should be noted that the 2008 judgment of the Federal Labour Court (see previous footnote) made no mention of the 1993 judgment. An omission of that kind might possibly have been avoided through a more careful study of the legal commentaries.

29. E. Kempen in E. Kempen and U. Zachert (eds) *Tarifvertragsgesetz*, § 2 paragraph 88; H. Oetker in H. Wiedemann (ed.) *Tarifvertragsgesetz*, § 2 paragraph 123 et seq.; and G. Peter in W. Däubler (ed.) *Tarifvertragsgesetz*, § 2 paragraph 84.

30. See the judgment of the Federal Labour Court of 24 June 1998 in Case 4 AZR 208/97, reported as AP Nr. 1 zu § 20 UmwG. See also M. Löwisch and V. Rieble *Tarifvertragsgesetz*, § 2 paragraph 149; and H. Oetker in H. Wiedemann (ed) *Tarifvertragsgesetz*, § 2 paragraph 128. Moreover, the Federal Labour Court has upheld the conclusion of a company-level collective agreement covering the employees of a company that at the time the agreement was signed had not yet been founded. See its judgment of 24 January 2001 in Case 4 AZR 4/00, reported as AP Nr. 1 zu § 3 BetrVG 1972.

31. See M. Löwisch and V. Rieble *Tarifvertragsgesetz*, § 2 paragraph 148; and H. Oetker in H. Wiedemann (ed.) *Tarifvertragsgesetz*, § 2 paragraph 145.

However, to be regarded as an employer a party must employ or intend to employ one or more employees.<sup>32</sup>

Even if an investor acquires 100% of the shares in a company it will not become a party to the contracts of employment. It is true that, in practice, even in a public limited company (*Aktiengesellschaft*), where decision-taking powers are vested with the management board and supervisory board, an investor will be in a position to exercise considerable influence on working conditions such as to impact on the company's fortunes. Nonetheless, this does not change the fact that it will not become party to the contracts. The question whether in cases of severe abuse of the corporate form different rules apply need not detain us here. The possibility to pierce the corporate veil remains the exception not the rule. Moreover, this technique simply extends the list of parties which may be held liable or widens the basis of their liability. However, it does not result in any change to the identity of the contracting parties.<sup>33</sup>

Given the fact that the real authority and decision-making power can hide behind the corporate veil and, as a result, may counteract any possibility to have sensible negotiations with a view to reaching an agreement, this situation might be regarded with some concern. However, reform to section 2(1) of the Collective Agreements Act remains unnecessary provided that the instrument of collective accords continues to be legally recognised as a device by which agreements at a collective level can be made also involving the parties with the real decision-making powers.

The investor agreement concluded between IG BAU and ACS does not constitute a collective agreement. For good reason, it is not specified as such. Instead, the parties refer to an 'accord'. Moreover, it does not contain any provisions which seek to directly shape the substance of individual employment relationships.

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32. The fact that ACS is an employer of workers in Spain does not justify treating it as having the capacity to conclude a collective agreement in the entirely different role of an investor.

33. For an overview of the various types of liability following the piercing of the corporate veil, see W. Däubler in W. Däubler, M. Kittner, T. Klebe and P. Wedde (eds) *Kommentar zum BetrVG*, 13th edition, Frankfurt 2012, §§ 112, 112a paragraph 188 et seq.

## 5. Can an investor agreement be regarded as a collective accord?

Both the permitted scope of a collective accord and the parties competent to conclude such accords are matters which have attracted relatively little attention hitherto. One explanation may be the fact that such accords have generally always been concluded on a consensual basis and, as a result, legal challenge would have been counterproductive. It can be taken as agreed that the parties to such agreements must address matters considered to be within the domain of 'working and economic conditions'. There does not appear to be any justification for removing certain issues from that domain and precluding regulation by way of collective accord. On the contrary, the diversity of industrial practice, in which all manner of issues have been made subject to collective accord,<sup>34</sup> would appear to suggest that further restrictions are unnecessary. Similarly, the fact that the entity on the employers' side is not itself the employer would appear immaterial. In light of the spirit of Article 9(3) of the Basic Law, that is, to facilitate an equal footing for negotiations between the parties on the matters specified in that provision, it must be regarded as sufficient that the partner to the agreement is in a position to influence the working and economic conditions of the employees represented by the trade union. For this reason, the law allows collective accords to be reached with a parent company not having any employees of its own.<sup>35</sup> Similarly, the 1991 agreement on the calculation of social plan benefits<sup>36</sup> negotiated between trade unions and the Treuhandanstalt (the agency responsible for privatising companies previously controlled by the State in the German Democratic Republic) had as a signatory party an entity which was not as such employer of the workforce threatened by the redundancies. Only in the purely theoretical situation that a party to the agreement is a third party without any ability to influence the employers' side would the agreement no longer fall within the ambit of Article 9(3) of the Basic Law.

Thus, all the factors appear to suggest that the investor agreement may be regarded as a collective accord. It is conceivable, nonetheless, that

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34. For a more detailed overview, see W. Däubler in W. Däubler (ed.) *Tarifvertragsgesetz*, Introduction, paragraph 847 et seq. and U. Zachert in E. Kempen and U. Zachert (eds) *Tarifvertragsgesetz*, § 1 paragraph 736 et seq.

35. See above footnote 32.

36. For more details on this agreement, see W. Däubler, 'Verbesserungen im Sozialplanrecht der neuen Bundesländer', *Arbeitsrecht im Betrieb* 1991, pp. 179-180.

certain elements lack the necessary link to working and economic conditions and, as a result, only take effect as provisions of a contract under the law of obligations. However, this cannot be presumed in the present case simply by reason of the fact that at the time the accord was reached ACS was merely a prospective controlling shareholder. The task of maintaining and improving working and economic conditions includes the taking of measures with a view to avoiding future problems and pursuit of agreements with those parties expected to take the helm in the near future.<sup>37</sup> This approach is reflected in part in the law on the constitution of the workplace which accords to the economic committee (a committee appointed by the works council in firms with over 100 employees), pursuant to point 9a of section 106(3) of the Works Constitution Act (*Betriebsverfassungsgesetz*), the right to be informed within the scope of its competence on all matters connected with an upcoming third-party takeover of the employer.<sup>38</sup>

Could the trade union IG BAU have organised lawful industrial action in pursuit of the investor agreement? Although this question did not arise in the case at hand, the answer in legal terms must be ‘yes’. Had industrial action been contemplated, the particular twist to the situation would have been the fact that such action would not have hit the investor directly (with whom the trade union wished to reach an agreement) but simply the company in which that investor was seeking to acquire a majority holding. However, if the investor had already acquired a significant holding and its intention to increase that was definitive, it would have to be presumed that the industrial pressure was aimed not against some unconnected third party but against a party with a substantive interest in the matter.

At the same time, the case at hand provides an opportunity to re-examine the effectiveness of industrial action with a view to achieving certain goals. Evidently, there are circumstances which are considerably more unattractive to a company than a withdrawal of labour lasting for a week or so and which result, therefore, in more far-reaching concessions. From the perspective of ACS, the crucial issue was whether as a

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37. To the same effect, see the short written opinion by U. Preis of 25 January 2011.

38. The fact that this right is of limited practical effect is, of course, an entirely different matter. On that point, see W. Däubler in W. Däubler, M. Kittner, T. Klebe and P. Wedde (eds) *Betriebsverfassungsgesetz*, 13th edition, § 106 paragraph 86 et seq., with further references.

foreign investor it would be treated as an ‘intruder’ or whether German competitors and authorities would apply the usual standards of fairness. The first possibility is laden with risks which are difficult to predict and, should they materialise, these could result in a detriment, if not a serious detriment, to the company’s financial position. For that very reason, ACS was willing to make far-reaching concessions going significantly beyond the standard content of collective agreements.

Recent corporate behaviour features two further instances in which public pressure resulted in decisions being taken which cannot easily be conceived as the objective of a legitimate strike. The first concerns the retail group Lidl, whose image was already seriously tarnished following revelations that surfaced in 2008 detailing the illegal surveillance of its workforce.<sup>39</sup> A year later, a further scandal emerged. Data stored illegally concerning health and sickness records of the workforce was found abandoned in a waste disposal container. As a result, the head of its German operations had to leave<sup>40</sup> and leading data protection experts were hired to develop a scheme for improved data protection. By way of contrast, it is barely conceivable that a strike could be pursued with the objective of forcing the chairman of a company’s board to resign. Such a tactic would almost certainly be opposed by the argument that, as a matter of company law, the board must ‘exercise its own responsibility’ in managing the company’s affairs (section 76(1) of the Stock Corporations Act (*Aktiengesetz*)) and, hence, that this cannot be questioned by means of a strike. The risk of a drop in sales as a result of consumers avoiding its stores is likely to be perceived by a company as a considerably greater threat than the much more remote likelihood of being hit by a strike lasting for a few days.

The second case concerns the retail group Schlecker, a well-known retailer of household essentials which in the meantime became insolvent. This company hit the headlines in connection with the restructuring of its stores. It emerged that it had dismissed the workers in those stores for redundancy before re-hiring them on only 50% of their previous wages through Meniar, another company in the group, which operated as

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39. On the specific incidents, see the interesting report by the data protection supervisor for Baden-Württemberg published in *Recht der Datenverarbeitung* 2008, pp. 216-218.

40. See the report published in the *Süddeutsche Zeitung* newspaper [www.sueddeutsche.de/wirtschaft/datenschutzaffaere-bei-discounter-das-system-lidl-1.402173](http://www.sueddeutsche.de/wirtschaft/datenschutzaffaere-bei-discounter-das-system-lidl-1.402173) [accessed 27 August 2011].

a temporary employment agency. That agency then placed those workers in jobs similar or identical to their previous positions. The public criticism of that scheme resulted in Schlecker abandoning the practice within a few months and, in its place, concluding a collective agreement with the trade union ver.di applying to all employees within the group.<sup>41</sup> A trade union demand backed by the threat of a strike that Schlecker should close its subsidiary Meniar would certainly have provoked considerable legal controversy. Many would have argued that the decision whether or not to continue the operations of a subsidiary is a commercial decision which is protected by the constitutional freedom to pursue a trade or business (Article 12(1) of the Basic Law).

These examples help underline the fact that the decline in the importance of the collective bargaining system is caused not only by falling membership levels on both sides and a splintering of the workforce into smaller and more diffuse groups. Also the limitations imposed on the right to strike have weakened the collective bargaining system such that other market-based and consumer-driven strategies are now deployed, generally with considerable support from the media, to resolve problems which are, traditionally, core matters for industrial relations. Whether this leads to companies having an easier ride is difficult to judge. Suffice it to say that clumsy and short-sighted corporate behaviour can provoke losses considerably greater than those resulting from a week-long strike.<sup>42</sup>

## 6. Individual issues

In light of the novelty of the IG BAU – ACS accord, it appears appropriate to undertake a legal analysis of its individual provisions. This may be of assistance in the case of comparable accords in the future.

### 6.1 Provisions on working and economic conditions

In paragraph 4 of the accord, ACS indicates that it ‘respects’ the collective and workplace agreements in force at Hochtief and that it does

41. For more details, see [www.mindestlohn.de/news/meldung/2010/juni-2010/schlecker-lohndumping-gestoppt/](http://www.mindestlohn.de/news/meldung/2010/juni-2010/schlecker-lohndumping-gestoppt/) [accessed 4 January 2012].

42. On the adverse effects of a strike and the possibility to minimise these as a result of overtime working following a strike, see W. Däubler in W. Däubler (ed.) *Arbeitskampfrecht*, § 8 paragraph 26 et seq.

not intend to introduce changes to employees' working conditions or to the system of worker participation at plant level and on the supervisory board. This constitutes an acceptance of the existing labour law framework at Hochtief. ACS undertakes to refrain from any initiatives seeking to bring about change in that regard. The accord does not specify what those initiatives might be. However, one can easily imagine steps to influence members of the supervisory board and more particularly members of the management board seeking to persuade them to reduce labour costs. Consequently, it would be difficult to dispute the fact that paragraph 4 relates to 'working and economic conditions'.

Paragraph 5 of the accord strengthens this point in relation to workforce reductions through compulsory redundancies. ACS undertakes not to take any initiatives in that direction. On the contrary, ACS promises to support the board of Hochtief should it decide to give a commitment not to introduce any redundancies. It is clear that here, too, the accord concerns matters within the ambit of Article 9(3) of the Basic Law.

Paragraph 6 of the accord establishes as an objective the safeguarding of the existing jobs in Germany and the creation of new jobs. To achieve this, the accord provides for the 'development' of markets, in particular the German market, in a manner which is sustainable and achieves an 'appropriate profitability'. In this case, it is less the subject-matter of the provision than its enforceability that causes problems. What is meant by the phrase 'development of the German market'? What should be the size of the company's advertising budget? Is the company required to take on an unprofitable order if follow-up orders with comfortable profit margins are likely? Detailed questions of this kind cannot be answered by reference to the wording of the accord. Consequently, to this extent – as is also the case with certain social partner agreements in the chemicals industry – the accord must be regarded as simply establishing overarching goals. Only in extreme circumstances, for example, if the company were to withdraw from the German market, is it conceivable that the provision could confer actionable rights. On the other hand, it is clear simply by reference to the fact that the provision's wording is similar to that used in section 92a of the Works Constitution Act that it concerns 'working and economic conditions'.

Paragraph 8 of the accord provides that IG BAU will remain the sole negotiating partner for the Hochtief group. This prevents collective bargaining with other trade unions. Given that German law on collective bargaining – unlike the law on the constitution of the workplace – does

not recognise a duty to bargain,<sup>43</sup> an individual employer is entitled to enter into a sole bargaining agreement with a specific trade union. However, that would not prevent a competitor trade union from seeking to open negotiations with the employer and, should things go that far, forcing it to the bargaining table by means of a strike. In such a situation, the provision in the accord that allows for departure from the agreed terms following a change in circumstances might come into play.

Paragraph 9 of the accord provides that a candidate for the board of directors position responsible for human resources in each of the relevant companies in the Hochtief group will only be proposed ‘following negotiations with the trade union representatives on the relevant supervisory board’. This provision refers to any proposal advanced by ACS, which, having regard to the voting power of the various shareholders at the general meeting, would carry considerable weight. From its wording, the phrase ‘following negotiations’ does not have a meaning as firm as ‘subject to agreement with’ and, hence, cannot be regarded as a right of veto. On the other hand, it means more than mere consultation. What is likely to have been intended is that both sides should negotiate with a view to reaching an agreement and that a proposal coming from ACS may depart from the trade union position only where there are good reasons for doing so. Infringement of this procedural rule potentially could be sanctioned by a court order setting aside the election result. Such a solution presupposes, however, that the substance of this procedural requirement has been incorporated into the company’s rules or the rules of procedure of the supervisory board.

## 6.2 Provisions relating only to corporate and business freedoms

The ambit of Article 9(3) of the Basic Law does not extend to paragraph 3 of the accord concerning the operative business of Hochtief. This is a matter for which that company’s board continues to remain responsible.

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43. See the judgments of the Federal Labour Court of 2 August 1963 in Case 1 AZR 9/63, reported as AP Nr. 5 zu Art. 9 GG; 14 July 1981 in Case 1 AZR 159/78, reported as AP Nr. 1 zu § 1 TVG Verhandlungspflicht; and 14 February 1989 in Case 1 AZR 142/88, reported as AP Nr. 52 zu Art. 9 GG. See also M. Löwisch and V. Rieble, cited above, *Grundl.* paragraph 55; K. Nebe in W. Däubler (ed.) *Tarifvertragsgesetz*, § 1 paragraph 107 et seq.; and U. Zachert in E. Kempen and U. Zachert (eds) *Tarifvertragsgesetz*, § 1 paragraph 27. For an opposing view, see F. Gamillscheg *Kollektives Arbeitsrecht*, Volume I, § 7 I 4 (p. 276), and G. Thüsing in H. Wiedemann (ed.) *Tarifvertragsgesetz*, § 1 paragraph 216 et seq.

As shareholder, ACS will not become involved in the operative decisions of management and also will not seek to conclude an agreement which places Hochtief under its control. These are all questions concerning relationships amongst shareholders and between shareholders and management. For that reason, in classifying this provision, the only form of agreement conceivable is a contract under the law of obligations.

Paragraph 7 of the accord also concerns purely commercial issues. Cooperation is to be improved between the various business areas of the Hochtief group. Greater emphasis is to be placed on generating orders for other business areas within the group. This provision, too, has only indirect repercussions (if any) on the workforce and, as a consequence, this also must be classified as the term of contract under the law of obligations. As to its effectiveness, however, there cannot be any doubts.

### 6.3 Provisions falling into a grey area

Paragraph 1 of the accord provides that Hochtief AG will remain an independent company operational in its own right or through the activities of subsidiaries. Moreover, it may not be converted into a European company (SE). In terms of its wording, this provision concerns simply matters of corporate structure and questions of company law. However, the implications for the workforce may be substantial as in the absence of operative independence many jobs could be under threat. These are matters which are addressed separately in paragraphs 5 and 6 of the accord. Consequently, it must be presumed here that the stipulation simply concerns matters of corporate structure and, hence, constitutes the term of a purely contractual agreement under the law of obligations. Moreover, this provision is effective. It is open to a majority shareholder to agree to exercise its influence or to refrain from such. Although it may indeed be questionable whether it could commit itself indefinitely, the present accord is limited in time and expires on 31 December 2013. In accordance with the rule established in the second sentence of section 137 of the Civil Code, a commitment to exclude the adoption of the legal form of a European company (SE) will be regarded a valid stipulation not to exercise rights of ownership in Hochtief AG in such manner as results in their conversion to similar rights in a European company.

Paragraph 2 of the accord specifies that the company's main administration is to remain in the city of Essen. This commitment relates less to

the issue of the company's seat. Instead, it concerns the location of its substantive (administrative) activities. In other words, this is a commitment guaranteeing the future of a particular plant or site which can be the subject-matter of a collective accord. The question whether a strike in pursuit of a commitment of that kind may be regarded as lawful is a matter on which I have written elsewhere.<sup>44</sup> Following a careful analysis of the opposing arguments, I conclude that such a strike is indeed lawful and, consequently, further discussion is not appropriate here.

#### 6.4 Whether the provisions of the accord are binding

Collective accords and contracts under the law of obligations may be limited to the identification of recommendations where non-compliance does not result in any sanctions. The most prominent example of that approach is to be found in the social partner agreements in the chemicals industry. In commercial dealings, too, the parties may limit themselves to letters of intent.<sup>45</sup> Whether in a particular case binding commitments or simply recommendations are intended is a question of interpretation.

The accord at issue is clear in its formulation of many (but not all) points and is not limited simply to the identification of an objective. This is true, for example, in relation to the guarantee for the Essen site. Likewise, this applies also to the statement by ACS that it would accept a commitment to guarantee jobs and, hence, its undertaking not to oppose such. Furthermore, the commitment to respect existing collective agreements and collective accords is not hedged or qualified in any way. In addition, it must be noted that the accord is limited in time and set to expire on 31 December 2013. This is hardly a provision that would have been agreed if the stipulations were intended simply as non-binding.

Ultimately, however, all this applies only if ACS acquires the majority of Hochtief shares. Where it retains a holding of between 30% and 50%, ACS merely agrees to act 'in the spirit of these commitments'. The exact meaning of that phrase is unlikely ever to be resolved by a court. The most plausible approach to its interpretation suggests that the same principles should apply subject only to the provision that ACS has the

44. W. Däubler in W. Däubler (ed.) *Arbeitskampfrecht*, § 13 paragraphs 40–46.

45. On the concept of a letter of intent, see W. Däubler *BGB kompakt*, Chapter 11, paragraph 153.

possibility to derogate to the extent that this is justified by its minority position.

Finally, following the practice of many common law jurisdictions, the accord incorporates a material adverse change (MAC) clause. It allows ACS to depart from the agreed terms (whose binding qualities are thus once again emphasised) if there is a material adverse change in the circumstances affecting Hochtief. In the present case, this means changes affecting the basis for the transaction, in other words, new circumstances which were not and could not have been anticipated. These are circumstances which would also have to be taken into consideration in accordance with the rule established in section 313 of the Civil Code or the corresponding principles governing collective agreements and collective accords. However, in the present case, the parties did not take advantage of the possibility to specify the risks and potential changes.<sup>46</sup>

## 7. Conclusion

This chapter has shown that a relatively new instrument, the investor agreement, can be used to safeguard employee influence. This instrument is interesting within the context of this book's discussion of company law and the Sustainable Company because it can be used to supplement board level employee representation. It will therefore be worthwhile to observe the evolution of the Hochtief-ACS agreement in practice as well as its take-up by trade unions in other situations. It would also be interesting to look at how this instrument could be implemented in other national contexts.

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46. For a more detailed comparison of the rule established by section 313 of the Civil Code and the MAC clause, see G. Picot and R. Duggal 'Unternehmenskauf: Schutz vor wesentlich nachteiligen Veränderungen der Grundlagen der Transaktion durch sog. MAC-Klauseln', *Der Betrieb* 2003, pp. 2635-2642.

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# **Chapter 9**

## **The importance of worker representatives on company boards and their right to consult with their trade union organisation and its management**

**Ingemar Hamskär**

### **1. Introduction**

This chapter addresses the need to respect the rights of worker representatives in company law and the law on the dealing in securities and under corporate governance regulations both at national and European level. The conflict between worker rights defined under labour and company law on the one hand and securities law on the other can be especially problematic in the case of worker representatives on company boards. These representatives are, as a rule, affected by both labour law and company law. Although such worker representatives frequently need to consult with other worker representatives who are not members of the board, such needs can collide with the recent tendency in securities law to place more and more restrictions on disclosure beyond the company board of important information which might affect the share price or involve trade secrets. This conflict is exemplified in a case referred to the European Court of Justice (ECJ) in 2004, which will be discussed below.

The main conclusion in this chapter is that European legislation in the area of company and securities law and corporate governance principles need to respect these national and European rights and the legitimate needs of worker representatives to fulfil their functions. Rather than granting supremacy to shareholder interests, EU law should recognise the principle that companies are a community of interests in which workers are a key stakeholder. Worker participation constitutes a fundamental right in the EU. Thus, existing national systems of worker participation need not only to be protected but also upgraded by way of EU legislation. The current discussion on European company law and corporate governance provides a context for airing these demands.

## 2. A legal challenge to a worker representative's right to consult

In 2004, the Swedish Government intervened in a case before the ECJ (Case C-384/02 *Criminal proceedings against Grøngaard and Bang* [2005] ECR I 9939) in which a Danish court referred the following very basic question (among others) for a preliminary ruling: 'Does Article 3(a) of Directive 89/592 preclude a person from disclosing inside information in the case where that person received the inside information in his capacity as an employee elected member of the Board of the undertaking to which the inside information relates and that information is disclosed to the General Secretary of the trade union which organises the employees who elected the person concerned as a board member?'

Directive 89/592<sup>1</sup> (Insider Directive) was introduced into Danish law in the Law on dealings in transferable securities. Section 35(1) of that law states: 'The purchase or sale, or incitement to the purchase or sale, of transferable securities may not be effected by anyone with inside information which may have a bearing on the transaction.' Section 36(1) of the same law provides:

Any person in possession of inside information may not disclose such information to any person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.<sup>2</sup>

Knud Grøngaard was the workers' representative on the company board at a financial institution (RealDanmark) that was about to merge with a bank (Danske bank). He was also the chairperson of the department within Finansforbundet (Danish Financial Sector Union) that organised over 90 percent of the employees at RealDanmark. Allan Bang was the General Secretary of Finansforbundet. Grøngaard consulted with Bang and gave him information about both the date and proposed rate of exchange between the shares in the two companies. Bang, in turn, passed on the information to two close colleagues on the staff of the Finansforbundet office. One of these colleagues used the information and

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1. Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ L 334, 18.11.1989, p. 30.

2. The directive was transposed into Swedish law in a similar way in section 7 of the Act on penalties due to market manipulations when trading in financial securities (2005:377).

bought shares, and was eventually sentenced for breaking the insider dealing rules. Prosecutions were also brought against Grøngaard and Allan. The main issue in the case was whether a worker representative on a company board was prohibited by the legislation in question (law on the dealing in securities) from consulting with the president of his trade union federation on the issue of a planned merger that could lead to the redundancy of thousands of employees (members), and whether the president of the federation in turn could share the information with his closest advisors. Should the consultation and sharing of information by the trade union official be seen as having been made in the normal course of the exercise of his employment, profession or duties as a worker representative within the exception stated above or did the main rule apply?

Along with others, TCO (Swedish Confederation of Professional Employees)<sup>3</sup> drew the Swedish Government's attention to the case before the ECJ and its significance for the Swedish rules on worker representatives on company boards. These rules are similar to the Danish rules but are not identical. At the hearing before the ECJ, the Swedish Government expressed the important view that, as far as possible, it should be for national courts to rule on the extent to which worker representatives on company boards may share insider information with other worker representatives. It emphasised that the extent of and systems for worker participation differed considerably between Member States, and that EU legislation on worker representation did not establish any minimum rules concerning board-level worker representation (Ahlberg 2004). These were arguments that also made a distinct mark in the ruling (paragraphs 39-40 of the judgment).

The argument advanced by the Swedish Government concerns the effect, in this context, of an important aspect of the principle of subsidiarity. Namely, something that is a normal part of the task of worker representatives in Denmark or Sweden may seem alien to the task provided for in the legal system of other Member States.

In a relatively short ruling, the ECJ held that to share the information at issue conflicts *prima facie* with the main rule of the Directive. However,

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3. The Swedish Confederation of Professional Employees ([www.tco.se](http://www.tco.se)) has 1.2 million members, and covers both private and public sectors.

this does not apply if there is a close link between the sharing of information and the carrying out of the individual's function. The Court underlined that in the case of an exception it must be interpreted restrictively (paragraphs 27-33) and, in that connection, set out a number of broad guidelines for the national court to consider. It indicated that the sharing of information may be compatible with the directive if it is necessary to fulfil the individual's function (paragraph 34). In that connection, it should be considered whether the circle of people receiving the information is limited (paragraph 36) and also how sensitive the information is (paragraphs 37-38). A test of proportionality should be applied asking whether, having regard to the exact timings of the actions concerned, it was necessary to share all the information at issue in order for the individual to fulfil his duty. Finally, the ECJ reiterated that, in making the final assessment, consideration must be given to the individual nature of the national legal system at issue (paragraphs 39-40).

Both Grøngaard and Bang were found guilty of breaking the insider rules by the Danish first and second instance courts but were acquitted by the Danish Supreme Court (Højesteret).<sup>4</sup> The Supreme Court found that it accorded with the purpose of the exception and the preparatory materials to the law that a worker representative on a company board has the right to consult with the president of his trade union federation on issues concerning a merger which have considerable significance for the employees. The court found that this was also common practice. The court underlined that Grøngaard consulted with Bang, not only because he wanted to be prepared before the public announcement of the merger, but also to consult on his own position relative to the planned merger. The Supreme Court noted that the merger would include many members of the federation and would lead to major staff cuts. Against that background, it found that it was a normal step on the part of Grøngaard in the exercise of his task to share the information that the merger negotiations had started and at what date the merger would be made public. The reason for sharing the information concerning the rate of exchange between the shares in the two companies was to discuss whether there might be a higher bid from elsewhere involving fewer redundancies. Consequently, the Supreme Court found that the disclosure was made on objective grounds and was a normal step in the discharge of

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4. Judgment of 14 May 2009 in case 219/2008 *Public prosecutor v Knud Grøngaard and Allan Bang*.

his duty. Both Grøngaard and Bang were cleared of all criminal charges. Why was it so important for Swedish trade union organisations and the Swedish Government to intervene in a case concerning worker representation in Denmark as a way, ultimately, to defend worker influence on Swedish company boards? The answer lies in the fact that, if the outcome had been different, the case could have had serious effects limiting workers' influence on Swedish company boards. However, the issue remains critical. As the Insider Directive is currently under review, it is important to ensure that any changes to the directive do not limit the legal scope for worker representatives on company boards to share information with and consult the leaders of their trade union organisations. This scope has been acknowledged by the ruling of the ECJ and confirmed at national level by the Danish Supreme Court. In these circumstances, it is appropriate to recall that Article 27 of the EU Charter of Fundamental Rights guarantees 'workers' right to information and consultation in the undertaking' and that a limitation of national practice in this area through an internal market directive would be controversial to say the least.

The preliminary position of the Swedish Government concerning the ongoing work of the EU Council on insider dealing states the following as regards the aim of enlarging the extent of insider crimes:

The definitions concerning what is to be seen as criminal must be carefully considered, especially against the background that the proposed directive leads to demands for administrative sanctions. As the proposal concerns the spreading of information in media it is also important to consider that the provisions are not in conflict with the Swedish Freedom of Press Act and the Freedom of Speech law. It is furthermore important that the directive does not lead to the workers' representatives on company boards being prohibited from sharing information with other trade union representatives in accordance with the elaborations of the EU Court in the case Grøngaard and Bang (C 384-02). (Swedish Government 2011).

To put this position in context, it is helpful to examine the background to and the purpose and content of the Swedish rules on worker representation on company boards.

### **3. The Swedish Board Representation (Private sector employees) Act**

#### 3.1 Background and purpose

The issue of employee representation on company boards began being discussed more seriously in Sweden during the latter half of the 1960s. The executive of TCO appointed a committee, known as SAMKO, in September 1969 to look into the issues of cooperation between management and employees at the workplace. Among the measures that the committee suggested was representation for the workers on company boards. Together with the Swedish Trade Union Confederation (LO), TCO tried to regulate these issues through collective agreements, but the employers' organisations refused as they did not consider that they had the mandate to regulate issues that were normally reserved for the company annual general meeting. TCO and LO then asked the government to introduce legislation giving workers the right to representation on company boards.

The first legislation on board-level worker representation came into force in 1973-74 through two different acts, one relating to limited liability companies and cooperative associations (LSA) and one for bank institutes and insurance companies (LSABF). After a successful trial period, the legislation was made permanent, with some changes introduced a few years later. The present legislation on the right to board-level representation for workers came into force on 1 January 1988 and on all substantial issues has remained unchanged since then.

The legislation on worker representation on company boards that was introduced mainly during the 1970s must be seen as one part of a reform process in Sweden which seeks to make working life more democratic. Subsequently, the Act on Co-determination (MBL) (1976:580) came into force with rules on information and consultation and, as a result, laid the foundation for increased employee influence at the workplace. Thereafter, legislation was increasingly supplemented, or even replaced, through collective agreements. Seen from this perspective, the right to worker representation on company boards is a complement to the regulatory regime that provides for employee participation in Sweden. At the same time, it is clear that the rules on board-level worker representation also include elements associated with company law (Companies Act (2005/06:26)). For example, this legislation contains rules on how

company boards should be constituted, how they should work, and what obligations and responsibilities individual board members have.

The legislation that came into force during the 1970s concerning the right to board representation was, however, not without reservations on the part of trade unions. They were initially hesitant in relation to forms of participation that involved taking part in managerial functions within companies. Participation in the decision making process was viewed as raising possible conflicts of interest as the worker representatives would simultaneously have to be loyal both to the company and to the employees. It was feared that worker representatives would find themselves becoming pawns in difficult company situations in which any criticism of board decisions was directed towards worker representatives instead of, more accurately, being directed towards company management itself. The initial view of trade unions changed as demands for working life to become more democratic strengthened towards the end of the 1960s. Important decisions at both TCO and LO congresses at the beginning of the 1970s laid down broad outlines for an enlarged democracy in the workplace and emphasised, in addition, the right to worker representation on company boards as an important step towards increasing influence in companies.

The legislation (on worker representation on company boards) first met opposition from the employers' side who were of the view that cooperation between a company and its employees should take place on a voluntary basis and not be mandated by legislation. After the successful trial period at the beginning of the 1970s, the employers changed their view, noting that the legislation had had positive effects, and recommended its continuation.<sup>5</sup> This positive view was confirmed in the preparatory work for the 1987 legislation<sup>6</sup> and also in academic research (Levinson 2001) at a later date.

Despite this common view shared by the Swedish social partners regarding the importance of worker representation, this right is not unthreatened, particularly when one takes account of the actions of other players at the supranational (European) level. This is evident from the different proposals that come up from time to time at both European and national

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5. Government bill 1975/76:166, p. 96.

6. Government bill 1987/88:10, p. 44.

level concerning new European legal forms (for example, the European private company (SPE)) and in relation to corporate governance (Swedish Government 2004) where mostly it is the economic independence of companies and the protection for shareholders that are stressed. This may be due to the fact that a majority of the owners of global companies with support from the European Commission and, in particular, its Internal Market and Services Directorate do not share the same attitude to cooperation that is held by most representatives of the social partners in Sweden (Lundberg and Bruun 2005). This is a policy that, to my mind, conflicts with the fundamental rights recognised within the EU and contradicts a strengthened EU social dimension desired by the citizens. It also obstructs an effective fight against economic and financial crises as worker representatives on a company board have an interest in long-term perspectives, which is beneficial to the work of the board. The fact that a company board which includes worker representatives can reach unanimous decisions concerning important issues attests to stability and a long-term perspective. A worker representative often has unique insight into the company workings which is a great asset to the board. These are insights that should be of utmost importance to companies owned by foreign interests which ought to embrace the employee influence that prevails in the country of operation.

### 3.2 The main content of the Swedish legislation

In private companies in Sweden that have at least twenty five employees (regardless of the form of employment or working time), the employees are entitled to appoint two representatives to the company board and one deputy for each representative. This is the rule applying to companies up to an average of 999 employees per financial year. In companies that conduct business in different sectors and in the most recent financial year have employed an average of at least 1,000 employees in Sweden, the employees are entitled to three representatives on the company board and three deputies. However, the number of employee representatives may not exceed the number of other company board members.<sup>7</sup> This legislation applies to those businesses that are limited liability companies, cooperative associations, banks and insurance companies. It does not apply to trading partnerships, limited partnership companies

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7. When the number of votes are equal, the chairperson has a casting vote.

or foundations. Exemptions from the rules may in some cases be given by the Tribunal for Employee Representation on Boards of Directors.

The representatives are appointed by the workers' organisation that has a *collective agreement* with the employer.<sup>8</sup> It should be noted that a worker representative on a company board does not only represent their own trade union organisation and its members. The worker representative represents all employees at the company, also non-organised employees as well as those that are members of other trade union organisations (Lavén 1988). In principle, worker representatives should be appointed by the employees in the company, but this may not always be the case.<sup>9</sup> According to the preparatory works on the legislation, the legislature presumes that trade union organisations will take equality between women and men into consideration when they appoint representatives to company boards. This concern for equality arises as a result of the major imbalance between men and women in the boardroom both in the public sector and private industry.<sup>10</sup> In May 2011, TCO stated in response to an ETUC draft reaction to the European Commission Green Paper on Corporate Governance Framework that the EU should push for equal representation between men and women on company boards using an acceptable approach, as it is an urgent issue and basically concerns equal treatment and democracy.

The purpose of having worker representatives on company boards and social dialogue in the workplace is to achieve industrial democracy. Employees should gain insight into and knowledge of the basis for the company's actions on different issues and an understanding as to why the company takes certain decisions. Company management should gain from the perspectives employees bring to the activities of the board. As mentioned above, worker representatives often have an interest in the long-term effects of decisions and this, in itself, has a positive effect on the activities of the board. All members of a company board have the same rights, obligations and responsibilities. This principle of equality ensures that both the members appointed by the annual general meeting and the worker representatives have a duty to look after the interests of the company.

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8. When the number of votes are equal, the chairperson has a casting vote.

9. Government bill 1987/88:10, p. 57.

10. *Ibid.*, p. 58.

The Board Representation (Private sector employees) Act sets out certain detailed rules on the form and content of the activities of the board. This complements the Companies Act, which regulates the duties of the board in general terms. Under these provisions, worker representatives are to receive the available board documents in reasonable time and in an appropriate manner before the board takes its decision. The deputy of a worker representative also has the right to attend the board meeting even when the ordinary representative attends. One of the worker representatives also has the right to attend and participate in the deliberations of a working committee consisting of board members and officials of the company if the matter under discussion is to be decided later by the board. However, worker representatives have no right to attend and participate in decisions that concern collective agreements related to industrial action. That exclusion does not, however, prevent a worker representative from taking part in other board decisions that are, or may become, subject to negotiations on cooperation between the trade union and the company.

The Board Representation (Private sector employees) Act contains no specific rules of confidentiality in relation to worker representatives. Likewise, the Companies Act does not make any specific provision in that regard. In practice, confidentiality must be maintained by worker representatives to the same extent as other board members in relation to any facts whose disclosure could harm the company.<sup>11</sup>

The Board Representation Act requires employees and their trade union organisations to be made aware of the activities of the company, i.e. it presupposes a fairly open flow of information. The fact that a worker representative is also a trade union representative who is appointed by the trade union with an ultimate responsibility to the employees in the company gives the board function a distinctive feature. This is something that has been recognised by the legislature.<sup>12</sup> Worker representation on company boards will therefore lead to a shifting of the traditional boundaries concerning the scope of confidentiality. As far as it is necessary to fulfil the function of an employee board-level representative, confidentiality has to be limited. There are no explicit legislative rules

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11. See the report by the Committee on Civil Law on the government bill concerning the Act on protection of company secrets; LU 1988/89:30, p. 30.
  12. Government bill 1987/88:10, p. 66.

which establish that worker representatives have the right to share information with, for example, the local trade union committee. However, normally there should not be any obstacle to such a confidential flow of information. In this connection, it is important to observe that the information and consultation rules in the Act on Co-determination (MBL) give trade union organisations far-reaching opportunities to scrutinise companies and that this right to information also applies to items of information that may be regarded as confidential. Individuals who have received some confidential information in their capacity as an employee representative may also share this information with another committee member in that organisation without breaching any confidences. In turn, the principle of confidentiality also applies to the other committee member. In this context, to treat a worker representative on the board of a company differently from a trade union representative in a consultation for the purposes of the MBL does not seem very practical and, as a rule, ought not to be legally permitted.

There are good reasons why worker representatives on company boards should be able to discuss issues that are dealt with on the board with other trade union representatives – especially within the local trade union committee but also, as in the Danish case, with the leadership at federation level and, if necessary, to get support and help from this level on difficult legal and economic issues. It is not reasonable that, as regards the opportunity to discuss a matter with those giving the mandate and to obtain support and help from experts, there should be restrictions on board members appointed by trade unions different to those which apply to other board members appointed by or representing the company's owners. Specifically and more candidly, the question is whether the developments in EU law have led, or will lead in the future, to a shift of that kind.<sup>13</sup>

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13. Following agreement on the Treaty of Lisbon, the EU Charter of Fundamental Rights has become legally binding, which includes the right to information and consultation, and the EU has adopted secondary legislation on board-level worker participation in the European company (SE). The EU will become a party to the European Convention on Human Rights and Fundamental Freedoms (ECHR). The protection for freedom of speech established in Article 10 ECHR has been strengthened by new rulings of the European Court of Human Rights (case no 39293/98 *Fuentes Bobo v Spain*, 29 February 2000; case no 14277/04 *Guja v Moldavia*, 12 February 2008; and case no 28274/08 *Heinisch v Germany*, 21 July 2011).

A prosecution in Sweden similar to the one that took place in Denmark in *Grøngaard and Bang* would naturally have to be assessed in light of Sweden's distinctive national legal character including the common practice that exists in this area. The Swedish Government has expressed concern that a new or revised insider directive would reduce the scope of national law in that regard. Consequently, it is seeking to prevent any wording that would prohibit worker representatives on company boards from sharing information with other trade union representatives as permitted by the ECJ in *Grøngaard and Bang*.

#### **4. Conclusions**

In Sweden, a worker representative on a company board normally has the right to consult with other trade union representatives in his own trade union committee (local union or department) or corresponding centrally-placed trade union representatives prior to decisions being taken at the board meeting. The fact that this right normally exists points in favour of an interpretation of legislation and/or national practice which allows for the continued exercise of such right. Further support for that view can be found in the ECJ judgment in *Grøngaard and Bang* and the final ruling of the Danish Supreme Court neither of which reduces the scope of that right. It is important for employees, companies and society as a whole that this scope is not limited by a revised future directive.

Following the ECJ ruling in *Grøngaard and Bang* and the subsequent decision of the Danish Supreme Court it is now clear that, notwithstanding the main rule of the Insider Directive, it is not incompatible with the current directive for a worker representative on a company board in accordance with national practice, as is the case in Denmark, to seek advice from his trade union leadership and/or with the group that has appointed him and, as a consequence, to share sensitive information with them. The same conclusion could be drawn for Sweden.

It is fundamental that in the area of worker participation future EU proposals on corporate governance and securities law do not allow national rules and practices concerning company board representation (or other aspects of labour law) that are more far-reaching than the EU standards to be neglected. At the same time, good cross-border rules on worker participation are needed. Following that, as a first step, there needs to be a general right to basic board representation for all employees in Europe,

irrespective of where the company decides to register or locate its head office. These rules should reflect the fact that worker representatives on company boards, or similar, have a legitimate need to consult with their trade union committee and leadership prior to important company board decisions. It is also important that future EU rules for worker involvement in cross-border situations respect systems of worker rights and national practice in this area that go further than the EU rules. When the employees concerned are subject to different national rules/models of worker participation the strongest model for participation should apply. The question of what is the strongest model should be decided by the majority of the workers concerned.

Consequently, reform and upgrading of the EU rules on workers' rights of involvement is necessary. A good starting point for such a reform could be the European Commission's current consultation on the future European company law *acquis*. This presupposes, however, that the proposals are based on the premise that workers' right to information and consultation and also participation are fundamental rights for employees in Europe.<sup>14</sup>

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14. See Article 27 of the EU Charter of Fundamental Rights and Heuschmid (2009).



# Chapter 10

## The current state of information and consultation rights in the European Union

Isabelle Schömann

### 1. Introduction

One of the core elements of the Sustainable Company is the informing and consultation of workers on a wide range of strategic and operational issues. Although information and consultation rights are recognised as fundamental social rights for workers in the EU, actual practice falls far short of this ideal. First, information and consultation rights are quite fragmented, as they are defined for specific situations or in specific kinds of companies in more than 25 directives in the areas of labour and company law. Second, the actual implementation of many of these directives is weak or incomplete. Third, existing rights are often not recognised in practice. Thus, in reality, the European framework for information and consultation represents a long and tedious climb towards democracy in Europe (Schömann *et al.* 2006).

This chapter examines the current state of information and consultation rights in the EU. Section two of this chapter shows that these are recognised as fundamental social rights. However, the EU rights of information and consultation are in fact very fragmented (section three) and can be considered the ‘poor relation’ of EU social legislation. Although the long standing initiative of the European Commission towards better regulation is currently addressing the general issue of information and consultation of workers, both the initiative itself and the methodology used are to be criticised (section four). In this respect, the ETUC’s call in 2011 for European minimum standards for information, consultation and participation is a much more promising approach towards realising workers’ fundamental rights to information and consultation.

## **2. Information and consultation are fundamental social rights**

The European directives on information and consultation are a clear expression of the willingness to make employees citizens in their places of work. The same intention is reflected in the European Charter of fundamental rights (referred to in the Lisbon Treaty) which gives information and consultation rights the status of a basic right of European citizens. Article 27 of the European Charter of fundamental rights stresses that ‘workers or their representatives must, at the appropriate levels, be guaranteed information and consultation in good time in the cases and under the conditions provided for by community law and national laws and practices’. As the first article of chapter IV of the Charter entitled ‘solidarity’, this provision on workers’ right to information and consultation implies that the EU is based not only on traditional individual and liberal rights, but equally on social rights creating networks of solidarity among the citizens of the EU. The aim of information is to empower employees’ representatives, ensuring that they can obtain adequate facts on the issue at stake in order to prepare a substantive statement. This statement is an essential part of the following step: consultation. This process involves an exchange of views between management and representatives of labour in order to establish a continuous dialogue between them, so that they may reach an agreement on decisions falling within the scope of the employer’s discretion.

The employer has the obligation to inform and consult workers or their representatives on all matters, including those which concern them outside the undertaking. Information and consultation must take place ‘at the appropriate levels’, including the level of establishments, undertakings or group of undertaking regardless of their scope of operation. Article 27 of the EU Charter of fundamental rights thus creates a guarantee of information and consultation for workers at both national and transnational levels.

The employer has the obligation to inform and consult either the workers directly, or the worker representatives. However, information and consultation rights cannot be reduced to a right only for individual workers. Were employers to be permitted to ignore and undermine worker representatives, including trade unions, this would contradict the guarantee for freedom of association set out in Article 12 of the EU Charter of fundamental rights. Therefore, direct information and consultation

of individual workers could be an ‘appropriate level’ only in undertakings or establishments where no worker representatives have been elected. In the same vein, the view that the guarantee of information and consultation to ‘worker representatives’ applies only to works councils and not to trade union representatives is contested. Given that not all EU Member States operate a ‘dual-channel system’, the interpretation of ‘representatives’ as being either trade union representatives or these together with works councils appointed from the workforce as a whole within the undertaking is the more inclusive. Finally, Article 27 extends to the more general dimension of protecting human dignity (Article 1 of the EU Charter of Fundamental Rights) and is not restricted simply to traditional social rights and the objective of democratisation of the economy. As such, it expands the scope both of traditional social rights and of practices of democratisation to encompass threats to workers’ dignity in the many new forms these threats assume in a globalised economy, society and environment (Blanke 2006).

### **3. The fragmented rights to information and consultation in the European Union**

Information and consultation rights in EU law are currently some of the most fragmented rights in the entire EU legislative corpus. In total, more than 25 directives deal with information and consultation either in a general or specific sense. The first steps to set up procedures of information and consultation of workers and their representatives in specific circumstances of the development of undertakings were taken with the adoption of Directive 75/129/EEC on collective redundancies (codified in Directive 98/59/EC)<sup>1</sup> and Directive 77/187/EEC on safeguarding of employees’ rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses (codified in Directive 2001/23/EC).<sup>2</sup> The first systematic step towards a general right of information and consultation of workers within the undertaking was taken by Directive 94/45/EC on the establishment of European Works Councils (recast

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1. Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies, OJ L 225, 12.8.1998, p. 16.

2. Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees’ rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, OJ L 82, 22.3.2001, p. 16.

by Directive 2009/38/EC).<sup>3</sup> The general system has been strengthened and complemented by Directive 2001/86/EC on employee involvement within the European company (*Societas Europea - SE*)<sup>4</sup> and the general framework Directive 2002/14/EC of on information and consultation at national level.<sup>5</sup>

Additionally, a large number of directives in the field of health and safety guarantee information and consultation rights of the workforce. Framework Directive 89/391/EEC introduced measures to encourage improvements in the safety and health of workers at work.<sup>6</sup> This general framework has been complemented by a range of directives targeting (1) particularly sensitive risk groups, for example, Directive 91/383/EEC on the safety and health at work of workers with a fixed-duration employment relationship or a temporary employment relationship,<sup>7</sup> or indirectly, for example, by way of Directive 2003/88/EC concerning certain aspects of the organisation of working time,<sup>8</sup> as well as (2) specific sectors, for example, Directive 92/91/EEC concerning the minimum requirements for improving the safety and health protection of workers in the mineral- extracting industries through drilling<sup>9</sup> or Directive 93/103/EC concerning the minimum safety and health requirements for work on board fishing vessels,<sup>10</sup> or (3) specific aspects of the working environment, for example, Directive 2000/54/EC on the protection of workers from risks related to exposure to biological agents

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3. Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees, OJ L 122, 12.5.2009, p. 28.
  4. Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, OJ L 294, 10.11.2001, p. 22.
  5. Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community, OJ L 80, 23.3.2002, p. 29.
  6. Council Directive 89/391/EEC of 12 June 1989 on the introduction of measures to encourage improvements in the safety and health of workers at work, OJ L 183, 29.6.1989, p. 1.
  7. Council Directive 91/383/EEC of 25 June 1991 supplementing the measures to encourage improvements in the safety and health at work of workers with a fixed- duration employment relationship or a temporary employment relationship, OJ L 206, 29.7.1991, p. 19.
  8. Directive 2003/88/EC of the European Parliament and of the Council of 4 November 2003 concerning certain aspects of the organisation of working time, OJ L 299, 18.11.2003, p. 9.
  9. Council Directive 92/91/EEC of 3 November 1992 concerning the minimum requirements for improving the safety and health protection of workers in the mineral- extracting industries through drilling, OJ L 348, 28.11.1992, p. 9.
  10. Council Directive 93/103/EC of 23 November 1993 concerning the minimum safety and health requirements for work on board fishing vessels, OJ L 307, 13.12.1993, p. 1.

at work.<sup>11</sup> All those directives required national legislation on information and consultation of worker representatives in these specific areas.

However, only Directive 2002/14/EC establishes a general framework from 2005 onwards (the deadline for its transposition in the Member States) in relation to the information and consultation of workers in the European Union. This piece of legislation thus represents a substantial contribution to the consolidation of European Union social law in the area of information and consultation of workers. Indeed, it is the first EU directive to impose a general obligation to inform and consult workers in the European Union and thus represents an indispensable complement to the existing but fragmented measures on workers' rights to information and consultation in specific types of company situation. The general directive on information and consultation (Directive 2002/14/EC) lays down for the first time a European standard of information and consultation rights in national companies. This is in contrast to other directives which aim at improving employee involvement rights in Community-scale companies. This approach is particularly relevant for countries (such as the UK, Ireland, and Malta) where no such rules existed previously. This minimum standard is complemented by specific rights of information and consultation.

To sum up, the architecture of information and consultation rights in the European Union has been shaped progressively to a considerable extent by the need to secure workers' involvement and social democracy within undertakings when issues of working conditions and the working environment are at stake, with special provision in the case of difficult business situations and in relation to sensitive risk groups. Clearly, such fragmentation creates confusion and legal insecurity both for workers and their representatives as well as for management, a situation that is compounded by the fact that most directives are poorly implemented. Furthermore, this architecture has been strongly inspired by the national labour law of those continental European countries which traditionally have made provision for information and consultation rights. Other shaping features include the influence of European business law and rulings of the Court of Justice of the European Union (CJEU). However,

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11. Directive 2000/54/EC of the European Parliament and of the Council of 18 September 2000 on the protection of workers from risks related to exposure to biological agents at work, OJ L 262, 17.10.2000, p. 21.

information and consultation rights appear, none the less, to be the ‘poor relation’ of EU social legislation.

#### **4. Shortcomings in national implementation of information and consultation rights**

In general, the financial and economic crisis did not reveal previously ‘hidden problems’ in respect of the implementation of the transfer of undertakings, collective redundancies and general information and consultation directives (European Labour Law Network 2010, confirming Schömann *et al.* 2006). Rather it shed additional light on already existing and well-known problems (Barnard 2010). Four main issues are identified in relation to the three directives at stake: (1) incorrect implementation, (2) avoidance of the provisions of the directives, (3) uncertainty about key definitions and concepts, and (4) enforcement difficulties. Mainstreamed issues addressed in the collective redundancies and transfers of undertakings directives include domestic dismissals protection law, insolvency and bankruptcy, collective agreements, enforcement mechanisms, employees’ benefits and pensions. Thus, the definition of the concept at stake in those directives remains a major source of legal uncertainty. Implementation of the general information and consultation directive is still not optimal as regards the timing and content of the information provided and the nature of the consultation carried out. Practical arrangements as well as the protection afforded to worker representatives in the exercise of their rights reveal loopholes in domestic implementation provisions.

In relation to Directive 98/59/EC on collective redundancies, the definition of ‘collective redundancies’ remains a contested issue, leading to legal uncertainty in various respects. Problems arise, for example, as a result of different definitions depending of the status of the workers concerned, non-application of the directive to certain categories of workers (executive staff – air transport staff – temporary agency workers), the staggering of dismissals so as to avoid triggering the threshold for information and consultation, and recourse to ‘termination agreements’ that do not automatically fall within the scope of the directive. Furthermore, the issue of enforcement in respect of the consultation of worker representatives lacks explicit domestic provisions in respect of the content and timing of the consultation, on the (choice of) worker representatives to be consulted. In addition, the legal consequences (sanctions) in case

of infringement of the obligation to inform and consult the workforce and/or in relation to the timing and content of the notification to the public authorities are anything but clear and efficient. The issue of the priority list for dismissal reveals a large degree of employer autonomy in some countries, leading to lack of equity.

Dismissal protection in groups of undertakings raises concerns in relation to the liability of the group and not simply the undertaking carrying out the dismissals, whether there is an obligation requiring further employment within the group and the issue of continuity of service (and the rights attached thereto) in the case of such further employment. An additional issue, rarely addressed by domestic legislation or the courts, is the recourse had to external workers (temporary agency workers or subcontractors) when dismissing permanent staff. Finally, the lack of control/enforcement by the administrative authorities ensuring respect for the procedure has been noted as a particular problem.

In relation to Directive 2001/23/EC on transfers of undertakings, the scope and definition of a ‘transfer of an undertaking’ remain unclear, leading to legal uncertainty. Furthermore, practice with regard to the application of the directive to civil servants and state-owned companies remains highly heterogeneous, revealing a lack of consistency in this respect.

As far as the scope and definition are concerned, case-law of the CJEU has not provided an unambiguous definition of a ‘transfer of an undertaking’, leading to difficulties in interpreting the concept at national level, in particular in relation to issues such as outsourcing, transfers within groups of undertakings and public services (whether or not recourse may be had to the exception for administrative reorganisation of public authorities and transfer of administrative functions between public administrative authorities). Terms and conditions of employment and the relationship with trade unions following the transfer are other major areas of judicial conflict. Further issues arise also in relation to (1) the liability of the transferor (for severance payments and contributions to company pension schemes) before and/or after the transfer; (2) the transfer of undertaking as a ground for dismissal; (3) the distinction between transfers and situations of bankruptcy and insolvency and the recourse to the latter to avoid employee protection; (4) the difficult harmonisation of collective agreements within the company after a transfer, leading to inequality of treatment in relation to remuneration; (5) the

failure to respect the obligation to inform and consult; (6) reemployment/dismissal after the transfer took place; (7) the lack of sanctions.

In relation to Directive 2002/14/CE on information and consultation, the limited coverage of the collective agreements transposing the directive leads in some countries to the non-application of the provisions to employers which are not bound by a collective agreement. In the same vein, the question arises whether freedom of association is respected when employees fall under the provisions although they are not trade union members. Deviations from the statutory provisions by way of collective agreement to the detriment of workers have also been reported. Moreover, issues arise concerning the threshold triggering information and consultation rights (for example, excluding categories of workers such as fixed-term workers or artificially splitting an undertaking to ensure that the threshold for application of the legal and/or collectively bargained provisions is not triggered). As far as practical arrangements are concerned, the lack of an appropriate institutional framework and an inadequate 'culture' of social dialogue highlight the fact that there are difficulties in defining – in particular in countries with a dual channel of representation – whether the right to information and consultation should be accorded to trade unions or worker representatives. Not in every Member State is the right to information and consultation automatic. In some cases, it needs to be requested by a certain percentage of the workforce. The timing and content of the information and consultation remain issues of conflict. In addition, there are doubts whether domestic provisions on confidentiality are in conformity with the directive. Enforcement remains an issue, as the right to information and consultation is sometimes perceived an individual right and enforcement mechanisms appear not to properly protect workers.

## **5. The European Commission's fitness check of information and consultation rights**

At the beginning of 2000, the European Commission launched a reflection on the methods to achieve better regulation under the heading of 'better law-making', putting the focus on the quality and effectiveness of European legislation and on ensuring legal certainty. Renamed 'better regulation', the 2005 programme of the European Commission has been shifted to competitiveness, investment, economic growth and the right incentives for businesses, leaving aside the issue of legal certainty. The

aim of this exercise is to fight red tape under the assumption that less red tape will automatically lead to more growth insofar as it could lead to considerable savings for businesses. However, no direct link between the level of regulation and EU competitiveness has been shown. A range of methodological tools have been created to achieve better regulation, such as (1) the impact assessment, although the European Commission places an emphasis on the economic and not the social and environmental impact (European Commission 2005), (2) the screening of pending legislative proposals and withdrawal of obsolete or irrelevant proposals and (3) the simplification of European legislation by means of repeal, codification and recast, as well as by co-regulation and self-regulation.

In its rolling programme 2005-2008, the European Commission envisaged the codification of five social policy directives including those on collective redundancies (Directive 98/59/EC), on the transfer of undertakings (Directive 2001/23/EC) and on general information and consultation (Directive 2002/14/EC) (European Commission 2006). However, on the basis of an expert report (Ales 2007) and following two European Parliament resolutions of 2007 and 2009, the European Commission has undertaken, as part of its 2010 Work Programme, a review of the body of EU legislation in selected policy fields. The methodology proposed is a 'fitness check' to keep current regulation fit for purpose, thus identifying excessive burdens, overlaps, gaps, inconsistencies and obsolete measures. The European Commission is looking for (1) concrete findings on the effectiveness, efficiency, relevance and added value of the *acquis* in the areas under scrutiny that will serve (2) for drawing policy conclusions. As a result of this exercise, legislation could be withdrawn or amended, and new instruments and/or tools proposed to complement existing legislation. The overall results obtained by DG Employment during the fitness check exercise will be presented in a Commission communication in 2012 outlining the key conclusions and next steps. This communication will be accompanied by a staff working paper setting out in detail the evidence by Member State and the positions of stakeholders.

The 2010 fitness check is a pilot exercise taking place in four areas: employment and social policy, environment, transport and industrial policy. DG Employment has decided to carry out its fitness check in the area of information and consultation and in particular on three directives: Directive 98/59/EC on collective redundancies, Directive 2001/23/EC on transfers of undertakings and Directive 2002/14/EC on information and consultation. The review of the three directives will rely on an evi-

dence-based approach and integrate legal, economic and social effects of the existing legislation. In addition, ‘stakeholders’ (representatives of the labour ministries of the Member States and EU social partners) have been invited to become involved in this process and participate in regular European Commission working groups to assist in gathering relevant information, to discuss the different studies on information and consultation of workers, to highlight different national experiences regarding the implementation of the directives and to express views on actions that the Commission may undertake in this area.

## **6. An alternative approach to strengthening information and consultation rights**

In May 2011, Bernadette Ségol, General Secretary of the European Trade Union Confederation (ETUC), reiterated that the ETUC supports genuine efforts to improve EU regulation, but doubted whether fitness checks could actually contribute to improving legislation, querying whether those checks did not simply represent another step towards deregulation. Indeed, the European Commission fitness check falls under the smart regulation agenda already much criticised for its intention to cut red tape for business without considering the social implications. The ETUC is therefore concerned about the ‘fitness checks’ which aim to identify ‘excessive burdens’. It is of major importance for the ETUC to ensure, in addition to proper consultation of the social partners, that any measures to improve legislation do not undermine the objective of the legal act in question, for example by lowering standards.

Furthermore, questions arise when scrutinising the fitness check exercise. The choice of a general directive on information and consultation of workers (Directive 2002/14/EC) and two specific directives (on transfers and collective redundancies) is not clear. Other directives deal with worker information and consultation, such as the recast European Works Council Directive or the SE Directive, but they are deliberately excluded. If, as the Commission states, the exercise is to promote coherence between all directives on information and consultation in order to ensure the quality of legislation, the question arises why other directives on information and consultation are excluded from the exercise.

The ‘better regulation’ agenda pursued during the first Barroso Commission aimed at simplifying the Community *acquis*, i.e. the body of EU law

and regulation, and achieving better quality legislation. Evaluation of the actions taken points to mixed results whether in terms of methodological issues, the lack of a conclusive outcome in practice, the proliferation of intermediate bodies to reduce administrative burdens, the lack of simplification of procedures and processes, or a lack of evidence that the actions led to savings. Renamed 'smart regulation' under the second Barroso Commission, the Commission fitness check exercise applies a cost benefit analysis to all the issues at stake (employment and social policy, environment, transport and industrial policy). Serious concerns have already been expressed about the impact of such initiatives on workers' rights in terms of lowering core labour standards with regard to health and safety at the workplace (Vogel 2009). In particular, the methodology puts the emphasis on how to minimise costs to business, thus measuring more costs than the benefits of legislation. However, assessment of social legislation must take into account the purpose of each law, without disregarding the social, environmental and indirect costs but also the cost of non-regulation or costs that are useful to the quality of regulation (Van den Abeele 2009). The methodology proposed and used by the European Commission does not allow it to check whether the balance between the competitiveness, productivity and efficiency of legislation, on the one hand, and security, sustainable development and social cohesion, on the other, is respected. The ETUC is therefore sceptical about measuring the costs of the directives on information and consultation for workers. Furthermore, the benefits of the information and consultation directives can be measured less in financial terms than in social terms (democratic participation of the workforce in management issues). Thus, it is difficult to measure the social (and economic) benefits and costs when the directives are not implemented correctly.

In its resolution 'Strengthening worker involvement: minimum standards for information, consultation and participation in Europe' adopted on 28 April 2011, the ETUC Executive Committee stressed that the current economic crisis creates an important momentum to be used to re-establish and strengthen worker involvement in different forms: information, consultation and participation in the company. Information and consultation of workers is a long-standing fundamental right of workers and a crucial component of social dialogue at company level. Worker involvement strengthens democracy at the enterprise level and research shows that worker participation impacts positively on productivity and the well-being of workers and that a well-functioning participation system can create a win-win situation.

The ETUC's call for the definition and implementation of European minimum standards for information, consultation and participation would thus be a much more promising approach towards realising workers' fundamental rights than the Commission's current 'better regulation' approach. In this regard, the call by Aline Conchon in this volume (chapter 3) for a holistic approach to company and labour law is also relevant in the 'long climb' to achieve industrial democracy in the EU.

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# Chapter 11

## Extending the stakeholder approach to the community: mechanisms for participative modernisation in public utilities

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In collaboration with Yves Sintomer and Annabelle Houdret

### 1. Introduction: stakeholder value and community

This chapter extends the concept of stakeholder involvement to include the participation of citizens in corporate governance. Community involvement is considered as particularly important in the case of public utilities. For the purposes of this chapter, these are enterprises which are owned by public authorities and charged with the provision of services of general interest (SGI), such as water, electricity, public transport, waste collection, etc. However, although these enterprises are not owned by private interests, public utilities are organised as companies governed by private law, such as a plc, GmbH, SA, etc.<sup>2</sup>

In some European countries, the number of public utilities in private law status has increased. This means that, instead of following the neo-liberal doctrine of transferring the provision of public services to private companies (i.e. privatisation), in some countries, local governments

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1. This chapter has been written in the context of a project on democratic control of public utilities that is underway at the University of Potsdam. The project has received financial support from the German Thyssen Foundation. This chapter also refers to a project on citizen participation in water utilities. That project has been commissioned by the Water Department of Paris Municipality and is coordinated by Yves Sintomer, Annabelle Houdret, and the author of this chapter. For the purposes of the present chapter, reports from that project by Anja Röcke on water consumer councils in England and Wales, Ernesto Ganuza, Héloïse Nez and Julien Talpin on deliberative polling in the Spanish region of Andalusia, and Rémi Barbier and Clémence Bedu on a citizen jury in the French city of Nantes are used. The author wishes to express his thanks to all the colleagues involved in the project and to the foundations and local authorities for their support. Special thanks also go to the GOODCORP project for extending an invitation to join the debate on stakeholder concepts.
  2. Sometimes public utilities are also organised under public law, but this has changed in the last decades, with private law now the dominant form. This is why this article primarily considers the private form of business organisation for public utilities. Unless specifically mentioned, we refer to public utilities in private law status.

have opted for an alternative method, i.e. creating their own enterprises. Public utilities have flourished in Germany, the Nordic countries, and in southern European countries such as Italy, Spain, and to some degree Portugal (Aars and Rinkjob 2011; Grossi and Reichard 2008; Killian *et al.* 2006). In some countries where services have been privatised to a considerable extent, such as France, a debate on re-municipalisation has begun.

In face of the growing importance of public utilities, this chapter discusses whether there is a special need to include the community in corporate governance. I argue that public utilities differ from privately owned companies because they have a hybrid character (Koppell 2003; Karré 2011). On the one hand, public utilities often have to act according to market conditions and respond to competition,<sup>3</sup> as most other companies do. For this reason, they have an interest in ‘keeping the shutters down’, i.e. keeping strategic information confidential in order to prevent competitors from profiting from this information. On the other hand, public utilities are owned by a public body. For this reason, there is also an interest in their democratic control. This chapter takes as its starting point that the tension provoked by those two arguments is not adequately balanced through the conventional understanding of stakeholder value. The original concept tends to focus on the representation of workers on the company board,<sup>4</sup> whereas other stakeholders remain neglected (Freeman and Reed 1983; Parkinson 2003). In contrast, this chapter seeks to analyse how the community could be integrated in corporate governance. It is argued that the involvement of the community is different to participation by employees. Therefore, participative devices other than company board membership are also presented (Vitols and Kluge 2011) and the potential benefits of community participation evaluated. Furthermore, the chapter argues that conflicts of interest with other stakeholders such as employees have to be taken into account, because these could potentially weaken community participation and its positive effects.

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3. Some public utilities are not subject directly to competition as they enjoy ‘in-house’ conditions or a natural monopoly. Although this is true for water in some European countries, managers tend, nevertheless, to maintain secrecy.

4. In countries with two-tier board systems, community representatives would sit in the top or supervisory board. In countries with one-tier board systems, community representatives would be included as non-executive members of the company board. This article relies mainly on experiences in Germany with a two two-tier system. Readers should be aware that the systems vary across countries. For an overview see Bohinc (2011).

Participation in public utilities is a relatively new research issue, especially in relation to countries in the Global North. In some Latin American and Maghreb countries, participation has been demonstrated to have a positive effect (Balanyá *et al.* 2005). In line with those findings, Hall and Lobina (2008), who compared different forms of corporate governance, state that citizen involvement leads to better service quality, including for those who are socially marginalised. However, in the countries in the Global North examined, the data is very fragmented and research is still at an early stage (von Braunmühl 2005).

In this chapter, the term ‘community’ is used initially in a general sense without differentiation. For these purposes, ‘community’ includes the participation of individual citizens, randomly selected citizens, members of associations, etc. Through a description of participative devices, the groups which participate will be identified. Later, to provide a clearer definition of ‘community’, different roles such as clients, users, and citizens will be specified (see section 5).

In the existing literature on the issue, two arguments for community participation can be identified. First, in relation to the lack of democracy mentioned above, it is argued that the growth of public utilities leads to an ‘oligarchisation’ of local democracy. In terms of ‘political equality’, it is problematic that only a minority of local councillors – those appointed to the board of the utility – have access to its meetings. Hence, both the councillors who are excluded and the community itself may have a common interest in the democratic opening of decision making in public utilities. NGOs fighting against the privatisation of utilities may also support this engagement. However, it should be noted, as discussed below, that this thesis on oligarchisation is not without its critics. Second, there are indications that community participation could improve the performance of public utilities. Following the example of the public administration, it is possible that the involvement of citizens might contribute to participative modernisation (Sintomer *et al.* 2008, 2012). Hence, we will explore whether such experiences could be transferred from local administration to public utilities. Which types of benefits can be expected? What are the limits that have to be taken into consideration?

The idea of this chapter is to combine the two issues: the question of democratic legitimacy and those of participative modernisation. In order to get answers to these questions, participative procedures used in relation to the provision of public water services are evaluated through

the framework of participative modernisation. This framework was developed by Sintomer *et al.* (2008, 2012) in the context of participative reforms in public administrations. In the absence of in-depth research, the evidence presented here is derived primarily from theoretical reflections. The central issue is to identify the types of effects which are associated – on account of their organisational structure – with particular types of participatory devices. In order to shed light on the question, the results of recent case studies have been integrated. In particular, data from two projects is used. First, the author has recently initiated a broader project on the democratic control of public utilities at the University of Potsdam. Second, prior to that project, relevant data was collected in the framework of projects on citizen participation in European water utilities (Sintomer *et al.* 2010a). In all case studies, data was collected through interviews with local stakeholders such as local mayors, managers, public employees, and citizens. In some cases, observations of participative procedures were also undertaken. This helped to establish an idea of the general dynamics of a particular procedure as well as information about participants.

In line with the arguments for community involvement specified above, section 2 starts with an explanation of ‘political equality’ and discusses the thesis of oligarchisation of local democracy through the expansion of public utilities. Then, in section 3, the argument of ‘participative modernisation’ is explained, setting out a framework for evaluation, which is applied in section 4 to devices for community participation in public utilities. Here, different types of involvement and their (potential) effects are discussed. Finally, section 5 considers the interests of different stakeholders, asking whether there is conflict among them that could hinder the development of an enlarged stakeholder concept. In the light of that analysis, section 6 provides an indication of the kind of legislative framework that might facilitate community integration in the stakeholder concept.

## **2. Is there a lack of democracy in public utilities?**

The development of an enlarged stakeholder concept in this chapter begins with a discussion of the legitimacy of community involvement in public utilities. The main argument advanced is that public utilities differ from privately-owned enterprises by the very fact that they are owned by a public institution. Therefore, so the argument goes, a broad majori-

ty of local councillors – but also the community – should have some control of those utilities. However, this interpretation is open to challenge. Although some authors support the need for a democratic opening by stressing the ‘oligarchic’ character of public utilities, other approaches state that the local council (municipality) already has a broad influence. Therefore, before exploring specific examples of community participation, this section gives an overview of the theoretical debate on the public control of public utilities. The idea of ‘political equality’ is used here as the central criterion for comparison.

## 2.1 The value of political equality

‘Democracy’ is defined as government by the people, but it would in fact be difficult to organise democratic life if every citizen participated in important decisions. In most democracies this problem is solved by the election of representatives, who decide in the place of all. In this connection, the notion of ‘political equality’ as defined by Robert Dahl (1971, 2006) at least ensures that everyone has the chance to vote and to be elected. Consequently, in theory, everyone has the potential to be part of the government for some time. In parliamentary democracies, the government is determined by a majority of the political representatives, while the remainder of the elected representatives have the duty to control the government. To realise this aim, every representative has the same rights, that is, each one can demand answers and information on issues they wish to investigate, can contribute to policymaking by working in parliamentary commissions, and can propose amendments to be voted on in the assembly. In this connection, it can be argued that political equality is important not only in relation to the political franchise and the possibility to be elected, but also among elected representatives. Extending this further, it can be argued that political equality should also apply to public utilities on a local level, because they are owned by the municipality and therefore belong to the public administration. Hence, seen from the perspective of democratic legitimacy, there is no reason why public utilities should be controlled to a lesser extent than government departments.

The value of political equality has also become important for citizens outside of elections, because of developments in the notion of democracy. Beyond the mere election of representatives, citizens are increasingly called upon to participate directly in policymaking. The local level

in particular has become an arena for democratic innovations (Smith 2009). In some countries, such as Germany, referendums were established. In this way, citizenry itself can make decisions which are binding on local councillors. In France, for example, the Law Vaillant on community participation has strengthened neighbourhood councils. In other countries, participation increased under the umbrella of Local Agenda 21. This document, drawn up at the 1992 Rio de Janeiro UN conference, identifies municipalities as a key agent for sustainable development. Consequently, many cities in Europe discussed local strategies for improving ecology with their citizens by setting up working groups or other procedures for an ongoing dialogue. Perhaps the most compelling illustration of the spread of new forms of citizen participation is a procedure known as participatory budgeting. Here, citizens exercise control over the income and expenditure items of municipal budgets. The incidence of this form of citizen participation increased from a dozen municipalities in 2001 to more than 250 in all of Europe in 2011 (Sintomer *et al.* 2008, 2012). But what does all this mean in the face of a growing number of public utilities?

## 2.2 The limits of political equality

As already indicated in the introduction, in many cases, the providers of utility services have changed their legal form from public to private. For example, ‘Eigenbetrieb’ has become ‘GmbH’ and/or ‘AG’ (Germany), ‘ambito territoriale ottimale (ATO)’ has changed into ‘S.r.l.’ (Italy), ‘régie’ has been replaced by ‘SEM’ (France), ‘organismo autónomo’ has been transformed into ‘SL’ or ‘SA’ (Spain), etc. Hence, the overwhelming majority of public utilities is organised now under private law status.<sup>5</sup> These changes are more than symbolic, because company law entails certain constraints which affect the possibilities for control by councillors and citizens engaged in local politics.

As regards the notion of ‘political equality’, three general theses can be observed in relation to the political control of public utilities. The first, the thesis of oligarchisation, states that political equality is reduced in public utilities, because only those elected officials who are appointed to

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5. One exception may be France. Here, at least on the local level, public utilities are mostly organised under public law status. But in the end, the number of public utilities is not so high. In water services, for example, 80 per cent of water is provided by private companies.

the company board can obtain information on municipal enterprises. In many cases, this is just a small group, because – due to proportional representation – only the larger parties have the right to appoint members. In the German city of Potsdam, for example, of the 55 city councillors only five are entitled to participate in the company board’s meetings. All others are excluded from key information. They cannot determine prices (for gas, water, public transport, etc.) and cannot participate in the board’s discussions on the company’s future development. This perspective is challenged by theories based on the notion of ‘new public management’. Their central idea is that the local council defines objectives, while agencies – here, public utilities – are free to decide how to realise those aims (Pollitt *et al.* 2001). This approach, also known as ‘steering at arm’s length’, argues that ‘too tight political control over policy implementation may hamper rather than help the accomplishment of policy goals’ (Aars and Ringkjøb 2011: 831). Therefore, according to this approach, the company board is not considered as important as in the thesis of oligarchisation. According to a third approach, the creation of public utilities does not change anything in relation to democratic control (Thiemeyer 1989). Given the limited access to company boards, initial examination would appear to refute that interpretation. Observed more closely, however, this approach may also be congruent with the notion of oligarchisation. This follows when it is realised that local democracy has always been dominated by leaders and hence is by convention oligarchic. Under current arrangements, company boards generally have as members those individuals who have traditionally decided on local policy: the mayor or deputy mayor chairs the company board, the leaders of the largest political groups are ordinary board members, and the directors of service departments are replaced by the managers of public utilities.

Of those three interpretations, the present chapter relies on the thesis of oligarchisation. Of course, due to different legal regimes, generalisations for all of Europe should be made with some care. However, the basic assumption here is that – notwithstanding differences resulting from variations in the legal framework – public utilities in private law status generally tend to restrict and not promote democratic control. This approach will be illustrated now with the example of the German city of Potsdam by comparing the work of the municipal council (local parliament) with the logic of public utilities. Table 1 contrasts the different aspects of public control available in relation to decision making by municipal councils and public utilities. The table shows that political control is much greater if services are organised under the public law

**Table 1 Comparison of access to local council and company board deliberations**

	Municipal Council (public law status)	Public utility (private law status)
Meetings	All councillors and interested citizens	Public is excluded. Only councillors appointed to the board may attend
Non-public meetings	All councillors (even those which are not appointed to the municipal council's working commissions)	Only councillors appointed to the board may attend
Access to files	All councillors have the right to demand access to files	Only councillors appointed to the board may attend
Reporting to party colleagues	Permitted even in relation to confidential matters	Ambivalent situation, tendency not to report
Consequences for whistle-blowing of confidential information	As a rule, only a symbolic threat	General nervousness as board members are personally liable if they cause tangible or intangible loss or damage to the company
General orientation	Everything is public, unless expressly forbidden	Everything said in board meetings is confidential by reason of company law

Note: Based on observations in Germany.

status of local government departments and not public utilities. In this connection, the following points may be observed. The *meetings* of municipal councils are not only open to all councillors, but also to interested citizens and the media. In contrast, the company board meets behind closed doors. For example, according to German company law, this is a legal requirement and board meetings cannot be opened even if there is a political will to do so.<sup>6</sup> Regarding the local council, councillors can also participate in the non-public parts of council's commission, even if they are not officially appointed to the commission. Access to documents is also limited in public utilities of private law status. In contrast, as a rule, councillors can demand to read internal files if they wish to inves-

6. Theoretically, in Germany board meetings in companies of less than 500 employees can be held publicly, but according to the present information on file no cases of this have been reported. If public utility has a public law status, however, parts of the meeting are held in public.

tigate a certain matter or to verify information given by the government of the municipality. Furthermore, it is not always clear whether those councillors appointed to the company board can report on the affairs of the public utility and provide information to other council colleagues. The exchange of views between councillors is generally considered important in exercising control of the government function. As a rule, all councillors should have the same opportunities to obtain information, but the limited access to the company board of a public utility restricts this possibility and undermines the notion of political equality. The legal situation and the specific information company board members can pass on to their council colleagues remain unclear. Members of a board are required by law to ensure the company's confidential affairs remain secret. In Potsdam, board members do not really know which kind of information constitutes a secret and which does not. Therefore, the fear of repercussions creates a general tendency to maintain secrecy about everything said in board meetings. Consequently, things that could be said publicly are silenced.

We have seen that there is a lack of political equality for elected representatives when we compare local councils with the company boards of public utilities. The inequality is stronger still if we look at community involvement, as citizens are excluded from board meetings. Furthermore, if we look at the new forms of citizen participation mentioned above, affairs of public utilities are mostly excluded. For example, in relation to participatory budgeting – currently the most emblematic symbol of citizen participation – Sintomer *et al.* (2008, 2012) state that citizens in most cities cannot make proposals for public utilities. As a result, two countervailing tendencies can be observed. On the one hand, we have a clear interest of citizens to become involved in local politics by frequenting unconventional forms of participation. On the other hand, the increasing prevalence of public utilities indicates a growing sphere that remains outside the scope of larger public control. Hence, the question remains: is there is a way to overcome the lack of democracy in public utilities?

### **3. A framework for 'participative modernisation'**

The previous section argued that, compared to the possibilities which exist in relation to the public administration, there is a lack of democratic control over public utilities. One explanation for this could be that

democratic opening is limited by constraints of markets and competition. However, for the purposes of this chapter, it is presumed that this does not necessarily mean that all participation is impossible. In support of an enlarged stakeholder concept, it is important to show that not only the public administration but also public utilities could benefit from community involvement. Therefore, this section gives an introduction to the idea of 'participative modernisation'. After providing a brief overview of general reform approaches, it will expand the concept by presenting a framework developed by Sintomer *et al.* (2008, 2012). This scheme was established in the context of community involvement in public administration. It will be discussed here how it could be applied to public utilities. Later in this chapter, this framework will be applied to specific examples of citizen involvement in public utilities.

Pollitt *et al.* (2007) compare the notion of new public management to a chameleon. This means that there is no single route to achieve a superior functioning of public services. Since the first reform movement in the 1970s, the renewal of public administration has taken different shapes and orientations. In order to illustrate different reform approaches, a typology proposed by Bouckaert and Pollitt (2004: 183-194) is used here. For a certain period, the most common approach to reform was the privatiser type, which seeks to remove the bureaucratic mode of working. With this aim in mind, public services have been delegated to private companies or quasi-autonomous organisations, as was the case in Great Britain during the 1980s. In other countries, privatisations have been considered the best way to overcome the bureaucratic mode of working of the public administration. In the 1990s, however, Northern European countries in particular developed alternative approaches. For example, the marketiser type of reform relies on competition between public institutions. In order to reduce costs of production, performance indicators of different municipalities are compared. This means that, through a process of benchmarking between institutions, criteria for success can be identified. Finally, the moderniser type introduces logic and instruments from business management to the bureaucratic mode of the public administration. In some ways it can be said that the public administration has taken its cue here from the private sector, compacting hierarchies, strengthening the autonomy of departments, decentralising departments' resource management, changing budget planning from classical incremental budgeting to budgeting by product, etc. However, it has come to light that even when the appropriate instruments have been implemented, the public administration does not change its behav-

our so easily. For that reason, citizen participation has been discovered, and is used to facilitate institutional change. In their analysis of participatory budgeting, Sintomer *et al.* defined eight dimensions of participative modernisation. The discussion below sets out how these dimensions could be applied to public utilities.

Sintomer *et al.* (2012) considered that participation might improve cooperation between the different units and departments of institutions. Citizens do not have the organisational structure of the administration in mind when they articulate their needs. In many cases, in order to realise citizens' proposals, cooperation between different units is necessary. Even if public utilities are not considered as bureaucratic as public administrations, participation may here also promote transversal cooperation between business units or working groups; in this way, the company can act as a whole and not as a fragmented unit. Citizens also want problems to be solved within a certain time. This 'acceleration' concerns both public administrations and public utilities. Citizens put institutions under pressure to respond quickly. This might lead to an acceleration of organisational procedures. Furthermore, the involvement of citizens could lead from another perspective also to acceleration. If the views of citizens are considered in planning processes, for instance, the realisation of projects may be easier, because resistance from potential protest movements is potentially reduced. In some cases, citizens offer to support the realisation of proposals with their own manpower. Here, participation can result in service provision by citizens. One example of this is when citizens volunteer in public libraries. The discussion of whether volunteering is also likely in public utilities requires consideration of specific examples – we will return to this question after the presentation of cases in the following section. Obviously, participatory procedures could contribute to problem solving by widening the range of ideas. This is the case for participative procedures with workshop characteristics in which different stakeholders have time to discuss solutions to problems. As will be shown later, this form of participative modernisation is very important for public utilities. The expertise of citizens and associations might help to improve service provision. For example, environmental associations could provide useful knowledge for water companies, or cyclists' associations for the organisation of public transport. Some governments expect proposals for cost reduction to result from participation. It must be verified by case study analysis whether this is possible only within a certain type of participation – such as participatory budgeting – or if it can also be transferred to public utilities. Sometimes conventional ap-

proaches to modernisation, as indicated above, are blocked. However, citizen participation may promote structural changes and new working procedures, because, in order to respond to citizens' demands, institutions have to abandon their bureaucratic way of working. Public utilities can perhaps also improve their flexibility if they involve the community. If modernisation is to be successful, there must be at least some degree of control of the administration exerted by the participants. Institutions may be more attentive to realise their aims if the public is more vocal.

It is argued here that the effects of participative modernisation may help convince managers and other stakeholders to integrate the community in an enlarged stakeholder concept. For municipalities which follow the moderniser type of administrative renewal it will be much easier than for those which are utilizing in the privatiser type. In the first case the idea is to maintain the competitiveness of public services, and participative modernisation tries to strengthen this orientation. In contrast to this, participative modernisation would not be possible where governments tend to abolish public services. The idea of 'participative modernisation', however, is not beyond criticism. Agents of a radical participatory democracy contend that 'participative modernisation' does not really delegate power to the hands of citizens. From their perspective, participation remains consultative and it is always the government or the manager who has the final say. We will now test whether that assumption is true, or whether there are, in fact, participative devices that truly involve the community in the affairs of public utilities.

#### **4. Community participation in water utilities**

This section brings together the two sides of the coin involved in the community participation approach to an enlarged stakeholder model. Now that the need for a democratic opening of public utilities has been explained (section 2) and the framework of participative modernisation has been presented (section 3), specific experiences will be presented. What kinds of procedures allow the community to participate in the affairs of public utilities? What kind of effects can be expected? The following analysis takes, in turn, the devices of consumer councils, client forums, deliberative polling, and citizen juries, which are presented and evaluated in accordance with the framework of participative modernisation introduced in the previous section. All examples are taken from companies entrusted with the public supply of water. With the excep-

tion of one example, all are public utilities. Each subsection starts with a short description of the participative device itself. And here, as indicated in the introduction, it will be specified who exactly participates using the device, and the parts of the community which can be reached on that basis. As we will see, this depends significantly on the device that is used.

Since research on this issue is still at an initial stage, the presentation of results relies mainly on potential effects. Specifically, our discussion seeks to establish which kind of effect could be delivered by each instrument as a result of its organisational structure. In order to gain a more reliable impression of the real impact of each instrument, the predicted effects are compared with the first results collected from international research on water companies. This data comes partly from a project financed by Paris Municipality and coordinated by Yves Sintomer, Carsten Herzberg, and Annabelle Houdret (2010a, 2010b). Where reports relating to that research are used, the text mentions the names of the relevant researchers. The other evidence is gathered from an ongoing project on public utilities realised by the author of this chapter. But before beginning our analysis of participative devices, some words about water services in Europe must be said.

#### 4.1 The organisation of the European water sector

The water sector in Europe is mainly located at the local level of political structures. In most countries, the municipality itself organises these services (Finger *et al.* 2007). There are only two exceptions. One of these is France, where concessions are very common. This means that the service is provided by a private agency for a certain period, usually between 8 and 25 years, but ownership remains with the municipality. In contrast, in England, water services are completely organised by private companies. The market is shared between about a dozen private companies, which are regulated by the national agency Ofwat. Thus, from the overall European perspective, privately-owned companies have relatively little impact. However, it must be noted that even if private sector companies do not constitute the majority, they are indeed active in some countries either in public-private partnerships or in their own right. This is the case in Germany, Denmark, Portugal, Spain, etc. But in these countries, as already indicated in the introduction, the most important development is that public services have changed their form of business organisation and now operate as public utilities. In the context

of the ‘moderniser’ type of administrative reform – which introduces the logic of private business organisations to the public sector – the entities delivering public services are no longer governed by public law and have become private law bodies. Therefore, the theses on oligarchisation of local democracy have acquired greater importance, as has the question of a democratic opening of public utilities with a view to fostering political equality.

As for the legal framework, the Water Framework Directive<sup>7</sup> establishes some common guidelines. The directive also promotes participation in general, and, hence, may be relied on to support an enlarged concept of stakeholder participation in the field of water. In practice, however, community involvement is more commonly implemented in relation to river and lake management than to domestic water supply. The Directive also provides that the pricing of water services has to cover the real costs of production. Hall and Lobina (2008) observe that this has led to higher prices in some countries, because subsidies have been disallowed. At a national level, the legal framework differs from country to country and reforms are currently underway in many countries in particular in relation to public-private partnerships. Moreover, the reform of European company law, on which this book focuses, can be seen to reflect changing concepts of the company and its role in the provision of public services. The conclusion will discuss how law could promote an enlarged stakeholder concept in that regard.

## 4.2 Community participation on company boards (Germany and France)

One of the central struggles in relation to the company boards of companies has been to gain employee representation. Some European countries require this form of participation, while others do not. Through their participation on the board of a company, employees are in position to influence company policy on crucial questions, and can take part in decision making. Furthermore, they have access to important information. Clearly, therefore, access to company boards is a crucial element in any stakeholder value concept.

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7. Directive 2000/60/EC of the European Parliament and of the Council of 23 October 2000 establishing a framework for Community action in the field of water policy, OJ L 327, 22.12.2000, p. 1.

Theoretically, there is no legal obstacle to letting the community participate on the company board of a company. In public utilities, the company board mainly consists of councillors. Boards are usually small groups, the idea being to facilitate a favourable environment for discussions. In practice, the number of board members varies. In Germany, for example, the company board of a public utility in a midsize city commonly has between 6 and 18 members.<sup>8</sup> Boards have already been enlarged for employees, so some further seats could presumably be allocated to the community. Like employees, of course, the community would never have a majority of seats on the board. More critical than this, though, is the question of who participates. As there are only a small number of seats, it is difficult to open boards to individuals as interested citizens. Their legitimisation would be problematic. Instead, the participation of associations, especially those which are experienced in environmental or consumer matters, would appear an adequate solution. Their legitimacy would derive from the fact that, as associations, they already constitute an ‘accumulation of interests’. Their integration would clearly produce effects in the fields of ‘expertise’ and ‘problem solving’, because associations have acquired specific knowledge in their specialist areas. They could provide input to the company board on specific issues such as the environmental consequences of technical measures, or they could advise on standards and exercise control of a company’s environmental or social performance. Consumer associations may also be capable of advising on cost reductions, because they have an interest in ensuring that customers pay fair prices for water or other services provided by the public utility.

Although there is not a huge wealth of data available, it appears very realistic to presume these effects. The main challenge is to engage the political will of the municipality’s political leaders. Participation on a company board means the sharing of real power. There are not many public utilities in which associations can participate, and if they are allowed to participate, restrictions usually apply. In Paris Public Water Company, one of the most participative public utilities in Europe, associations form part of the board, but they have only an advisory role. In the German city of Münster, the board of the ‘Stadtwerke’, a public utility providing multiple services: water, energy, public transport, etc.,

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8. In large cities, such as Cologne, the number of seats on the company board may be greater. However, in all cases, in comparison with the local council itself, only a minority of political representatives will have access to such a forum.

also integrates the community. Of the 18 seats on the board, a certain number are designated for individuals. These are nominees of the political parties and it can be assumed, therefore, that mostly they are party members or individuals close to a party's interests. Consequently, there is no opportunity for the independent mobilisation of community participation on company boards.

### 4.3 Water councils (England and Wales)

The general idea of a consumer council is to act as a watchdog organisation. Independent institutions are tasked with controlling the conduct of companies providing services of general interest. Their remit covers pricing policy, the quality of services (for example, water purity standards), consumer opinion, etc. In order to realise these aims, watchdog organisations need to be free of government influence, have their own resources and access to crucial information, and in all cases the organisations must consist of competent members. If these conditions are present, consumer councils can not only exercise control, but also contribute to problem solving, because their members are specialised in the field. Furthermore, the expertise of consumer councils could also be used to develop proposals for cost reductions. How do the water consumer councils for England and Wales respond to this ideal?

In her case study on the water councils of England and Wales, Anja Röcke (2010) points out that the context for community participation in water companies in England and Wales is quite different to the situation in other European countries. Over recent decades, the water sector has been radically transformed as a result of neoliberal policies. Municipalities lost their responsibility for water and public utilities were replaced by private companies. In this context, more than 1 600 public utilities have been replaced by 10 regional private sector providers (Röcke 2010). The Department for Environment, Food and Rural Affairs (Defra), a department of central government, is now responsible for water politics in general. In addition, the market is supervised by a regulatory agency, Ofwat (the Water Services Regulation Authority). In this context, a non-departmental body, the Consumer Council for Water (CC Water), was established in 2005 in accordance with the Water Act 2003 (Röcke 2010). The organisational structure of CC Water is quite complex. It has a national board of about eleven members, consisting of a chair, a chief executive, four independent members, and representatives of the coun-

cil's regional sub-boards in England and Wales. The chair and the chief executive have part time jobs; ordinary council members are paid for 2-3 days per month (CC Water 2011). Government institutions appoint council members, but they are usually independent people, such as respected figures in the area of science or health policy. The board meets several times a year, the meetings are open to the interested public, and minutes are published online. The Council's budget for actions is about £6.14 million (around 7.3 million Euros) (CC Water 2010).

In its annual review, CC Water documents the results of its efforts. In 2007-8, it ensured that three regional water companies invested more than £90 million (around 107 million Euros) in infrastructure, and at times it also convinced companies to maintain stable prices (CC Water 2008). Furthermore, the council can point to its success in relation to consumer complaints. Therefore, on the basis of CC Water's own account set out in its annual reviews, it is realistic to presume effects in relation to 'expertise', 'problem solving', and 'cost reductions'. Due to the private ownership of the water companies, however, the influence of the council is limited. Therefore, the companies only make the compromises that are favourable to their interests. The council has no power, only a consultative influence. Its main strategy is based on communication with government, regulatory agencies, and companies. In short, the council cannot fundamentally change water policy; it can only, as Röcke (2010) states, prevent excesses.

#### 4.4 Client forums (Münster, Germany)

Client forums are tasked with advising companies on certain issues of service delivery, mostly determined by the companies themselves. Although their numbers remain limited, these forums are the most widespread device in Germany and in Europe or community participation in companies' affairs. Client forums are not an exclusive device of public utilities, because private sector companies also use this method of consultation. In contrast to consumer councils, the idea is not to exercise control, but to help the company to improve its products.

In the German city of Münster, the public utility 'Statdwerke Münster', a provider of multiple services including energy, water, and public transport, has recently started such a process. Through the medium of public announcements, the utility invites all interested users to an open meet-

ing twice a year. In general, between 25 and 35 members of the public attend these three-hour meetings. At the first meeting, held in April 2011, participants could speak freely on topics of their choice. They selected the issues of pricing policy, strategy of energy policy, public transport, sponsoring, customer service, and recommendations for reducing energy consumption (Stadtwerke Münster 2011). On each of these issues a working group developed specific recommendations, which were first documented in a chart and later in the minutes of the meeting. Some of the proposals were directed at cost reductions. Also, a manager reported that community expertise gave him useful advice. Initially, the CEO had been advised by an external consultant on how to design a user-friendly bill, but this format was criticised by all the customers. Consequently, the manager stated, ‘if the users say that this is too complex, I would be better off listening to those who have to pay the bill’.<sup>9</sup>

Overall, client forums have the potential to deliver a broad variety of modernisation effects. In addition to providing citizen expertise and proposals for cost reductions and encouraging the acceleration of procedures, forums could also, if integrated in a broader strategy of company modernisation, contribute to transversal cooperation between the different units of the company. This is the case if a citizen proposal concerns not only one office of the company, but also the cooperation of different services. It should be noted, however, that in contrast to company boards – and to a certain degree in contrast to consumer councils – participation in client forums is completely controlled by the company itself, which in some cases may be less attractive to the community.

#### 4.5 Deliberative polling (Andalusia, Spain)

Seen conceptually, deliberative polling has a stronger influence. It is not seen as mere consultation on the improvement of products, as is the case with client forums. Deliberative Polling® was developed by political scientist James Fishkin (2003) at Stanford University and has mainly been applied in the context of political decisions by government. The idea is that ordinary citizens express their opinions after having a deeper discussion of a specific topic and listening to different standpoints. Therefore, a randomly selected representative sample of citizens is invited to

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9. Interview with the CEO of Stadtwerke Münster on 13 January 2012.

meet in workshops for a few days. In order to determine if opinions have changed, participants must respond to questionnaires twice, once before and once after the workshop. If different groups block a political decision, deliberative polling can be used to identify new arguments. The following information about Andalusia is taken from the research of Ernesto Ganuza (2011) and Heloise Nez and Julien Talpin (2010).

In the Spanish region of Andalusia, the general water strategy has spurred political conflict over the use of water. In this context, it must be stressed that Andalusia is a warm region in the south of Europe, and, as a result, water is limited and constitutes a valuable resource. Due to demands of the European Union, the Andalusian Government had to implement a new law defining the strategy for water exploitation in the region. The general problem it faced was the presence of two opposing viewpoints preventing a solution. On the one hand, there was the agricultural point of view, which took an economic perspective on the use of water, in this case that the exploitation of water should serve to increase societal wealth. In contrast, the environmental point of view regarded water as a resource for future generations. In order to obtain a clearer view of this conflict, the Andalusian Government assigned the organisation of a deliberative poll to an academic research institute (Ganuza 2011, Nez and Talpin 2010). First, 1 500 randomly selected inhabitants from all parts of the region were contacted and asked to respond to a questionnaire on water policy. Then, 150 of the participants – who seemed to be most representative based on age, sex, and social group – were invited to a three-day workshop. In small groups, the participants discussed water strategies and listened to experts representing the two opposing positions on water policy. After the meeting, they responded to further questionnaires in order to determine if the discussion had changed their opinion. In general, two types of results can be expected from this method. First, if the deliberative polling shows a clear preference, government gains a better understanding of the kind of solution it has to pursue. In this way, deliberative polling can contribute to ‘problem solving’. Second, if the results of a deliberative poll increase the acceptance of solutions, it can lead to the acceleration of procedures, because resistance can be reduced.

The real effects of Andalusian deliberative polling have not been so clear. One reason for this was that the Government hesitated to use the results in public debates. One positive effect, though, was that the 150 participants became much more informed about the politics of water. On the

other hand, one of the disadvantages of the random selection method is that people outside the sample cannot participate. This constitutes a real limit to community participation in the affairs of public utilities.

#### 4.6 Citizen jury (Nantes, France)

Like deliberative polling, the *citizen jury* is a dialogue-based device for community participation. The participants are also selected by a representative sample. The objective here is not to observe the transformation of opinions, but to obtain detailed information on the solution to a problem. Here too, participants meet for a few days, gather in working groups, and listen to a variety of opposing arguments. In contrast to deliberative polling, however, participants try to reach to a consensus. This does not mean that they declare their preference for only one solution; they can also propose alternatives. In all cases, the output of a citizen jury is a detailed report, often written by the moderators of the process but approved by all participants. The following information about Nantes is taken from a case study report by Clémence Bedu and Rémi Barbier (2010).

In 2009, the urban intermunicipal government of Nantes organised a citizen jury. The intermunicipal government is generally responsible for water policy in its area. The government fixes the prices and standards, and decides which operator is to provide the water services. At present, under the existing concession, one public utility and two private sector companies are contracted to provide these services, which is a very common situation in the French context. As regards community involvement, French law requires that in municipalities with more than 10 000 residents a consumer council composed of local councillors and representatives of local associations has to be installed. This council evaluates the price policy for all public services, including water. However, in contrast to the meetings of the Consumer Council for Water (England and Wales), the public is excluded from these meetings of the French consumer councils. Typically, local residents are not aware that such an institution exists, and even the formal members lack the motivation to attend the meetings. Therefore, Nantes intermunicipal government decided to collect proposals for a better participative policy. The main questions, as Clémence Bedu and Rémi Barbier (2010) stated in their research report, focused on how the work of the consumer council could be made more attractive. Also, how could a broader public be included?

Could this be done through a different participative device? With these objectives in mind, 15 participants were invited to a citizen jury which met over the course of three weekends. Ten of the participants were randomly selected, and the remaining five were members of local associations. The work of the citizen jury included the phases of education, expert listening, and deliberation. For this, not only presentations but also interactive methods such as theatre role-plays were used. Finally, the group prioritised its proposals through a process of voting and reports detailing the results were drawn up by the members (Nantes Metropole, Dem'eau and Cemagref 2009).

Like deliberative polling, the citizen jury can lead to an 'acceleration of procedures' and 'problem solving', because the government has the opportunity to hear a detailed report in which the 'citizens' expertise' comes out. If the citizen jury is organised around financial questions, this method can also lead to 'cost reductions'. In Nantes, however, the jury mainly contributed to problem solving. Although the jury proposals were at first rejected by the councillors, who considered the report to be too critical, at a later stage, a joint commission consisting of councillors and jury members discussed proposals for improving participation in the consumer council and in the area of water in general.

#### 4.7 Overview of effects

Although there is still a gap between real and potential effects, the cases presented generally show that community involvement can produce favourable results. In this section, some criteria that facilitate effects will be highlighted. Naturally, it is not helpful to oversimplify and ignore problems, but for analytical reasons it makes sense first to discuss the potential effects – the problems will be discussed in the following section. This information may be helpful for those who are interested in the implementation of participative devices in public utilities. For that reason, this subsection provides some guidelines for the implementation of participative devices.

Taking a look at Table 2, some comments can be made concerning the effects of participation on modernisation. Again, it must be remembered that at this stage of research, the links between specific participative devices and types of effects constitute, first and foremost, hypotheses. It is the task of future research to validate and develop them, because, as

Table 2 Potential effects on participative modernisation by device

	Board representation	Consumer council	Client forum	Deliberative polling	Citizen jury
Transversal cooperation	–	–	X	–	–
Acceleration of procedures	–	–		X	X
Service provision by citizens	–	–	–	–	–
Provision of expertise by citizens and associations	X	X	X	–	X
Problem solving	X	X	–	X	X
Cost reductions	X	X	X	–	X
Structural changes	–	–	X	–	–
Control by citizens	X	X	–	–	–

Note: X = effects can be expected; – = no effects can be expected.

this section has shown, the devices do not automatically lead to their predicted effects. Taking these caveats into account, the following comments can be made. First, among the selected devices, the most widespread effects concern the ‘expertise of citizens and associations’ and the potential for ‘problem solving’ and ‘cost reductions’. This impact is possible if participatory devices offer a space for deeper, ongoing discussions, as is the case with deliberative polling, citizen juries, and consumer councils. Of course, this is also possible in the small groups of company boards. Second, broader effects of modernisation, that is, the integration of ‘transversal cooperation’ between internal company units and ‘structural changes’, are likely if participation is an ongoing process and not isolated to single events. As citizen juries and deliberative polling are very complex and may only be organised in specific and one-off situations, they may not encourage a structural change in companies’ internal structures and performance. This is in contrast to client forums, which are intended to meet frequently. Furthermore, it can be expected that proposals developed by client forums will be diverse and demand cooperation between different offices of the company. Such proposals

may also foster ongoing procedural and structural changes. Third, it must be noted that 'control' is likely to be a rare effect of community participation. Control is only possible if participative institutions have a certain autonomy and the right to access crucial company information. This is most often the case in relation to participation on company boards, as a result of rights conferred by company law. To some degree, consumer councils may also control companies' performance, but their influence is limited by their external status. Fourth, it has been observed that 'service provision by citizens' does not appear to result. It is possible that the private law status of the service provider inhibits citizens from becoming concerned, in other words they do not feel concerned if an enterprise lacks the capacity to realise its task. Fifth, and finally, it is reasonable to presume that one device alone will not contribute much to a democratic opening: Experiences of participative modernisation in the public administration have shown that community participation has to be accompanied by other changes to structure as well as changes of attitude amongst the agents concerned (Sintomer *et al.* 2008). Applying this experience to public utilities, this means, for example, that the overall orientation of a company will not change simply through the organisation of a single client forum. It makes a difference, however, if client forums are embedded in a general strategy of transparency and trust. In this case, for example, the forum could be complemented by reports on sponsoring placed on the company's website and large-scale company boards including politicians from all political groups. Additionally, as will be shown in the next section, it is important that the attitude of key agents – such as employees and managers – towards community participation is consistent with this line of thought.

The effects on participative modernisation demonstrated here may be relevant not only for political actors but also for managers in public utilities as an encouragement to join the debate on enlarged stakeholder concepts. However, as already indicated, there is still a divide between the potential and real effects of participative modernisation. In other words, companies could profit much more from community involvement than they have until this point. What are the reasons for this?

## **5. Enlarging the stakeholder approach**

In order to improve the effectiveness of the enlarged stakeholder approach, the following section will examine whether there are conflicts

between different stakeholder groups that inhibit the impact of community involvement. In other words, what changes are necessary to facilitate and improve community participation? Moreover, who is ‘the community’? In answering these questions, we will see that the community itself may also contain opposing interests, which influences its relationship to employees and other stakeholders. In order to understand better this relationship a conceptual distinction of different community roles will be proposed.

We start our reflection with the person who may be in the centre of power in public utilities: the manager. Some scholars have shown that the characteristics of managers in public utilities have changed (Edeling 2003). Previously, the service was typically headed by someone with technical/engineering skills. The idea was to deliver good quality and to ensure that everybody had secure access to water, energy, and other services. Today, as a result of changes over the last two decades, public utilities are steered by managers and guided by economic principles. In times of limited financial resources and criticism of bureaucratic modes of administration, public utilities have to prove their economic efficiency. However, given their focus on economic issues, these managers may be less open to community participation. In the city of Potsdam, to cite an example from a previous section, the manager considered himself to be the ‘big boss’. It was clear that he used his autonomy, as much as possible, to decide alone. He collaborated with the company board and party groups only where necessary, and would not voluntarily permit others – especially the community – to gain real power. This would not be in keeping with his self-definition as a manager. In these circumstances, perhaps it is necessary to change the legal status of public utilities in order to achieve community participation – we will come back to this point in the chapter’s conclusion – but at this point a different proposition should be made. Namely, during university degree programmes in business administration, future managers could be instructed in participative devices. As has been done recently in the case of public administration, managers could be shown that companies can benefit from community involvement, as this chapter demonstrates. Therefore, familiarity with participative devices could be included as requirement for new managers. Consequently, managers would consider participation a qualification that could further their professional careers.

For the implementation of new participative devices, managers need to know more clearly whom should they involve, and who is to be regarded

as the community. Until now, this chapter has defined citizens, associations, and other groups of civil society as the community. However, for a better understanding of this matter, it has to be realised that the participation of the community relies on different roles (see also Bogumil *et al.* 2001; Sintomer *et al.* 2008, 2012). In this connection, it was the idea of new public management to speak about members of the public as *clients*. In this discourse, attention is centred on good service quality and prices. Furthermore, clients would like to have easy access to services, and in keeping with this concept they should have the choice between different providers. Admittedly, this is not always possible in relation to services of general interest such as water, which can only be provided by the company that has been commissioned by local government to do so. However, this generally does not change the fact that public utilities treat citizens as clients. In some countries such as France, however, the French term *client* is replaced by *usager*<sup>10</sup> if services are provided by public administrations or publicly-owned companies. The differentiation is much more than nominal. The term *client* defines a relation based on an exchange of money for services (telephone services, for example), while the term *usager* implies that public administration is also responsible for those who have no money to pay for services. Giving this example from France, we would like to remember that low income people must also have access to basic service – a question which gets easily neglected if consumers are only considered as clients in economic terms. Developing this distinction, we would like to propose in addition to clients and usagers the role of citizens which is much more political. The central idea, here, is that citizens feel responsible for society as a whole and not only for particular interests. In fact, there could be a conflict between the roles of client and citizen. Whereas clients tend to focus on low prices, citizens might be receptive to prices that adequately cover environmental and social costs.

Differentiation between various roles is crucial to the relationship between the community and employees. The latter group is expected to defend worker rights: adequate wages, stable employment conditions, health and safety at work, etc. In general, employees support successful companies, because they seek to convert company profits into wage in-

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10. There is no English analogy for the French word *usager*. Therefore, we use here the French term in order to develop the different conceptual roles of clients, usager and citizens which we consider crucial for the understanding of community participation in public utilities.

creases and to promote long-term job security. However, employees and unions have not expressed any particular interest in promoting the participation of civil society in companies' affairs. One explanation for this could be that their relation to the community is ambivalent and depends on the role at issue. To clarify, the notion 'role' does not necessarily refer to different persons. What is important here is the capacity or status according to which one acts.

It is presumed here that employees can benefit from community participation if that participation functions through a *citizen* perspective. In their reasoning, citizens integrate the interests of others. For example, as members of company boards they may argue for long-term job security because they take account of all the local people employed by the company. In contrast, the client point of view does not consider the welfare of employees, the company, or society as a whole. Clients would like to secure the best conditions for themselves. Therefore, they are more likely to further the aims of the company and its employees if they are invited to participate in forum discussions on service and product quality. Here, for example, employees could learn from clients that water quality is poor in some parts of the town or at certain times of the year. This information is very useful, because it is the task of employees to ensure water quality. Similarly, one can imagine that clients may help employees to develop new products. Consequently, this could contribute indirectly to job security, assuming that the new products are successful.

As has been argued above, employees can clearly benefit from community participation if the community participates in the appropriate role and in the appropriate forum. Ideally, citizens would participate in strategic questions, and clients in the discussion of products. Therefore, it is crucial for an enlarged stakeholder concept to coherently link the different roles using suitable participative devices. For example, associations with an interest in political steering could be integrated into company boards, as has already begun in Paris Water Company. Here, associations pursue the role of citizens concerned with the general good. Similarly, client forums – as the name suggests – should be open to those who are interested in improving products and services. These devices are mainly consultative, and therefore it is less likely that they can impose solutions that are harmful to employee interests.

## 6. Conclusions: A legal framework to integrate the community

This chapter has discussed the procedures by which the community could be integrated in an enlarged stakeholder concept. In support of that concept, it has been argued that there is a lack of democracy in public utilities. Given that these bodies constitute part of the public administration and are responsible for services of general interest, the community should have the opportunity to participate in their affairs to the same extent it can where services are provided directly by local government. In order to convince other stakeholders, especially managers, of the benefits of community involvement it has been demonstrated that this could enhance the modernisation of public utilities. In order to detail the positive effects, different forms of community involvement have been analysed. From this it can be concluded that positive effects can be encouraged most effectively if the relationship between different stakeholders is regulated. In particular, the relationship between employees and the community in its different roles (citizens, clients, users, etc.) needs to be considered when participative devices are implemented.

In order to organise the coherent integration of stakeholders, it would be beneficial to establish a suitable legal framework. A first step would be to recognise that public utilities are different to private sector companies. Acknowledging their public character helps stress the public interest involved. Although the community is currently excluded from those utilities, integration of the community, as argued in this chapter, would be a legitimate aim in terms of political equality. A starting point for any legal proposals should be the relationship between company boards and the community. Table 1 (see section 2 above) could be helpful here as it compares access to local councils and company boards from the perspective of political equality. The table demonstrates that it makes a crucial difference whether public services are provided by local government departments or by public utilities. Therefore, the analysis clearly points in favour of some forms of democratic opening. For example, the participation of environmental and social associations on company boards would be beneficial. Furthermore, increased access to information could be given to individual citizens and consumer councils. Moreover, the analysis of consumer councils, deliberative polling, and citizen juries has shown that these external organisational devices need to be equipped with specific legal rights, and that discussions should be linked with decisions. Otherwise, there is a risk that such devices have no impact on public

utilities. In contrast, no additional legal framework is needed to encourage client forums. Managers themselves have an interest in establishing these devices, and it is highly likely that the number of client forums will increase in the future.

In light of these reflections, an initiative at the European level would be very useful. The proposal advanced here is that public utilities should be subject to a specialised legal regime which permits more democratic opening. This law could establish the participation of NGOs and community organisations on company boards in a voting capacity. Furthermore, all interested citizens should have the right to easily access information. In the same way as they are required to produce annual financial reports, public utilities should have the duty to inform the community – through reports published online – on questions of pricing and in relation to large infrastructure projects. Consequently, before major infrastructure projects are undertaken, the community should be consulted. This principle is already part of urban planning laws in some countries and could be applied also to public utilities. It would then be for public utilities themselves to determine whether consultation is realised by public assembly or other forms of dialogue-oriented participation (deliberative polling, citizen juries, etc.). Independently of this, consumer councils should be established at the national and sub-national levels in order to ensure consumers' rights. This could be important if, for competition reasons, public utilities cannot give complete information on prices.

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# **Chapter 12**

## **The emperor's new clothes – enlightened shareholder value and the UK Stewardship Code**

**Janet Williamson**

### **1. The role of shareholders in the UK's system of corporate governance**

In the UK, when it comes to corporate governance, there is only one stakeholder group that really counts: company shareholders. Unlike many continental European systems, workers do not have participation rights in corporate governance, and the rights to information and consultation that they do have – which are generally much weaker than those of continental European workers – are not linked to corporate governance but operate quite separately. While the terms ‘Anglo-Saxon’ or ‘Anglo-American’ are often used to link the UK and the US systems of corporate governance, what the two have most clearly in common is an absence of any element of workers’ participation, rather than sharing the same system of shareholder control. Although recent developments in the US such as ‘say on pay’ are starting to change this, shareholder rights remain significantly stronger in the UK than they are in the US. Thus, the shareholder value model of corporate governance is uniquely strong in the UK.

One reason for this is that, since the early 1990s, successive UK corporate governance reviews have emphasised the role of shareholders in monitoring and engaging with company boards, rather than regulation, as the means to improve corporate standards and behaviour. First came the Cadbury Committee, established in the early 1990s in response to the corporate scandals of BCCI and Polly Peck, which produced what became known as the Cadbury Code. This was followed by the Greenbury Committee set up in 1995 to address the issue of executive pay. In the late 1990s, the Hampel Committee reviewed the Greenbury Committee’s recommendations and amalgamated them with the Cadbury Committee’s to form one corporate governance code (known at the time as

the Combined Code of Corporate Governance); this was followed by the Turnbull Report on internal control and risk management in 1999, and the Higgs review of the role of non-executive directors in 2002. The now renamed Corporate Governance Code has continued to develop, with the most recent version being published in 2010. Throughout its genesis, the central theme of the Code has been the accountability of the board of directors to company shareholders.

Whether their powers are enshrined in the Corporate Governance Code, company law or in companies' Articles of Association, shareholders wield significant rights in the UK in relation to the companies whose shares they own. They have the power to elect directors at the annual general meetings of FTSE 350 companies, now on an annual basis. They have had an advisory vote on remuneration reports since 2003, and the UK Government announced in January 2012 that it will introduce a binding shareholder vote on directors' pay (Department for Business, Innovation and Skills 2012). Shareholders can propose resolutions at AGMs and vote on all resolutions. They can convene extraordinary general meetings.

Moreover, there is a widespread assumption in the UK that it is right and proper that shareholders should be the ones to act against corporate misdemeanours, and a common response from Government, when confronted with public outrage at egregious corporate behaviour, is 'it's a matter for shareholders' (unless it turns out that the Government is in fact the main shareholder as is the case with one of the UK's largest banks, Royal Bank of Scotland). Thus alongside the market for corporate control – in which shareholders also hold all the cards – shareholder engagement and power is seen as the main discipline on company behaviour in the UK, other than basic legal requirements.

However, the most fundamental right that shareholders enjoy is that in UK law directors' duties require company directors to promote shareholder interests. Recognising that there is a 'high road' to profitability based on investing in research and development and employee training and developing long-term relationships with stakeholders based on respect and trust, and a 'low road' route based on a low-wage, low-skill and low-investment model, the law encourages directors to serve shareholder interests in an 'enlightened' way. Thus, the 2006 Companies Act requires directors, in serving shareholder interests, to have regard to the interests of employees, suppliers and the local community, environmental and reputational impacts and the long-term consequences of their decisions.

Directors are required to report on how they have carried out these duties and on key information concerning employees, supplier relationships, social and community issues and environmental impacts. This is the 'enlightened' component of the term 'enlightened shareholder value'.

The rationale behind this formulation was the view that in the long term there is a convergence of interests between shareholders and other company stakeholders. Thus, the argument went, there is no need to give stakeholder interests equal status to those of shareholders or give stakeholders participation rights, because in the long run promoting shareholder interests is good for other stakeholders and indeed for the company itself.

## **2. Genesis of the Stewardship Code**

The financial crisis shattered the illusion that shareholders were monitoring boards effectively and turned a spotlight on the whole area of corporate governance and shareholder engagement as a discipline on company boards. In the UK, Sir David Walker was asked to undertake a review of corporate governance in UK banks and other financial industry entities, which reported in 2009 (Walker 2009). This was very critical of the quality and extent of shareholder engagement with bank boards and its recommendations included a proposal that the responsibilities of investors towards the companies whose shares they own should be set out in a code that would complement the Corporate Governance Code that focuses on the role of directors. The Stewardship Code was launched by the Financial Reporting Council (FRC) in July 2010.

The Stewardship Code is addressed to institutional investors (FRC 2010: 2). It is aimed primarily at asset managers, but encourages pension funds and other asset owners to apply the Code. Like the Corporate Governance Code, it is applied on a 'comply or explain basis'. While applying the Corporate Governance Code has long been a requirement of the UK Listing Rules, the Financial Services Authority (responsible for licensing UK financial services institutions) amended its rules so that since December 2010 all UK-authorized asset managers have been required to produce a statement of commitment to the Stewardship Code or explain why it is not appropriate to their business model (FSA 2010). Both are under the remit of the FRC, which has responsibility for updates and reviews of the Codes.

The content of the Stewardship Code was based on an existing code already drawn up by the Institutional Shareholders' Committee (ISC).<sup>1</sup> Its seven principles require that institutional investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have a robust policy on managing conflicts of interest in relation to stewardship, which should be publicly disclosed;
- monitor their investee companies;
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
- be willing to act collectively with other investors where appropriate;
- have a clear policy on voting and disclosure of voting activity; and
- report periodically on their stewardship and voting activities.

These principles are supplemented by guidance, which is more detailed on some areas of the Code than others.

### **3. A critique of the Stewardship Code and enlightened shareholder value**

Given the central role ascribed to shareholders within corporate governance in the UK, it is absolutely right and long overdue that some standards governing investors' responsibilities in relation to the companies whose shares they hold should be established. For this reason, the Trades Union Congress (TUC) welcomed the introduction of the Stewardship Code. It is the first high-level initiative to set out the responsibilities of investors and its introduction has already boosted discussion and debate on this important area.

In relation to the contents of the Code, it is a limitation in the TUC's view that, despite carrying out an extensive consultation on what should be included in the Stewardship Code, the FRC then decided to use the

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1. The ISC is a group of trade associations that represent institutional investors and comprises the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds. The ISC has now been renamed the Institutional Investor Committee.

existing ISC Code as the basis for the Stewardship Code, making only minor changes. The TUC would have wished the Stewardship Code to be considerably stronger on several issues, including voting disclosure. Another weakness is that it does not address the different parts of the investment chain clearly, and does not therefore set out the respective responsibilities of asset owners and consultants in relation to stewardship. Nonetheless, the Stewardship Code does encourage collaboration between investors over their engagement strategies with companies and encourages voting, reporting and the systematic monitoring of investee companies.

However, there is a more fundamental question that needs to be asked. Is the enlightened shareholder value system that the Stewardship Code enhances working as it should be, or is it the system itself that needs to change?

The rationale behind enlightened shareholder value is that, in the long run, the interests of shareholders converge with those of other stakeholders and, even more importantly, those of the company itself. Therefore, requiring directors to promote the interests of shareholders will, in the long run, be good for other stakeholders and for company performance. Following and extending this argument, if the purpose of companies is to promote their shareholders' interests, it makes sense to give shareholders the rights and tools to enable them to hold company boards to account. Or does it?

Patterns of share ownership have changed dramatically in recent years, posing a major challenge to the UK's reliance on shareholder engagement within its corporate governance system. In the 1960s, the majority of shares in UK companies were owned by individuals, many of whom took a reasonable level of interest in the companies whose shares they owned. By the 1980s, the majority of shares were owned by UK institutional investors such as pension funds and insurance companies. Today, this has changed again. The most recent figures from the Office for National Statistics (ONS) figures show that by the end of 2010 UK pension funds and insurance companies held just 5.1 per cent and 8.6 per cent of UK equities, respectively, the lowest percentages since the survey started in 1963 and sharply down from a combined total of 43 per cent in 1998 and 26 per cent in 2008. By December 2010, investors from outside the UK owned 41.2 per cent of UK listed shares, while individuals held 11.5 per cent (ONS 2012).

It will, by definition, be harder for investors from outside the UK to develop the kind of engaged relationships with UK companies that are envisaged by the UK's corporate governance system. Language, culture, proximity and availability of information all make engagement much more straightforward within a national context in comparison with engaging with companies abroad. This is reflected in responses to the TUC's Fund Manager Voting Survey. In the 2011 Survey, all 19 respondents to this question said they voted all their UK shares (with a couple of minor qualifications), while ten voted all their overseas shares (with a further seven saying they voted a significant proportion of their overseas shares). The UK's corporate governance system was not designed on the basis that the largest single share ownership block would be investors from outside the UK.

In contrast with individuals who generally own shares in a limited number of companies whose progress they follow closely, institutional investors generally hold highly diversified portfolios. The Investment Management Association (IMA) says that the average fund manager holds shares in 450 different companies, and for some it will be in the thousands. Just as an increasing proportion of UK shares are held by investors from outside the UK, an increasing proportion of equity holdings of UK institutional investors are global, rather than UK, equities. The sheer number of companies whose shares they hold poses major practical challenges for the ability of institutional investors to carry out their corporate governance responsibilities effectively. The TUC's Fund Manager Voting Survey asks each year about how many people fund managers have working on corporate governance and responsibility issues. With five exceptions – two teams of 30 or more, two teams of twenty or more and one with twelve people – all other respondents have less than ten staff working on these issues (TUC 2011). However skilled and dedicated such staff may be, it cannot be possible for them to engage effectively with all the companies whose shares they hold over all the issues for which shareholders are ultimately responsible.

The IMA's own survey makes it clear that its members are wary of too weighty expectations being placed on their governance role: 'The fact that UK investors now own a smaller proportion of UK companies has implications for the corporate engagement role that investment managers play in the governance of companies. There is concern amongst investment managers that there should not be unrealistic expectations of what they can achieve through engagement' (IMA 2010). If UK institu-

tional investors are to engage effectively on an informed and consistent basis with all the companies whose shares they own, this would require a very significant deployment of resources, considerably above the levels that most currently devote to engagement.

By setting out high-level guidance on monitoring and engagement with investee companies and encouraging collaboration between investors, the Stewardship Code does try to address these challenges. However, while it is still early days in the life of the Stewardship Code, there is no evidence to date that it has led to increased resources being allocated by asset managers to stewardship. The TUC's 2011 Fund Manager Voting Survey asked respondents what, if any, changes they had made to their voting and engagement practices as a result of the introduction of the Stewardship Code. Several respondents said that they had made no changes in response to the Code, with some saying they believed they already met its requirements. However, a number of respondents did identify changes made as a result of its introduction: several mentioned that they had improved engagement recordkeeping, and in addition, changes to stock-lending and conflicts of interest policies, reporting to clients and public reporting were all mentioned. Notably, only one respondent stated that it had increased the resources devoted to stewardship and only one said that communication with companies had changed as a result of the Stewardship Code (TUC 2011). Worryingly, recent changes within the market place suggest that, despite the Stewardship Code, asset managers are currently cutting back, rather than expanding, their engagement capacity (Aviva 2012). If shareholders do not have the capacity or motivation to engage sufficiently with the companies whose shares they own, this leaves a dangerous vacuum in corporate governance.

A further challenge for good stewardship is to ensure that voting and engagement is carried out in accordance with the wishes of the ultimate beneficiaries of investments. The TUC believes that the Stewardship Code should include a provision stating that asset managers should consult with their clients and beneficiaries on the policies on which their voting and engagement is based. Unfortunately, this area is not addressed by the Code, which stipulates that asset managers should report periodically to clients, which is welcome, but contains nothing to encourage asset managers to actively seek client and beneficiary views on their policies and stewardship performance. Given the disparate nature of asset managers' clients and beneficiaries and the lack of avenues for

engagement that exist between the latter and their fund managers, this is a serious omission. In the area of pensions, it can be difficult enough for trustees of a trust-based, defined benefit pension scheme to engage their fund managers in discussion around stewardship issues, but at least in this case there is a governance body that can act as a direct link between beneficiaries and the asset manager. In contract-based defined contribution pension schemes, the beneficiaries have no channel through which to raise issues or express their views. The impact on stewardship of the switch made by increasing numbers of UK companies from trust-based defined benefit pension schemes to contract-based defined contribution pension schemes has been insufficiently acknowledged in public policy debate. Similarly, with insurance, private pension and other retail products, beneficiaries have no democratic voice in discussions on stewardship decisions that are taken on their behalf. Failure to address this vital area is a significant deficiency in the Stewardship Code.

However, even if fund managers were to find the capacity and motivation for engagement and an effective way of ensuring that their strategies take into account their beneficiaries' views, there is an even more fundamental problem with reliance on shareholder interests as a proxy for wider stakeholder and company interests. The convergence between shareholder interests and those of other stakeholders and indeed the company itself only works if shareholders are long-term investors whose economic interest in a company is in receiving dividend payments over a period of time. If, however, the shareholder is a short-term share trader, whose economic interest is in selling a company's shares for a higher price than it bought them for, it will have a direct interest in promoting short-term strategies to boost the company's share price, even where these are in direct conflict with strategies for long-term, organic growth. In this case, its interests will not coincide with those of company stakeholders such as employees and suppliers, nor, very significantly, with the interests of the company itself. If the investor is shorting the stock, its interests will be diametrically opposed to those of the company and other stakeholders, including long-term shareholders, as it will stand to gain if the company's share price falls. In this scenario, it is far from clear why shareholders are the group whose interests companies are required to promote, and why shareholders have the ultimate say over how companies are run.

This fundamental issue of the divergence between the interests of short-term share traders and long-term company interests is not addressed in the Stewardship Code, which treats all investors the same. The Code has

nothing to say on share trading strategies or the desirability of long-term share ownership, restricting its focus to stewardship activities without acknowledging that the shape and impact of these activities will vary considerably depending on the underlying financial strategy of the fund manager.

The TUC has proposed that investors' governance rights in companies, including voting rights, should be dependent on a minimum period of share ownership, which we suggest should be two years. This would help to reduce the role played by short-term share traders in company decision making.

In addition, the TUC believes that directors' duties should be rewritten, so that directors are required to promote the long-term success of the company as their primary aim. In carrying out this duty, directors should be required to deliver sustainable returns to shareholders, promote the interests of employees, suppliers and customers, and have regard to community, environmental, human rights and reputational impacts. This would have the effect of rebalancing the interests of shareholders and other stakeholders, but all their interests would be secondary to the long-term success of the company itself.

## **4. Conclusion**

In conclusion, the Stewardship Code provides a welcome focus on the quality of investor engagement by encouraging asset managers to monitor and engage with investee companies. It does not address the respective roles of the different parts of the investment chain and nor does it encourage fund managers to consult with their clients and beneficiaries about their stewardship policies and performance, but it would be possible to amend it to repair these deficiencies.

But the Stewardship Code does not and indeed cannot address the fundamental problem with enlightened shareholder value, which is the divergence between the interests of short-term shareholders and those of other stakeholders, long-term shareholders and the company itself. This is the central contradiction at the heart of shareholder value systems of corporate governance, and addressing it requires steps that go beyond reforms of the existing system, welcome though these may be.

Nor can the Stewardship Code address the difficulties that fund managers face trying to engage with hundreds or thousands of companies whose shares they hold. This remains a major practical obstacle to the quality and quantity of engagement, and again addressing this would require structural change that is beyond the scope of the Stewardship Code.

The Stewardship Code has given the emperor some new clothes, but underneath the problems with enlightened shareholder value have not gone away. The time has come to look at more fundamental reform of the UK corporate governance system and the interests and rights that underpin it. Rather than prioritising shareholders over other stakeholder groups, corporate governance should be rebalanced so that its governing principles are the interests of long-term stakeholders and above all the long-term interests of the company.

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# Chapter 13

## Regulating companies as if the world matters: reflections from the ongoing 'Sustainable Companies' project

Beate Sjøfjell\*

### 1. Introduction: a moral imperative for action

The company is one of the most ingenious inventions of our time (Rajan and Zingales 2003: 59 and 160). With limited liability for its investors, enabling capital to be (in theory) put to its most efficient use, the company has become the backbone of our economies. But must this all-important component of our market economies be equated with environmental degradation to the extent that we risk dangerous loss of biodiversity and passing the tipping point of climate change? In my opinion it must not. We need to find out how to make the necessary changes. We have a moral imperative for action.<sup>1</sup>

Climate change is a case in point for the necessity of working toward a sustainable development; toward the achievement of economic development and social justice within the non-negotiable ecological limits of our planet. Sustainable development – the balancing of economic development, environmental protection, and social justice – has famously been defined as a development that 'meets the needs of the present without compromising the ability of the future generations to meet their own needs' (United Nations 1987: 27; analysed: Sjøfjell 2009a; Voigt 2009). According to even the most conservative estimates of the Intergovernmental Panel on Climate Change (IPCC), business as usual will

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\* I would like to express my gratitude to my colleagues in the research project 'Sustainable Companies' for their insightful contributions to our ongoing research. The views expressed in this chapter are my own and do not necessarily represent those of the project team. All comments are welcome at [beate.sjofjell@jus.uio.no](mailto:beate.sjofjell@jus.uio.no). This chapter is a slightly revised version of my earlier article (2012) *Wake Forest Law Review*, 47, 113-134 and is republished here with the kind permission of Wake Forest Law Review.

1. See Porritt (2007). The title of this chapter is inspired by and intended as a tribute to Jonathan Porritt's book.

most probably lead to climate change of a magnitude to which we cannot adapt, or to which we can adapt only at extremely high costs (IPCC 2007; Bernstein *et al.* 2007; United Nations 1987). Contrary to popular phraseology, dealing with climate change is not about saving the planet. The planet will take care of itself. The issue is whether we should preserve the very basis of our existence, of our societies as we know them today. As the Stern Review put it, climate change is ‘the greatest and widest-ranging market failure ever seen,’ posing ‘a unique challenge for economics’ (to which we may add: and also for law) (Stern 2006). Runaway climate change involves a high risk of severe environmental, social, and economic consequences. According to Adger *et al.* (2007: 7-22), ‘the resilience of many ecosystems is likely to be exceeded this century by an unprecedented combination of climate change, associated disturbances (e.g., flooding, drought, wildfire, insects, ocean acidification), and other global change drivers (e.g., land-use change, pollution, over-exploitation of resources)’. In that context, the challenge of climate change needs to be dealt with on all those levels, both in terms of mitigating as much as possible, and adapting to that which cannot be avoided.

Climate change is not the only crisis we face. There is a convergence of crises: the financial crises; the loss of biodiversity threatening the stability of our ecosystems (Sarukhán *et al.* 2005; Benjamin 2010); the peaking of fossil energy sources (Roberts 2010); and the harsh brutality of tens of thousands of people dying every day for poverty-related reasons. In the aftermath of one financial crisis and the furious effort to try to avoid a new full-blown crisis, the attention of world leaders is on stimulating growth and getting back to business as usual. Although there has been some talk of a ‘Global Green New Deal’, of turning the financial crisis into an opportunity for necessary transition to a green economy (United Nations Environmental Programme 2008; Barbier 2009; United Nations Environmental Programme website), generally speaking, environmental concerns have a tendency to be placed on the backburner, along with concerns for the underprivileged of this world, when jobs are lost, revenues disappear, stock markets quiver, and the financial basis of developed countries appears to be in danger. In that context, Barbier observes, ‘fossil fuel subsidies and other market distortions, as well as the lack of effective environmental pricing policies and regulations, will diminish the impacts of G20 green stimulus investments on long-term investment and job creation in green sectors. Without correcting existing market and policy distortions that underprice the use of natural resources, contribute to environmental degradation and worsen carbon

dependency, public investments to stimulate clean energy and other green sectors in the economy will be short lived. The failure to implement and coordinate green stimulus measures across all G20 economies also limits their effectiveness in ‘greening’ the global economy. Finally, the G20 has devoted less effort to assisting developing economies that have faced worsening poverty and environmental degradation as a result of the global recession.’ (Barbier 2010). Consequently, getting back on track with economic growth and business as usual is a postponement of the necessary focus on dealing with climate change and other over-riding environmental concerns – a postponement that may turn out to be highly detrimental to our chances of achieving a sustainable global society: financially, socially, and environmentally.<sup>2</sup>

It is the poor people of this world who are already suffering the most, who are hit first by financial crises (United Nations 2010), and who will continue to be affected the most, in the short term, as a consequence of climate change and the global energy situation (Braun 2007: 12; Bernstein *et al.* 2007). But ultimately these crises affect us all. There are many indications that business as usual is the right choice only if we desire a very uncertain future for our children and grandchildren (United Nations 2010). Unfortunately, by the time enough decision-makers realise that business as usual is not a viable alternative, it may very well be too late (Metz *et al.* 2007). That gives rise to the question: What do we do?

## 2. The role of companies

What then is the role of companies in this bigger picture? Surely it is not companies, but policymakers and lawmakers, our parliaments and governments, who should do what is necessary to lead us into sustainable development. The responsibility of the state is incontestable (Sjåfjell 2010a). However, a part of that responsibility is considering the role that companies must play (Sjåfjell 2009a). The great significance of the function of companies within the global economy and the vast impact that the operations of companies today have, on an aggregated level, on society in general and on the biosphere and the atmosphere, means that a critical analysis of the purpose of companies and the regulatory frame-

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2. Whether the current global uprising against the financial system can transmute into a call for sustainability in all three dimensions remains to be seen (see Stothard *et al.* 2011; Bond 2011).

work within which they operate is crucial to a deeper understanding of the correlation between society and sustainable development (*ibid.*). We cannot hope to achieve overarching societal goals without companies contributing to them. Companies are all-important components of our economies, with an enormous unrealised potential for mitigating climate change. As the IPCC has stated, there is potential to reduce greenhouse gas emissions with existing technology, but a number of barriers prevent this potential from being realised (Bernstein *et al.* 2007; Metz *et al.* 2007).

The supposed primacy of shareholders and of profit maximisation for shareholders is arguably one such barrier, and indeed prime among them (Sjøfjell 2009a: 82-91). Business acceptance of the nonprimacy of shareholder interests seems to be a necessary prerequisite for business to become sustainable, also in the environmental sense. As long as profit (maximisation) for shareholders is the overarching goal, any attempt at prioritising environmental concerns and prioritising climate change mitigation will quickly hit a ceiling (Sjøfjell 2011a). Certainly, profit in itself is good and necessary for the survival of our businesses providing workplaces, revenue, and in short, welfare. The search for profit is legitimate and necessary.<sup>3</sup> The problem arises when profit becomes the overarching objective to the detriment of other legitimate interests and societal goals. We need to find out how to change the framework within which profit is pursued, so that profit is pursued within the goal of sustainable development instead of the pursuit of profit being the main goal, with some good being done (or appearing to be done) in the name of corporate social responsibility.

### **3. The role of law**

#### **3.1 Beyond CSR and mainstream corporate governance: integration of environmental concerns**

There are two dominant debates concerning companies: the corporate social responsibility (CSR) debate and the corporate governance debate (Sjøfjell 2009b: 981). CSR in a sustainable development perspective could be seen as dealing with and bringing together two interrelated is-

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3. From the perspective of US law, see *Dodge v Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

sues:<sup>4</sup> first, legal compliance and, second, the company's responsibility for going beyond such compliance, with the legal rules forming the floor and the voluntary part of CSR constituting a striving beyond that, in other words, a race to the top (Sjåfjell 2011a: 56-64). In that sense, CSR would encompass and form a bridge between hard law, soft law, and ethical obligations. But CSR does not do this. Business lobbyists have captured the CSR concept and ensured that the definition legislators subscribe to is that of CSR as a voluntary activity (Commission 2002: 5; Sjåfjell 2009c; for indication of a possible change see Commission 2011a). The business message may be said to be: 'Do not legislate us, and we are willing to talk about how we behave'. This is not meant to ignore that good is done in the name of CSR. And certainly the CSR movement has led to or been a part of a process where no self-respecting business leader will claim that her company disregards CSR. However, as I have argued elsewhere, defining CSR through delimitation against legal obligations is deceptive and detrimental to the development of a sustainably and socially responsible business and has contributed to giving CSR a bad name (Sjåfjell 2011).

Much of what companies claim as credit on their CSR accounts is involvement with issues unrelated to their businesses, for example the company operating the Norwegian Airport Express organising computer classes for former drug addicts or the utility company Norsk Hydro funding the Oslo Philharmonic Orchestra. Funding the orchestra gives no indication at all of how Norsk Hydro is run as a business, how it contributes to or works against the mitigation of climate change, how its employees are treated, or whether it cares about the workers hired by its subcontractors (Norsk Hydro website). Organising computer classes for the underprivileged or funding cultural activities is not CSR in the true sense, rather, it is corporate charity work.<sup>5</sup>

The mainstream corporate governance debate concentrates on a small segment of the reality in which companies operate (Sjåfjell 2009a: 37-

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4. This could involve, for example, the inclusion in CSR debates of the three dimensions of sustainable development: environmental protection, social justice, and economic development, otherwise known simply as 'planet, people and profit' (Lambooy 2010: 10).

5. It could be argued, of course, that corporate charity work (CCW) is a part of an extended concept of CSR, but we should distinguish between CSR in the wide sense, including CCW, and the core of true CSR; for further explanation, see Sjåfjell (2011a). For different definitions of CSR, see generally Carroll and Shabana (2010).

44). This debate focuses on investors, first and foremost shareholders, and their relationship with the board of the company and, by extension, its management. The corporate governance debate has spawned a number of corporate governance codes (European Corporate Governance Institute website; Thomsen 2006) and legislative measures, such as the EU Directive on shareholder rights.<sup>6</sup> Heavily influenced by the dominant legal-economic theory of agency, the focus is on how to find the right incentives to make the board act as agents for the shareholders as principals with profit maximisation as the overarching goal (Sjøfjell 2009a: 82-91; 2010b; Greenfield 1997).<sup>7</sup>

Together with the capture of CSR as a voluntary affair for business, the narrow focus typical of the mainstream corporate governance debate promotes the shareholder primacy drive and the misconception that the company is and should be a vehicle for profit maximisation for shareholders only and that it is sufficient for companies to contribute to overarching societal goals (Berle 1931). A true integration of environmental concerns is required. The law, therefore, is necessary to ensure the contribution of companies, to level the playing field for companies that wish to actively contribute to the mitigation of climate change and of threats to biodiversity, and to ensure that their contributions are not limited by the competitive advantage that today's system tends to give irresponsible and short-sighted companies.

### 3.2 The limited effectiveness of environmental law

Having established that the law is necessary, this poses the question: What area of law? Environmental law and other forms of external regulation<sup>8</sup> are important, but the limits of external regulation are well documented and consist of a number of interlinked issues, briefly sketched here.

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6. Directive 2007/36/EC of the European Parliament and of the Council on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p. 17.

7. However, indications on EU level may now be found that these alleged truths are questioned and that the problems with a too short-term perspective that the shareholder primacy drive entails are acknowledged (Commission 2011b).

8. As opposed to the internal regulation of the competence, duties, and decision making in companies through company law.

First, external regulation is limited by the extraterritoriality issue or the issue of home state and host state. For example, while European companies may be under relatively strict environmental regulation in their home state, the jurisdictional scope of home state regulation does not typically cover the company's business in other countries (Anderson 2002: 409). The host state may have lax regulation or lacking enforcement. Developing countries, needing jobs and revenue, may be fearful of making demands on companies from developed countries (Dine 2005). Second, there is a regulatory lacuna at an international level. The stalled proposal for UN norms governing transnational companies (United Nations 2003) is indicative of that gap (Deva 2004; Hillemans 2003). Third, the legislatures cannot keep up with everything companies do or plan to do and the environmental consequences of their actions.<sup>9</sup> Fourth, there is the danger of loopholes, boilerplate formulas or other measures through which companies comply or seem to comply with the law at as low a cost as possible. This is the problem with reporting (Sjåfjell 2011a).

Finally, and perhaps most importantly, sustainable development is about going further than the antipollution approach that often characterises environmental law and other external regulation. Sustainable development is a way of thinking. To get decision-makers in companies to think in a certain manner an internal company perspective is required. In my opinion, this involves a company law perspective, not as an exclusive perspective, but as a necessary contribution.

### 3.3 The role of core company law

This chapter makes the argument that company law is a necessary tool for achieving sustainable companies, both to make the external regulation of companies more effective and to realise the potential within each company to make its own independent, creative, and active contribution to the mitigation of climate change. Let us take the mainstream corporate governance debate as a starting point. If the focus of the board, and by extension, the management, is to be primarily ensuring profit

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9. Goyder (1987: 36) gives the example of the countryside of Northamptonshire, England, being dug up in search of iron ore. 'It was some years before the government passed legislation imposing on companies the legal duty of reinstating fields and woods devastated by open-cast mining, and by then it was too late to recover much of the amenity value lost.'

for shareholders and keeping the share price high, and the whole system encourages shareholders to focus on their profits, who then is to be responsible for the company's action beyond its narrow obligation to comply with the law? In my opinion, this should be the responsibility of the board. But the board is under pressure from the shareholder primacy drive to focus on the short term rather than the long term and to disregard externalities that the company is not required by law to internalise (or which it can get away with ignoring).

In many jurisdictions, company law is seen as regulating the purpose of the company through its regulation of the relationship between the shareholders, the board, and management. Company law is thereby seen as supporting the shareholder primacy drive, although that view arguably is more a social norm than a legal one.<sup>10</sup> Combating the negative effects of the shareholder primacy drive therefore, in my opinion, entails redefining the purpose of the company and the role and the purpose of the board.<sup>11</sup> I believe redefining should be done in a principle-based manner, but it should be done in law, through the use of legal standards, instead of attempting to do this (only) through more or less voluntary codes and so on. The law needs to create a floor beneath which no company can go, thereby promoting a race to the top with each company contributing in its own individual, creative way.

## **4. The research project 'Sustainable Companies'**

### **4.1 Internalising environmental externalities**

The international team of the Oslo-based research project 'Sustainable Companies'<sup>12</sup> is dedicated to finding out how to move from the idea of internalising externalities (Sjøfjell 2009b: 1003-4) to a research-based proposal. Our vision is to contribute to the tools that make companies become part of the solution. The hypothesis underlying the project is that environmental sustainability in the operation of companies cannot

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10. See below section 4.3.

11. See below section 4.4.

12. For more information about this project, which is financed by the Research Council of Norway and has a dedicated team of thirty-five scholars from many regions of the world, see 'Sustainable Companies' (<http://www.jus.uio.no/ifp/english/research/projects/sustainable-companies/>).

be effectively achieved unless the objective is properly integrated into company law and thereby into the internal workings of the company. To test this hypothesis and to prepare the ground for well-founded proposals for reform at the end of the project period, an important first stage in the ‘Sustainable Companies’ project has been to map the barriers to and possibilities for the promotion of sustainable business in the hitherto often ignored area of company law (Richardson 2011). Team members in our project, from a wide range of jurisdictions including countries in Europe, the Americas, Africa, and Asia, have written country reports concerning the same set of questions with the main focus on core company law issues but also covering accounting/reporting and auditing/assurance, as well as the – in practice very important but in company law not adequately addressed – area of groups.<sup>13</sup> These country reports have formed the basis for the ongoing work with three cross-jurisdictional papers identifying the barriers to and possibilities for sustainable companies in the same three important areas: first, core company law; second, accounting/auditing rules; and third, the regulation of company groups.<sup>14</sup> In this chapter, a first tentative suggestion of the results of this mapping and what it entails for possible reforms is given.<sup>15</sup> For reasons that will be made clear below, the focus is on core company law.

## 4.2 Tentative results: possibilities and critique

On the face of it, we see tentative glimmers of hope and possibilities for the promotion of companies in the increasing focus on CSR and the ethical obligations of a company to consider the environmental and societal impacts of its business (illustrated by the emphasis placed on these issues by those selling sustainability services to business (PwC website)). An analysis of the results of the mapping indicates that the two debates

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13. The tentative analysis below is based on draft mapping papers. Direct references to the draft mapping papers are generally not made in this chapter. The final versions will be made available in 2012/2013 on the ‘Sustainable Companies’ publications page. The jurisdiction-specific papers published in the ‘Sustainable Companies’ project referred to below are initial discussions of some of the issues that are analysed over a broader scale in the mapping papers.

14. All three draft papers were presented at the international conference *Towards Sustainable Companies: Identifying New Avenues in Oslo* on 29–30 August 2011.

15. Again, the tentative summary of the results and what they entail for possible future reform is my own personal view, not necessarily representative of the view of the whole project team or of my co-authors for the cross-jurisdictional paper in core company law.

of CSR and mainstream corporate governance are reflected. On the one hand, there is more shareholder focus, also in continental European and Nordic countries originally having a wider perspective (for Norway see Sjøfjell 2011b). On the other hand, there is more focus on the wider corporate responsibility also in shareholder primacy strongholds such as the United Kingdom, with its enlightened shareholder value (Villiers 2011). Exceptionally, the consideration of the environment is directly included in legal requirements of the duties of the board, as in the UK Companies Act 2006, while in jurisdictions like Germany we even see an increased emphasis in company law on a pluralistic view of the interests of the company (Deipenbrock 2011). In countries that have had to rebuild their societies after communism, or as in South Africa after apartheid, we see tendencies to new approaches based on a broader understanding of the societal significance of companies (Croucher and Miles 2010). Certainly company law in many jurisdictions allows the inclusion of environmental concerns and also the prioritisation of environmental protection over short-term profit, and we find legal sources that substantiate that from a legislative perspective. Companies are expected to contribute toward societal goals wider than that of shareholder profit maximisation (Sjøfjell 2011b).

These two partly conflicting trends seem to lead to reporting being seen as the solution, as a compromise satisfying both groups, especially in the form it takes in most countries, where the extent to which companies internalise environmental (and other) externalities is voluntary, while the reporting itself is not, an approach that may be seen as underpinned through theories of reflexive law (Buhmann 2011a). We see this in EU law and it is taken further in Norway (Sjøfjell 2011a) and Denmark (Buhmann 2011b). We see the same tendency in some corporate governance codes, notably in the Netherlands (Lambooy 2010: 107-46). There are some court cases that arguably indicate a new approach, *inter alia*, in cases concerning the piercing of the corporate veil (Sjøfjell 2010c).

There are also some business initiatives, in Germany and in Ireland for example, that seem to be working to contribute toward sustainable development (for Germany, see Deipenbrock 2011). There are some institutional investors, some pension funds, which are on their way toward what may become truly socially responsible investment (Halvorsen

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16. The two debates are introduced above in section 3.1.

2011; Richardson 2008). And we see a very slowly growing tendency in public opinion to require more from companies (Ralph 2011).

However, the positive tendencies are not sufficient, neither in their current scope nor in their capacity to develop, it is too little and most likely going to be too late. Even more seriously, there is a two-pronged danger which results from preferring CSR talk and reporting as a (perceived) solution. The first danger concerns reporting. When the core duty is not in place, when the decision makers in companies are not required to integrate environmental concerns into the decisions on how the core business of the company is to be run, and when there is no hard law stating that companies must be run in a socially responsible manner, we risk that environmental reporting is neither relevant nor reliable (Berthelot *et al.* 2003). There are even studies that indicate ‘a negative relation, i.e., the more a firm discloses, the worse its environmental performance’ (ibid.: 20). The uglier the company, the more makeup it uses. Similar problems are reported concerning the disclosure of social issues (Laufer 2003: 255-7). The second danger is inherent in much of the CSR talk. Corporate charity work is often used instead of true CSR, leading to greenwashing and deflecting our attention from how the core business of the company is actually run (Sjåfjell 2011a). Further, all the CSR talk creates a danger of the wool being pulled over our eyes, making us believe that enough is being done. This is the danger with the company law reforms that are perceived by some as positive, notably the codification of ‘enlightened’ shareholder value in the UK Companies Act (Deva 2011). If this is seen as a step forward, it may serve to take the pressure off the legislature to undertake proper reform, due to the misconception that progress has been made in terms of internalising externalities in business decision making, when the truth seems to be that nothing has changed at all, at least not for the better. In the United Kingdom, as in most of the rest of the world, we are still seeing business as usual, or, more accurately, with the current financial unrest following the financial crisis of 2008, desperate attempts to keep business going as usual (Wolf 2011). But business as usual is not and cannot be an alternative for humanity desiring to ensure viable ecosystems for future generations.<sup>17</sup>

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17. In his Opinion in Case C-176/03 *Commission v Council* [2005] ECR I-7879, Advocate General Ruiz-Jarabo Colomer cites in footnote 51 Demetrio Loperena Rota who states that ‘an acceptable environment is not the product of social development, but a prerequisite for it to exist, and is a right bound up with human life, without which there is neither mankind nor society nor law’ (Loperena Rota 1999).

### 4.3 Tentative results: the main barrier

The role of the board is central to the way companies are run and thereby to the contribution of companies to the mitigation of climate change and the mitigation of the destruction of biodiversity. Inspired by the ideas of agency theory, directors of the board are increasingly seen as agents for the shareholders as principals, with profit maximisation as the goal (Sjøfjell 2009a). The tentative results of our cross-jurisdictional analysis indicate that shareholder primacy and the perceived overarching goal of maximizing shareholder profit present the most important barriers to the contribution of companies to environmental sustainability. Indeed, all tentative possibilities, all glimmerings of hope, are negated through the dominance of shareholder primacy and the short-term shareholder profit maximisation drive.

This gives rise to the question: How can shareholder primacy be perceived as a main barrier in an analysis of company law, when shareholder primacy arguably is more of a social norm than a legal one? (Deakin 2005). There is a clear link, however, between this social norm and company law, because the social norm has developed within the framework of the law, as a result of what the law does and does not regulate (*ibid.*: 13-14). In my opinion, understanding this relationship may be a significant step towards understanding how we can achieve change, and it certainly is also indicative of the possibility that lies in company law as it is today.

How has company law allowed this myth of shareholder primacy and profit maximisation as a mandatory requirement to develop? To understand that, it may be useful to return to the starting point of this chapter, namely that the company is one of the most ingenious inventions of our time. We mostly take it for granted today, but the company with limited liability for its shareholders is a relatively recent innovation, and much younger than the enforceable contract, that perhaps was the most innovative contribution of Roman law (Watson 1984). Contracts and private property rights are necessary prerequisites for business as we know it and have much deeper historical roots as such (Mickelthwait and Wooldridge 2003: 4). The idea of the company with limited liability, where people can invest their money in a business venture and expect a cut of future profits if successful and not lose more than their investment if unsuccessful, is relatively speaking the newcomer in the world of business. From one perspective, this was arguably not new; banks lend money to

business projects along the same principles (Lau Hansen 2003: 34-36). The major difference is, however, that banks are protected through contract, while shareholders are not (*ibid.*: 31-36). Nor can shareholders be described as owners, in any full, traditional sense of the word ownership (Sjåfjell 2009a: 32-33 and 80-81).

History saw the rise of this innovative way of financing companies, putting capital to its purportedly most efficient use, but for that to work on a grand scale, investors needed some kind of protection. Naturally, therefore, company legislation setting up rules for companies with limited liability for their shareholders emphasises regulation of the relationship between the shareholders, on the one hand, and the company, through its board and management, on the other. This is not to say that no other interests involved in or affected by companies are dealt with in company legislation, most of these statutes have some rules on creditor protection.<sup>18</sup> The rights of creditors are, however, mainly regulated through other areas of law, with historical roots far surpassing those of companies with limited liability.

The focus on shareholders in company legislation has in many jurisdictions led to company law being perceived as regulating the purpose of the company through its regulation of the relationship between shareholders and the company. For example, Nordic legislation typically states that companies that do not have profit for the benefit of shareholders as a purpose should regulate in their articles of association how the profit of the company is to be distributed.<sup>19</sup> This is misconstrued, in my opinion, as setting out the purpose of the company understood as the company's only or main purpose. Understood historically, company legislation sets out the typical purpose that shareholders have with their relationship with companies in which they have shares, and serves

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18. Some, such as the Norwegian Companies Acts, also include rules on the involvement of employees in the decision making of companies, while the most central rules concerning the protection of employees are set out in a separate act, the Working Environment Act. Norway has two acts on limited liability companies: the Public Limited Liability Companies Act 13 June 1997 No 45 and the Private Limited Liability Companies Act 13 June 1997 No 46. For an English translation see Norwegian Institute of Public Accountants (2012). The Working Environment Act 17 June 2005 No 62 is freely available in an English translation at <http://www.arbeidstilsynet.no/binfil/download2.php?tid=92156>.

19. See Norwegian Public Limited Liability Companies Act § 2-2(2): 'If the objective of the company's activities is not to generate a financial return for its shareholders, the articles of association must contain provisions on the allocation of profit and the distribution of assets upon dissolution of the company.' (author's translation).

as a protection of that purpose in the sense that if companies do not intend to distribute dividends to shareholders at all, then potential investors should be forewarned in the articles of association. What the Nordic company legislation does not mention, and nor does company legislation, generally speaking, expressly regulate this point, is what the purpose of the company on an aggregate level is, and what the guidelines are according to which the company is to be run. The interlinked concepts of the purpose of the company and the interests of the company are therefore topics for debate in academic contributions, while in more pragmatic, practitioner-oriented literature the inference is simply drawn that shareholder focus in company legislation translates into a prioritisation of shareholder interest by the legislature. The historically explicable fact of the focus on the relationship between the shareholders and the company organs in company legislation, and the lack of express regulation of the purpose of the company and the interests of the company, has therefore led to the development within this vacuum of an idea of shareholder primacy.<sup>20</sup> This is not to say that shareholder primacy cannot be shown to have legal support in any jurisdiction. However, the dominance of the Anglo-American law-and-economics<sup>21</sup> inspired shareholder primacy<sup>22</sup> does seem to go far beyond anything that can be substantiated in a comparative analysis of company law.<sup>23</sup> Certainly the narrow, short-term perspective that the shareholder primacy drive has led to is contrary to company legislation anywhere, and detrimental to the societal goals to which the regulation of companies is meant to contribute (Sjøfjell 2009a: 90-91).

The vacuum in the company legislation of many jurisdictions and the resulting development of the shareholder primacy drive, with its detrimental effects, has led to the extraordinary state of affairs of the Reflection Group on the Future of EU Company Law suggesting that

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20. The development and rise of shareholder primacy has other explanations as well, but in a legal analysis this is a main point. For a broader discussion, see Keay (2011).

21. The positive contributions of law and economics to our understanding of company law and the consequences of various forms of regulation are, in my opinion, indisputable. However, so are the negative effects of the abuse of legal-economic theories meant to be descriptive as normative, and of the abundance of postulates based on concepts and ideas removed from the theories in which they originated and disconnected from the assumptions on which they are based (Sjøfjell 2011a).

22. To the extent that the end of history at one point was declared, see generally Hansmann and Kraakman (2000).

23. This holds true even in jurisdictions, such as the UK, where the prioritisation of shareholders over other interests may be said to have a legal basis (Deakin 2005: 11).

companies should be allowed to include in their articles of association that boards are allowed to promote the interests of the company and to employ a long-term perspective (Reflection Group 2011: 37-8). The Reflection Group thereby proposes to codify an acceptance of what, from any proper, in-depth company law analysis seems to be the state of law today, namely that shareholder profit maximisation and shareholder primacy are not the only, nor should they be the dominant, guidelines in the narrow, short-term sense that we see today and which may be seen as contributing to the convergence of crises that we face. The perverse effect of that well-intended proposal may unfortunately be that it is used as an argument to say that narrow, short-term shareholder primacy is the norm under European company law. Why, otherwise, would the Reflection Group suggest that the opposite should be expressly allowed?

#### 4.4 The way forward: tentative reflections

We see that what is perhaps the main barrier to sustainable companies has been allowed to flourish because of what the law regulates and what it does not. This also indicates a way forward. If a key problem is the lack of regulation of what the purpose of companies and the interests of companies are, then a clarifying regulation of those issues will not simply be an additional layer of detailed regulation that entails only more expenses and aggravation for companies, but will set a key issue straight in a principle-based manner that could be the start of a shift in a sustainable direction (Sjåfjell 2011b). However, as we are so far off track from sustainable development, with a dramatic shift needed to achieve the presumed safe harbour of no more than two degrees Celsius warming, in itself a prospect with many negative effects, we probably need to go beyond stipulating long-term, inclusive concepts of the purpose of the company and the interests of the company. In my opinion, what urgently needs to be done is to clarify that the company, on an aggregate level, may and should have profit as a core of its purpose (Sjåfjell 2009a: 103-110) – business cannot survive in the long run without making profit – but this should be sought within the overarching societal purpose of sustainable development. This would turn inside out the purpose of the company that shareholder primacy drive today promotes, where profit is the overarching purpose and perhaps some good may be done in the name of CSR.

Because shareholder primacy in the narrow, short-term sense has been allowed to develop for so long, we will also need to consider incentives to support a shift towards sustainable development, and removing disincentives for sustainability that encourage the myth of shareholders as owners and shareholder profit maximisation as the dominant guideline. The concept of the interests of the company as a guideline should be developed accordingly, and as I have suggested elsewhere, be teamed together with a concept of sustainable development as an overarching guideline (Sjøfjell 2009a: 103-110; 2009b: 987 and 1003-6).

A tentative conclusion from my point of view is that legal reform seems to be necessary not only to support the possibilities that company law today actually gives sustainable business, but to codify these possibilities expressly, preferably as mandatory guidelines, so that the competitive advantage is given to companies that wish to contribute to sustainable development and taken away from those that do not. Legal reform seems to be necessary to start the difficult process of removing the barriers created mainly through social norms that have been allowed to develop in the vacuum caused by the lack of definition of the purpose of companies and of the interests of the company in company law.

Only once these issues are clarified as a matter of company law do we have a good basis for discussing incentives and sanctions, such as liability, and necessary supportive measures such as accounting and reporting, taken seriously, and not as marketing and greenwashing and wool-over-the-eyes pulling as we have today.

Reforming core company law seems in short to present itself as a necessary prerequisite to achieving sustainable companies, both to make the external regulation of companies more effective and to realise the potential within each company to make its own independent, creative, and active contribution to the mitigation of climate change.

## **5. The proposals of the 'Sustainable Companies' project**

The 'Sustainable Companies' project seeks in the final phase of the project during 2013 to identify necessary measures to dismantle the barriers preventing business from becoming sustainable and legal mechanisms and incentives to propose which will promote truly responsible business.

For the European part of the project,<sup>24</sup> EU law, the common framework for thirty European countries, contains the legal basis for making necessary changes to achieve sustainable business (and sustainable development in general) (Sjåfjell 2009a: 2012). However, the necessary steps have not been taken (Dhondt 2003: 482). This lack of movement may be seen as indicative of a general problem. We may presume, in general, that legislators have sufficient knowledge – and at the EU level they have not only knowledge and a sufficient legal basis to move forward, but also legal obligations – to take action to achieve the goal of sustainable development (Sjåfjell 2012). Legislators nevertheless often seem to be powerless to move beyond path-dependent ways of dealing with the pervasive issues of our time. Legislative work tends to be reactive rather than proactive, based on postulates and superficial discussions, with a striking lack of time and energy devoted to in-depth analysis of the underlying issues and the consequences of existing and proposed new legislation (Sjåfjell 2009a: 293-463). The ‘Sustainable Companies’ project therefore aims to conclude its work with research-based concrete proposals for any necessary change on the EU level, as well as jurisdiction-specific proposals for a number of the countries represented in the project team. These may take the form of proposals for legal reform within and beyond company law as well as proposals for guidelines for companies wishing to become true contributors to sustainable development.

## 6. Conclusion: global challenges call for global debate

The challenges we face are global by nature. Global challenges ideally require a global approach and an unprecedented holistic and forward-looking approach (Stern 2006). The international climate negotiations in Copenhagen, Cancun and Durban have shown that we cannot depend on governments agreeing to the necessary measures to mitigate climate change as far as still possible. And even if the international community against all odds were to reach an agreement on a sufficient reduction in greenhouse gas emissions (the IPCC recommends these should peak in 2015), regulators around the world would be in dire need for effective proposals how to achieve those goals. And to reiterate: climate change is but one case in point for the necessity of a shift toward sustainable development (for others see Sarukhán *et al.* 2005: 2; Benjamin 2010).

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24. Europe was the starting point for the project, but the project happily has developed into an international research endeavour.

The 'Sustainable Companies' research project, with its international team of scholars, hopes to contribute one of the many necessary jigsaw puzzle pieces of sustainability. The work done by the ETUI represents another. Let us hope that there will be enough pieces in time to make the picture complete.

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# Chapter 14

## Sustainability reporting and the modernisation of EU accounting rules

Janja Hojnik

### 1. Introduction

Companies and other types of organisations are facing increasing public pressure to act in a socially and ecologically responsible manner. Effects upon society and the environment have become a key part of assessing the overall success of an organisation and its capacity for sustainable functioning. This is a consequence of growing awareness of the need to assure healthy ecosystems, social equality and good management of organisations. The sustainability performance of companies is increasingly being monitored by non-governmental organisations (NGOs), rating agencies and other organisations. Consequently, a widely-held view is that business entities must go beyond bare financial reporting and disclose comprehensive and credible information on a variety of environmental and social indicators. There is also a significant demand by investors for non-financial information on companies to measure and control the ‘reputational risk’ they face when investing in companies with poor environmental and social practices.

The revision of accounting standards is a core component of the reforms at the EU and global level<sup>1</sup> responding to the current economic crisis with the aim of increasing transparency and market confidence. This is also an opportunity to push for a stronger role for sustainability reporting, as in the context of a crisis companies often tend to pay less attention to social and environmental standards. In this respect more specific rules are needed. This is most notably the case for reporting on social and organisational restructuring, which has made considerably less progress than environmental reporting in the last decade, notwithstanding

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1. Most notably the initiatives of the Financial Stability Board.

the fact that employees are the key stakeholder group in companies. The economic crisis should therefore be used to establish stronger standards for socially responsible reporting. Such standards are necessary in order to enable the monitoring of companies and their progress towards sustainability.<sup>2</sup>

This chapter deals with legal aspects of sustainability reporting in the EU. It explores, first, the state of affairs in sustainability reporting regulation and points out recent increased support for integrated reporting. Second, EU rules in this field are discussed, starting with rules on financial reporting. This is important as developments in this field offer several lessons for future regulation of non-financial reporting. Furthermore, it is anticipated that financial and non-financial reporting will be integrated in the future. In relation to non-financial reporting, the current state of affairs is presented and open questions and legal alternatives for more effective and worker-oriented regulation are discussed.

## **2. From non-financial to integrated reporting**

### 2.1 General observations

For many years, annual reports were documents in which companies presented their financial results, recent achievements and vision for the future. Recently, however, among various groups interest in environmental, social and ethical achievements of companies has grown significantly. For this reason, companies increasingly include corporate responsibility matters in such reports. The underlying rationale is that financial accounts can only partially indicate both the risks and potential value of the company which derive from intangible factors, such as environmental and social risks, strategies, product innovativeness, trademarks, reputation, energy effectiveness, etc.

Non-financial reporting, also known as sustainability reporting,<sup>3</sup> enables companies to disclose such non-financial aspects of their business activities. Sustainability reporting thus refers to the practice of measuring and

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2. On the importance of sustainability reporting for realising the Sustainable Company see chapter 1 of Vitols and Kluge (2011).

3. Other terms in use include: corporate social responsibility (CSR) reporting, environmental social governance (ESG) reporting and triple bottom line (TBL) reporting.

disclosing as well as informing internal and external interest groups on progress towards the goal of sustainable development and social responsibility (in other words, *corporate social responsibility* (CSR)) (Ernst & Young 2009). The latter stands for predominantly voluntary commitments by companies to act ethically and to contribute to economic development in parallel with improving the quality of life for employees and their families, while at the same time helping the local and wider community.<sup>4</sup> The goal of socially responsible companies is therefore to contribute to improving society and creating a cleaner environment.

Many companies use non-financial reporting to improve their societal reputation. This form of transparency makes these companies appear more responsible and thus less risky to investors. This means that the main advantage of non-financial reporting is the transparency of the companies that disclose non-financial information. It improves competitive advantage and reputation and enhances the capacity to satisfy workers, shareholders and customers. It improves the quality of information available to employees. Investors have more reliable information for the comprehensive evaluation of companies. This, in turn, increases the trust of investors and leads to a better allocation of capital. It also increases trust of owners, donors, sponsors and financial institutions and assists branding. Consequently, non-financial reporting increases long-term competitiveness, facilitates access to capital and reduces reputational risks. Better disclosure of non-financial information enhances the image of an accountable enterprise. Furthermore it encourages positive relationships with other companies, public authorities, media, suppliers, the community in which the company works, as well as to the environment, as it may lead to increased sustainability. For example, Business in the Community, a British business-community charity promoting responsible business, has conducted research which reveals a significant link between effective management and governance of environmental and social issues and financial performance.<sup>5</sup> The results revealed that those companies which actively managed and measured social and environmental issues outperformed their FTSE 350 peers on total shareholder return by between 3.3% and 7.7% (Laboratory on Valuing Non-Financial Performance 2008). For all these reasons, despite the

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4. For a definition see World Business Council for Sustainable Development (2000).

5. The report examines the relationship between total shareholder return, dividend yield and share volatility and the management of non-financial issues in the 33 UK companies listed on the London Stock Exchange and included in the FTSE 350 index.

predominantly voluntary nature of sustainability reporting, most large multinationals listed on stock exchanges provide environmental and social information in some form.

Increasingly, non-financial reporting is affecting annual reports, since many of these annual reports include more information on CSR initiatives. Furthermore, many companies issue separate reports on social responsibility. The manner in which annual reports are published is also changing. Due to the importance of social responsibility initiatives for strengthening public image, companies are making efforts to make sure that annual reports, including information on social responsibility, reach consumers and investors. For this reason, companies use various media, including social networks such as Facebook and Twitter, to publicise the results contained in their annual reports. The reports increasingly include statements of reliability given to the reports by independent external sources with the aim of increasing the level of trust in the disclosed information. Development of CSR thus considerably influences accounting practices in general. In this respect the main challenge for the future is to develop measurable frameworks for sustainability reporting, harmonisation of definitions and more comparable use of such reports. The way to achieve it is to bring the national and supranational legislation and other rules in the field closer together.<sup>7</sup>

## 2.2 International standards on non-financial reporting

Despite its predominantly voluntary character, non-financial reporting is not totally devoid of legal provisions. At the global level a series of actors have developed individual principles and standards for non-financial reporting – e.g. Global Reporting Initiative (GRI), UN Global Compact, the ISO 26000 standard developed by the International Organization for Standardization, Organisation for Economic Co-operation and Development (OECD) guidelines, International Labour Organisation (ILO) conventions, International Accounting Standards Board (IASB) commen-

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6. See the *Methodologie* (2011: 2) which serves as a barometer of modern reporting practices.
  7. Synchronisation of voluntary standards on non-financial reporting with compulsory national and supranational requirements is supported by the recent initiative of the Global Reporting Initiative and the World Intellectual Capital Initiative to develop extensible business reporting language (XBRL) taxonomies for non-financial information. The importance of XBRL is underlined by the fact that the US Securities and Exchange Commission now requires financial reports to be filed in XBRL format.

tary, and initiatives of the Financial Stability Board (FSB) established by the G20 group. None of these is currently truly globally accepted in the same way as financial reporting standards are. None the less, GRI standards come very close to this and are, for this reason, presented in more detail.<sup>8</sup>

GRI develops standards of sustainability reporting that are widely used across the globe.<sup>9</sup> GRI was established in 1997 by the Coalition of environmentally responsible economies (Ceres) with the assistance of the environmental programme of the United Nations. In 1999, GRI published a draft version of *Sustainability Reporting Guidelines* and in 2000 the first complete version was published. GRI is a permanent institution of international law with a secretariat in Amsterdam. It is independent even though it cooperates with the environmental programme of the UN and with the initiative UN Global Compact.

GRI aims to ensure that, in the long term, sustainability reporting will become a regular feature of organisational behaviour in the same way as financial reporting has already become. Its standards are used by all kinds of organisation, including large corporations, public companies, small companies and non-governmental organisations. GRI standards constitute a framework for reporting on issues such as human rights, position of workers, environment, corruption, etc. They are considered the most credible of the international standards as they have been developed through a consensus-seeking, multi-stakeholder process. Participants in that process are drawn from global business, civil society, labour, academic and professional institutions.

GRI is seeking to gradually improve standards of sustainability reporting. Today the third generation of GRI standards (GRI-G3), published in October 2006, is in force. GRI-G3 standards include both principles and items, with the latter composed of several performance indicators. The principles of sustainability reporting help to define:

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8. See also Expert Group on Disclosure of Non-Financial information by EU Companies (2011a).
  9. In 2009, over 1 400 organisations from 60 states used their standards when preparing sustainability reports and eleven states referred to GRI standards in their national rules – see Global Reporting Initiative (2009/10). According to the GRI database, in 2010 sustainability reports were produced by nearly 2 000 companies – Sustainability Disclosure Database, <<http://database.globalreporting.org/search>> (8.1.2012). Additionally, international research shows that sustainable reporting is considerably better developed in Europe than in the USA – e.g. in 2010 only 251 companies from North America produced sustainability reports in contrast to 843 European companies.

- a) report content: principles of materiality, stakeholder inclusiveness, sustainability context, and completeness;
- b) report quality: principles of balance, comparability, accuracy, timeliness, reliability, and clarity; and
- c) report boundary: in preparing a sustainability report, a reporting organisation needs to set a 'boundary' that defines which entities are included in a report (e.g. parent company and its subsidiaries), and which are excluded (e.g. joint ventures) (Global Reporting Initiative 2005).

Performance indicators for sustainability reporting require disclosure of specific aspects. Items for reporting relate to matters such as:

- environment: materials, water, biodiversity, emissions, etc.
- human rights: clauses incorporating human rights concerns in investment and public procurement contracts, the prohibition of discrimination, freedom of association and collective bargaining, child labour, forced labour, etc.
- decent work: statistics on employees – total workforce by employment type, employment contract, region, gender, return to work and retention after parental leave, number of employees covered by collective bargaining, safety at work, education and training, equal pay for equal work, etc.
- society: impact of the business on the local community, corruption, compliance with competition and other regulatory legislation, etc.
- product responsibility: consumer protection, labelling, etc.

GRI-G3 standards are the basis for sustainability reporting. Other components of the framework include sector supplements (specific indicators for a particular industry) and national annexes (information specific to a particular country). The whole reporting framework (including GRI-G3 standards) is a free public good. It is worth mentioning that the fourth generation of sustainability reporting standards is currently being prepared (GRI-G4), with publication envisaged in 2013.<sup>10</sup>

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10. Given that the new generation of standards is also being developed by way of international consultations and workshops involving a broad spectrum of interest groups, GRI has appealed to interested stakeholders to cooperate.

## 2.3 Integrated reporting

Following the outbreak of the current financial crisis certain initiatives promoting integrated reporting have been developed. For example, the Prince of Wales' Accounting for Sustainability project produced a linked reporting framework in 2007. The aim of the project was to produce a series of case studies that document the ways in which connecting financial and sustainability information can improve organisational processes and actions.<sup>11</sup> As the crisis has demonstrated the need for capital market decision making to reflect long-term considerations, the project began to collaborate with the International Federation of Accountants (IFAC) and the GRI with a view to establishing an International Integrated Reporting Committee (IIRC), recently renamed the International Integrated Reporting Council.

The role of the IIRC, which was established in August 2010, is to help develop a new internationally accepted approach to reporting. The result of this process will be reports that not only provide financial information, but information about an organisation's governance, social and environmental performance in an integrated manner, reflecting the fact that all these elements (financial, governance, social and environmental) are closely related and interdependent.<sup>12</sup> As the IIRC explains:

Integrated reporting demonstrates the linkages between an organisation's strategy, governance and financial performance and the social, environmental and economic context within which it operates...Integrated reporting can help business to take more sustainable decisions and enable investors and other stakeholders to understand how an organisation is really performing (IIRC 2011b).

An integrated report should be a single report which is the organisation's primary report – in most jurisdictions this will be the annual report or

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11. The Prince's Accounting for Sustainability Project, *Accounting for Sustainability: Practical Insights Book*, <<http://www.accountingforsustainability.org/embedding-sustainability/accounting-for-sustainability-practical-insights-book>> (8.1.2012). Companies reporting using this framework, which links sustainability performance reporting with financial reporting and strategic direction in a connected way, include Aviva, BT and HSBC (see Hopwood *et al.* 2010).
  12. The IIRC published an Integrated Reporting Discussion Paper for public consultation in mid-2011 and launched a pilot programme for integrated reporting in October 2011 (IIRC 2011a).

equivalent. By addressing the material issues for an organisation, an integrated report should demonstrate in a clear and concise manner an organisation's ability to create and sustain value in the short, medium and longer term.<sup>13</sup>

In light of the increasing emphasis on sustainable development and the lessons learned in the last economic crisis, it is reasonable to expect that integrated reporting will prove an important goal for organisations as they face up to the challenges of the 21st century. In this respect, the EU should lead the way, adopting clear and effective rules, which will assure reliable integrated reports, and encouraging its trade partners to adopt comparable rules.

### **3. Regulating corporate reporting in the EU**

This section begins with an overview of the regulation of financial reporting in the EU before turning to existing initiatives and rules already adopted on sustainability reporting.

#### **3.1 Overview of the regulations on financial reporting**

Accountancy is the business discipline of collecting and analysing critical financial information about a business entity that is relevant for internal decision making (also known as management accounting) as well as for external entities, such as shareholders, creditors, financial analysts and government agencies (also known as financial accounting) (Eliot and Eliot 2004: 3). The latter is much more structured than the former as it needs to respond to various needs of the users outside the business entity and is therefore subject to different accounting principles at national, regional and international level. The need for reliable financial statements was accentuated after the 2001 series of financial informa-

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13. Corporate reporting on financial and non-financial information in a single document has grown as socially responsible investing (SRI) has grown faster than the investment industry overall. As more assets are managed within SRI frameworks, more investors are going beyond financial information to consider non-financial, extra-financial or environmental, social and governance (ESG) information in investment decisions. Companies that already produce integrated reports include BASF, Philips, Novo Nordisk and United Technologies Corporation.

tion frauds involving Enron Corporation and some other well-known corporations, in which management manipulated the figures shown in financial reports to suggest better economic performance than was the case. These problems highlighted the need to review the effectiveness of accounting standards, auditing regulations and corporate governance principles. The Enron scandal has led to the development of new regulations to improve the reliability of financial reporting across the globe, including the EU.

The accountancy framework of the EU was adopted more than thirty years ago. In 1978 the Council adopted the Fourth company law directive on the annual accounts of companies (Council of the European Union 1978). In 1983 the second important accountancy directive followed – the Seventh company law directive on consolidated accounts (Council of the European Union 1983).<sup>14</sup> These directives regulate issues concerning the formation, adoption and publication of (consolidated) annual accounts. They have increased the quality of accounting reporting and enabled comparability and mutual recognition of reports across the EU.<sup>15</sup> Nonetheless, from the early 1990s this accounting law framework started to cause increasing problems for corporations within the EU seeking to raise capital on international markets. Existing accountancy directives did not ensure the comparability of the accounts of public companies at international level, which proved to be detrimental to the holders of corporate securities and, in addition, prevented effective control of financial reporting. These disadvantages reflected the fact that the aim of the directives (in accordance with the nature of directives) was simply to harmonise accounting regulations of the Member States and not to achieve complete standardisation of accounting rules. Financial reports drafted on the basis of the directives and the relevant national implementing legislation did not fulfil international (above all US) legal requirements in the field. As a result, large European companies (global players) seeking to participate on international capital markets (in particular the New York Stock Exchange) needed to produce two sets of accounts. This was not only expensive but also led to confusion, both within the companies and on capital markets, as it was often the case that reports on the same company showed both a profit and a loss, depending on the accountancy rules applied in preparing the report.

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14. See also Council of the European Union 1986, 1991.

15. It is also worth mentioning Council of the European Union 1984.

In order to assist large European companies, the Commission issued a new accounting strategy in 1995 (European Commission 1995) with the objective of developing accounting standards recognised on all world capital markets. In this respect, the Commission proposed that the new approach should be oriented towards the International Accounting Standards (IAS),<sup>16</sup> which present an ‘exhaustive and conceptually strong set of reporting standards that are intended for the business public’.<sup>17</sup> IAS have been adopted by the International Accounting Standards Committee in London for over thirty years.<sup>18</sup> Since 1983 the Committee has comprised professional accounting organisations that are members of the International Accounting Association. This institutional backing ensures that the IAS have the status of well-devised and internationally recognised accounting standards. Moreover, these also enjoy the recognition of the International Organisation of Securities Commissions (IOSCO). On the basis of this strategy, the Commission adopted a proposal in 2001 for a regulation on the application of international accounting standards (European Commission 2001a). In its proposal, the Commission explained that the internal market approach to accounting in the EU is based on the political goal of establishing complete and effective capital markets. In its analysis, minimum requirements on financial reporting were no longer sufficient and measures to achieve ‘considerably higher level of comparability of business accounts across the internal market’ (ibid.) were needed. On the basis of this proposal, Regulation No 1606/2002 on the application of international accounting standards was adopted (European Parliament and the Council of the European Union 2002). It is one of the most important instruments of EU accounting law and serves as a basis for the endorsement and application of the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)<sup>19</sup> in the EU (Article 1 of Regulation

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16. It is interesting to note that the Commission did not consider the possibility of adopting US standards (US GAAP). The reason for this was that the US standards had been established for the US market only. The possibility of a political dimension to this decision cannot be disregarded, given that – in contrast to the IAS – the EU did not have a say in establishing US GAAP.
  17. See European Commission, [http://ec.europa.eu/internal\\_market/accounting/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/index_en.htm).
  18. The structure of the Committee was changed in April 2001 and it was replaced by the IAS Board.
  19. IFRS are issued by the International Accounting Standards Board (IASB). IAS were issued by the IASC, predecessor of IASB until 2000. As many of the standards forming part of IFRS are known by the older name of IAS, the latter term is used in this chapter. In a similar vein, Regulation No 1606/2002 is commonly known as the IAS Regulation.

No 1606/2002). The Regulation provides that ‘for each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with the international accounting standards adopted in accordance with the (special endorsement) procedure ... if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State ...’ (Article 4).

Table 1 Application of IAS by EU companies

	Consolidated accounts	Annual reports
Public limited companies	Obligated to use IAS	Member States may apply* IAS
Other limited companies	Member States may apply* IAS	Member States may apply* IAS

Note: \* Member States may *permit or require* application of IAS.

The Regulation also served as the legal basis for the establishment of a special Accounting Regulatory Committee. The Committee is composed of the national representatives of the Member States under the presidency of the Commission. The purpose of the Committee is to give opinions on Commission proposals to endorse IAS. The latter cannot apply directly in the EU,<sup>20</sup> as the EU cannot authorise a private law organisation, over which it has no direct influence, to form standards binding in the EU (European Union 2001). For that reason a special endorsement mechanism was needed, in accordance with which the Commission drafts a proposal to endorse one or more IAS for the purposes of EU law. The Committee either approves or rejects that endorsement. This mechanism ensures that within the EU only such IAS apply as do not contravene EU policy, and, at the same time, increases legal certainty, as specific regulations clearly indicate which IAS bind European companies.

Notwithstanding the adoption of the Regulation on IAS, the EU accounting directives remain in force. They are binding for a large group of business entities that are not bound by the Regulation on IAS. In order to ensure equal treatment (in other words, a level playing field) for the en-

20. IAS normally do not directly apply; their compulsory nature is recognised only in some states, including Croatia, Macedonia, Serbia, Armenia, Cyprus, Estonia and a few others.

tities that are subject to IAS and those that continue to apply national accounting provisions, the Commission adopted proposals to amend the existing accounting directives (e.g. the principle of prudence was replaced by the fair value principle). Additional amendments were also needed for reasons of general developments in the accountancy profession resulting from technological change (e.g. recognition and valuation of intangible assets). The first important amendment of the accounting directives was introduced by Directive 2001/65/EC, which changed the valuation rules (European Parliament and the Council of the European Union 2001). Other amendments were adopted in the directive revising certain accounting thresholds (Council of the European Union 2003). A third group of amendments were introduced by Directive 2003/51/EC (known as the Modernisation Directive) (European Parliament and the Council of the European Union 2003), which concluded the harmonisation of the accounting directives with IAS. In addition, as a measure to cut administrative costs, as identified in the Commission's action programme (European Commission 2007), Directive 2009/49/EC was adopted to allow Member States to exempt medium-sized entities, which often focus on only one business activity, from unnecessary obligations to disclose certain information in the notes to the annual accounts (European Parliament and the Council of the European Union 2009).

When the current financial crisis escalated, numerous international accounting rules were severely criticised. Consequently, at present the Commission is endeavouring to achieve a global agreement on a single system of accounting standards ensuring greater financial transparency. This is in line with the latest publication of stricter requirements for disclosure of risk related to financial instruments by the International Accounting Standards Board (IASB). In addition, it is also planned to adopt stricter requirements in relation to disclosure of off-balance sheet items. Furthermore, the Commission recently proposed the simplification of accounting rules for small and medium-sized enterprises (SMEs) and reducing burdensome reporting obligations for listed companies, including SMEs, adding further to cost savings (European Commission 2011a; see also European Union 2011).

### 3.2 Regulating non-financial reporting

As regards regulation on non-financial reporting, the achievements of EU are considerably more modest.

## Recommendation on disclosure of environmental issues

The EU's commitment to sustainability reporting was first demonstrated in 1992, when the Commission published its fifth action programme on the environment *Towards sustainability* (European Commission 1992). Among a range of proposals in the area of environmental protection, it provides for a Community initiative in the area of accounting. Following amendments introduced by the 1997 Treaty of Amsterdam, a new provision was inserted in the EC Treaty. This acknowledges that a key element for promoting sustainable development is the principle that environmental protection requirements must be integrated into other policies (now Article 11 of the Treaty on the Functioning of the European Union (TFEU)). This was supplemented in 2001 by a Commission communication concerning the Sixth action plan for the environment (European Commission 2001b). Notwithstanding those measures, the Commission observed in the same year that:

the lack of explicit rules has contributed to a situation where different stakeholders, including regulatory authorities, investors, financial analysts and the public in general may consider the environmental information disclosed by companies to be either inadequate or unreliable. Investors need to know how companies deal with environmental issues. Regulatory authorities have an interest in monitoring the application of environmental regulations and the associated costs. Nonetheless, voluntary disclosure of environmental data in the annual accounts and annual reports of companies is still running at low levels, even though it is often perceived that enterprises face increasing environmental costs for pollution prevention and clean-up equipment and for waste clean-up and monitoring systems, in particular those enterprises operating in sectors that have significant impacts on the environment (European Commission 2001c: 33).

The first step in resolving those problems was the adoption on 30 May 2001 of a Recommendation on the recognition, measurement and disclosure of environmental issues in the annual accounts and reports of companies (*ibid.*). The Recommendation clarifies the accounting rules and indicates how the quality, transparency and comparability of environmental data given in companies' annual accounts and annual reports can be improved. It states that the absence of a common set of rules for disclosing matters relating to the environment in financial information

makes it very difficult to make valid comparisons between companies. The Recommendation encourages companies to improve the environmental information provided to the regulatory authorities, investors, financial analysts and the public in general. In that regard, it encourages Member States to ensure that companies covered by the Fourth and Seventh Company Law Directives and banks and insurance companies observe its provisions. As the recommendation is not binding (Article 288 TFEU), its practical effect is dependent upon the persuasive power of the Commission, which called for the Member States to take account of the recommendation and report to the Commission on the measures taken in this respect.

### **EU accounting directives**

Following the adoption of the Modernisation Directive in 2003, non-financial reporting has also become the subject of EU legislation. It is now addressed in the Fourth Company Law Directive as amended. Article 46(1)(b) of the modernised directive provides that, to the extent necessary for an understanding of the company's development, performance or position, the analysis in the annual report shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. A similar provision to that set out in Article 46 of the Fourth Directive is now also included in Article 36(1) of the Seventh Company Law Directive, which regulates the content of consolidated annual reports. Their importance is further emphasised in the Transparency Directive, which in Article 4(5) provides that '(t)he management report shall be drawn up in accordance with Article 46 of Directive 78/660/EEC and, if the issuer is required to prepare consolidated accounts, in accordance with Article 36 of Directive 83/349/EEC' (European Parliament and the Council of the European Union 2004: 45).

In comparison with the provisions on financial reporting, which are very precise and comprehensive, provisions on non-financial reporting can be considered, at best, modest. Considering the importance of sustainable development and CSR for the future development of the European economy and society, the present EU regulation on non-financial reporting cannot be perceived as satisfactory as it lacks sufficient legal obligation. Non-financial reporting is voluntary as the directives support it only 'to the extent necessary'. According to respondents to the Commission's public consultation (European Commission 2011b), this makes it

difficult for shareholders and investors to make reasonable assessments of CSR-related activities. Some even stated that the voluntary regime is simply a means of enhancing company reputation and inadequate as a mechanism to ensure the greater objectives of CSR reporting. In this respect, the ETUC recently emphasised that ‘it is not enough to “invite” companies to act responsibly; more concrete/binding measures are needed’ (ETUC 2011: para. 17).

A further problem is that there are considerable differences in the treatment of companies across the EU. As directives are harmonisation instruments not designed to establish uniform rules, certain Member States (United Kingdom, France, Netherlands, Sweden and Denmark) have adopted provisions that exceed the requirements established in the directives – e.g. Denmark has adopted the UN Global Compact as a reference, whereas the French law developed a national frame of reference. Furthermore, while some Member States provide for compulsory non-financial reporting, others adopted the ‘comply or explain’ system. This situation hinders the single market and creates difficulties in benchmarking between companies in different jurisdictions. Moreover, Member States may exempt small and medium-sized companies from the obligation of reporting on these matters, which additionally diminishes the importance of non-financial reporting.

Given that the provisions on sustainability reporting were only recently introduced into the accounting directives (that is, in 2005, when the importance of CSR was already widely acknowledged), it is surprising that the matter has not been regulated in more detail. The reasons for the voluntary approach of the Commission may be found in the preamble to Directive 2003/51/EC, which states in recital 9 that:

The annual report and the consolidated annual report are important elements of financial reporting. ... The information should not be restricted to the financial aspects of the company’s business. It is expected that, where appropriate, this should lead to an analysis of environmental and social aspects necessary for an understanding of the company’s development, performance or position. ... However, taking into account the evolving nature of this area of financial reporting and having regard to the potential burden placed on undertakings below certain sizes, Member States may choose to waive the obligation to provide non-financial information in the case of the annual report of such undertakings.

It is to be hoped that the crisis has taught decision-makers that long-term sustainability is an aim, which deserves support through all instruments available to this end. After all, hardly any legal field can be described as ‘non-evolving’. Were we to wait for the legal evolution in a particular field to end before adopting any binding legislation hardly any matters in society would be subject to legal regulation. In addition, it should be noted that, since 2001 when the Commission proposed the Modernisation Directive, principles on non-financial reporting have certainly gained considerably wider recognition and support than they had before.

## **4. Towards more efficient regulation of non-financial reporting in the EU**

### 4.1 Setting the floor for action

Having regard to the differences between the Member States in their requirements on sustainability reporting and in light of the pressure to expand CSR, demands have strengthened recently for improved comparability, reliability and relevancy of the information disclosed by companies. As a consequence, the Commission is showing a commitment to more effective rules on sustainability reporting. Several of its initiatives suggest that we can expect more detailed requirements for sustainability reporting in the future.

In this respect, the EU’s growth strategy ‘Europe 2020’ promotes the renewal of CSR (European Commission 2010). On the basis of this, in its Single Market Act, adopted in April 2011, the Commission again stressed that reforms envisaged should ‘contribute to sustainable development, based on a highly competitive social market economy’ and that the internal market is based on a ‘highly competitive social market economy’ (European Commission 2011c: 5), which reflects the trend towards inclusive, socially fairer and environmentally sustainable growth. Most importantly, amongst the twelve levers to boost growth and strengthen confidence, it sets out an initiative to redefine the role of business in today’s economy, focusing on improving transparency, particularly in the areas of environment, human rights and sustainable development. The Commission observed that new business models are being used, in which these societal concerns are taking precedence over the exclusive objective of financial profit, and announced that it will present a legisla-

tive proposal on the transparency of the social and environmental information provided by companies in all sectors.

In a new package on more responsible businesses published in October 2011, the Commission adopted a new communication, in which it put forward a simpler definition of CSR as ‘the responsibility of enterprises for their impacts on society’ (European Commission 2011d: 6), and outlined what companies should do to meet that responsibility.<sup>21</sup> In this connection, the Commission emphasised that one of the EU’s cornerstone policies is to improve company disclosure of social and environmental information, reiterating its intention to bring forward legislative proposals on this issue.

More specific Commission activities to improve regulation on non-financial reporting began in 2009, when the Commission started its discussions with various interest groups by way of organising a series of workshops throughout 2010. This was followed up in November 2010 when it launched a public consultation on disclosure of non-financial information which ended in January 2011. In relation to that consultation, the Commission reports that half of the respondents described the current regime on sustainability reporting applicable in their respective jurisdiction as poor or very poor (European Commission 2011b). In the process of improving current EU rules on non-financial reporting, the Commission has commissioned the Centre for Strategy and Evaluation Services (CSES) to produce a specific study including qualitative analysis of current reporting practices in the EU and a cost/benefit analysis of non-financial reporting by companies. Furthermore, the Commission has established an Expert/Steering Group on Disclosure of Non-financial information (‘the Expert Group’), with the specific mandate to provide expert advice to the Commission (Expert Group on Disclosure 2011b).

## 4.2 Regulatory alternatives for more efficient non-financial reporting in the EU

When deciding on future approaches towards non-financial reporting, the Commission will have to choose between several alternatives, al-

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21. For the ETUC’s position on the Communication see ETUC (2011).

though in many cases these can be developed cumulatively. These alternatives range from a number of non-binding (soft law) instruments to strict uniform and binding legislation.

Non-binding instruments to spread non-financial reporting include the sharing of best practices, better guidance and creation of greater incentives for companies within a voluntary regime (e.g. awards for exemplary sustainability reports), industry self-assessment and benchmarks. Furthermore, the EU could also encourage voluntary reporting and promote existing international frameworks for non-financial reporting. In this respect, the Commission could issue a recommendation or guidelines on social reporting, as it has done in relation to environmental reporting, and thus emphasise the benefits of sustainability reporting for a company's reputation and competitiveness. In accordance with their non-binding nature, all these instruments allow for flexibility on the part of the companies preparing reports. At the same time, this implies maintaining the fragmented status quo, in which certain Member States observe high standards whereas others do not. Similarly, it allows companies that perform well with respect to sustainability to prepare reports, whereas other companies do not disclose or selectively disclose aspects that they want to. Namely, if a company performs well with regard to environmental sustainability, this does not necessarily imply that it is also performing well with regard to social sustainability.

In order to ensure clear disclosure requirements, and hence a level playing field, coherence and comparability across the EU, a change in the existing EU legal regime for corporate reporting is needed. As was stated earlier, in this respect, the Commission has promised a legislative proposal on the transparency of social and environmental information on several occasions. Two different legislative instruments are available in that regard: a directive and a regulation. In the field of financial reporting both forms of legislative instrument are used. Directives are employed when certain differences in regulation between the Member States are tolerable. Regulations are adopted when a completely uniform approach is needed in order to ensure the international comparability of the reports prepared by European companies. In the field of non-financial reporting as well, a regulation would be an appropriate instrument should the Commission decide to give binding force to one set of international standards on sustainability reporting (e.g. GRI standards), as has been done in relation to IAS in the field of financial reporting. Since these standards on sustainability reporting are adopted by private entities and

do not bind the EU, a regulation of that kind could ensure their legal status within the EU and, at the same time, establish a special committee that would assess individual standards' suitability for EU companies. That committee's endorsement of the standards would introduce them into the EU legal order, hence giving the EU control over the standards applying to EU companies. Despite the advantages of having a regulation in the field of non-financial reporting, given the present state of development of non-financial reporting in the EU, it is hard to expect political support for the introduction of such uniform rules. Even in the field of financial reporting Regulation No 1606/2002 only applies to certain companies (public listed companies) and in relation to particular reports (consolidated accounts). This suggests that when considering future legislation in the field of non-financial reporting, it is more realistic to expect a directive than a regulation.

With respect to a directive on non-financial reporting two alternatives are available. The first possibility is to amend existing EU accounting directives (Fourth and Seventh Company Law Directives) and possibly also the Transparency Directive, which refers to the former two directives in respect of non-financial reporting. The second possibility is to adopt a new directive entirely dedicated to the issues of non-financial reporting. Although both alternatives are acceptable, the advantage of the former is that integration of the rules on non-financial reporting in existing legislative acts on corporate reporting might indicate stronger EU support for the developing concept of integrated reporting. This would make it easier to require integrated reports on both financial and non-financial matters. On the other hand, a separate directive on non-financial reporting could perhaps emphasise more effectively the importance of sustainability reports, although this would probably mean a continuation of the practice of preparing two separate reports, one for financial and the other for non-financial matters.

### 4.3 Content of the report

#### **What information should European companies be required to disclose?**

Although the Commission has already indicated its intention to put forward a legislative proposal on non-financial reporting, this says nothing in relation to the content of such legislation. Two main options exist in this respect: either a principle-based approach or an approach support-

ing more detailed disclosure of information. A principle-based approach would impose a requirement on companies to reveal whether they have a CSR policy, and, if they do, to indicate how they implement it, and to identify the principal business risks and opportunities arising from social and environmental issues. On the other hand, more ambitious EU legislation in this regard would specify more detailed reporting requirements, requiring disclosure of key information (key performance indicators – KPIs) on issues such as employee engagement, customer satisfaction, public perception of the company, environmental policies and innovation (European Commission 2011b).

In any event, the Commission should at least establish some mandatory principles on non-financial reporting, on which KPIs should be based. In this regard, the Expert Group has agreed that non-financial information should be material, comparable, accurate, timely, reliable, clear, verifiable, forward-looking as well as retrospective (Expert Group on Disclosure 2011c). As regards the more precise content of the report, the Commission can either specify some general issues for reporting and/or establish a detailed list of KPIs. On the first point, the Expert Group agreed that non-financial disclosure should at least cover issues related to human rights, freedom of association, non-discrimination, diversity, equal remuneration, materials and waste, climate change, air quality, energy use and strategy, innovation and anti-corruption. As regards a list of key performance indicators, the Commission can either determine a specific list of reporting requirements or it can refer to one or more existing frameworks. Respondents to the Commission's public consultation generally suggested that appropriate reference to existing international standards and institutions should be made (e.g. to the GRI, UN Global Compact, ISO 26000, OECD Guidelines for Multinational Enterprises, etc.), and argued against the development of new EU-specific frameworks. Should the Commission decide to follow this opinion, it needs to determine all the same whether to select one or more sets of international standards, which should be respected by EU companies when reporting on non-financial matters, or whether the companies themselves should select relevant indicators, ideally in cooperation with their investors and other stakeholders, and disclose information in accordance with those indicators.

Should the Commission decide to select appropriate sets of standards, preference should certainly be given to those that are already accepted world-wide, that are comprehensive and which are both general (i.e. rel-

evant and common to all companies) and also sensitive to the needs of individual sectors. Although none of the international frameworks on non-financial reporting covers all reporting requirements that could potentially be considered, it would be beneficial for the Commission to make such a selection in order to achieve the comparability that is needed and to enable benchmarking. While it is true, as found by the Expert Group, that in comparison with reporting on financial information there is currently no truly globally accepted standard-setter for non-financial information, it must be observed that GRI come very close to this (Expert Group on Disclosure 2011a). It is also to be expected that, should the Commission give preference to one set of international standards on sustainability reporting (e.g. GRI), many other jurisdictions would follow the EU's choice. Furthermore, most of the organisations that set international standards are open to external suggestions on KPIs. In this respect, the EU should ensure its place in the organisation whose standards are to be endorsed in the EU legislation and hence assume a position to influence the content of future standards (such position would indeed be a 'reward' for the EU's support and promotion of the relevant standards). However, of considerably greater importance than the set of standards that might be promoted by the Commission is the question of companies' obligations in that regard. Will the Commission adopt a 'comply or explain' approach or will it introduce mandatory reporting requirements? This is a choice between flexibility and true commitment to sustainability. It is the choice that will have to be made by the EU institutions alone, given that there are irreconcilable differences between the main stakeholders, that is companies, and stakeholders in those companies; the former advocate flexibility and voluntariness, whereas representatives of social and environmental interests rightly emphasise that sustainability reporting should no longer be voluntary in the same way as financial reporting is not.

### **Worker-oriented reporting**

As regards the content of the sustainability reports, social reporting (i.e. reporting on human resources issues) needs to be put on the same footing as environmental reporting. Although employees hold the position of 'the most key stakeholder in their company' (Vitols 2010: 1), employee-related information currently lags behind environmental issues. In addition, current practice at company level varies significantly as far as reporting on employee-related issues is concerned. In general, such reporting is better in companies with worker participation mechanisms

(e.g. where a European Works Council is active). Volkswagen is often highlighted as an example of good practice. This is a business where employee representatives are involved in the development and improvement of sustainability reporting systems and in the communication of results to the workforce.

**Table 2 Frequency of reporting on GRI core indicators on labour practices and decent work, top 100 listed companies**

GRI core indicator	Description	% of top 100 listed companies reporting
LA1	Total workers by employment type, employment contract, and region	66
LA2	Total workers by employment type, employment contract, and region	56
LA4	% employees covered by collective bargaining	53
LA5	Minimum notice periods	36
LA7	Rates of injury, occupational diseases, lost days/absenteeism, number of work related fatalities by region	65
LA8	Education, training, counselling, prevention etc. regarding serious diseases	55
LA10	Average hours of training per year per employee by employee category	56
LA13	Composition of governance bodies and breakdown of employees per category according to gender, age group etc.	62
LA14	Ratio of basic salary of men to women by employee category	30

Source: Vitols (2010).

This differentiated practice is a result of undeveloped legal rules and the prevailing voluntariness in the field of sustainability reporting in the EU. A Commission workshop held with trade unions gave them an opportunity to present their views on the matter. This revealed that trade unions would like to see the current regime replaced with a disclosure regime having the following characteristics:

- mandatory disclosure requirements applying not only to listed companies but also a broad spectrum of unlisted firms (including SMEs);
- reporting on a wide variety of ESG indicators;
- standardisation of indicators to improve comparability over time (e.g. to measure progress) and across companies;

- inclusion of ‘special situations’ such as restructuring in the mandatory disclosure regime;
- expansion of indicators to improve supply chain disclosure;
- a participatory approach which includes workers and their representatives in the development and improvement of reporting systems, monitoring of progress and negotiation of sustainability strategies and goals.

Although the EU is confronted with a challenge to improve the whole regime on sustainability reporting, this is even more acute as regards social reporting. The fact that environmental reporting has been of greater concern to the EU than social reporting is evident from the 2001 Recommendation which is limited to the reporting of environmental aspects. This divergence between environmental and social issues can be discerned also from the report on the application of the Unfair Commercial Practices Directive. This addresses issues of unfair commercial practices in relation to the environmental impact of products but does not mention any social issues (European Parliament and the Council of the European Union 2005). Similarly, the Commission adopted the ‘Buying green’ handbook on environmental public procurement in 2005, whereas it took five years before an equivalent in the social field was adopted. As emphasised by the ETUC, ‘particular vigilance will be needed ... to ensure better integration of both social and environmental considerations’ (ETUC 2011, para. 17), not only in respect of public procurement and unfair commercial practices, but also in respect of corporate reporting regulation. In contrast to the many shareholders increasingly taking a short-term approach towards the company in which they invest, employees have long-term interests and, correspondingly, also adopt a long-term approach. This therefore justifies why the latter group should have a right to be informed on the impacts their company has on a wide range of indicators, including environmental indicators, which have the most direct impact on employees’ health and safety, and should have a more extensive role in reporting and sustainability initiatives at the company level.

#### 4.4 Other issues on non-financial reporting to be decided

##### **Which companies should be required to disclose non-financial information?**

In the context of the ongoing reform of corporate reporting, one of the most important issues to be determined is which companies should be

required to disclose non-financial information. This is primarily, but not exclusively, a question of size. Having regard to their impact on the economy and local communities and as leaders of business trends, the prevailing opinion is that large companies should be required to report on non-financial aspects of their business. However, as regards SMEs, opinions vary considerably.<sup>22</sup> Respondents to the Commission's public consultation suggested a phase-in approach, where the introduction of a new reporting requirement could apply, first, only to large companies, and later, following evaluation, to medium-sized companies. In addition, a significant majority of respondents agreed that small enterprises should not be subject to any mandatory requirement, in light of the administrative burden this would entail. This argument was countered by respondents who pointed out that, although not individually, in collective terms SMEs have a large impact on society and the environment, and for this reason should be included in the reporting of non-financial information. This is in line also with the principles of integrated reporting, where small companies are required to report, but subject to less stringent rules. Consequently, should the EU support integrated reporting, a coordinated approach towards financial and non-financial reporting will be needed.

A specific issue is whether institutional investors (e.g. pension funds) should be subject to specific or additional disclosure requirements, e.g. how environmental and social issues affect their investment decisions. This would be important in order to enhance long-term investment performance, while at the same time increasing transparency to their clients and stakeholders and would thus encourage those investors towards taking more sustainable action. In this respect, one of the UN Principles for Responsible Investment (UN PRI) – Principle No 3 states: 'We will seek appropriate disclosure on ESG issues by the entities in which we invest'. In pursuit of that approach, it proposes that institutional investors could:

- ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative);
- ask for ESG issues to be integrated within annual financial reports;

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22. For a definition of small and medium-sized companies for these purposes see Article 11 (small) and Article 27 (medium-sized) of the Fourth Company Law Directive (Council of the European Union 1978).

- ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact);
- support shareholder initiatives and resolutions promoting ESG disclosure (PRI 2012).

Finally, in relation to the addressees of the disclosure requirements, any future legislation on sustainability reporting will have to settle the issue of reporting boundary. This will entail a provision determining whether a report should simply include information at group level (the parent company and its subsidiaries) or go beyond this to include undertakings within the sphere of influence of the reporting company. In this respect, the first alternative will probably be sufficient to obtain adequate information on a company's sustainability performance and, at the same time, ensure legal certainty without imposing an excessive administrative burden upon the preparers of reports.

### **External assurance/auditing**

A further key issue to be addressed by future EU legislation concerns the question of whether non-financial information disclosed should be audited by external auditors or at least get some sort of external assurance. It is beyond doubt that there is value in getting non-financial reports assessed by independent experts in order to improve accuracy, completeness and comparability and enhance confidence amongst stakeholders (European Commission 2011b). Although this involves costs for companies, such cost should not be considered undue considering the limited value of unverified reports. Furthermore, although external assurance of non-financial information involves activities and qualifications significantly different to those required for auditing financial statements, this does not justify legislative approval of reports that are not externally assured. In line with the principle of proportionality, SMEs should perhaps be allowed to provide assurance opinions only rather than full audits, which would significantly limit the costs while forcing companies to prepare truthful reports. Additionally, the Commission should consider putting companies under an obligation to publish non-financial information online. As emphasised by the Commission's Expert Group, 'reports published online are de facto exposed to "public verification"' (Expert Group on Disclosure 2011b). This would enable all stakeholders (employees, consumers etc.) to verify the reports directly. In any event, internal stakeholders ought to be engaged in the preparation of sustain-

ability reports and not simply informed of the content of the final version. As stressed by the ETUC, ‘the presence of trade unions is the most effective monitoring system and mechanism for addressing grievances’ (ETUC 2011).

## 5. Conclusion

Short-term and socially irresponsible decision making in many companies has caused the crisis. To bring the EU economy out of the crisis and to prevent repetition, a fully engaged orientation towards sustainable development is needed. Sustainability reporting is an important instrument to achieve this objective, given that disclosure of certain aspects of business activities stimulates companies to actually perform better in the fields they report on. For the EU to achieve these objectives it needs to establish solid legal foundations for effective sustainability reporting that will establish a level playing field across the internal market. The legislation should bind all or at least the vast majority of business entities, which should be required to report on all the important environmental, social and other non-financial aspects of their businesses that affect sustainable development in society. Such information should be clear, precise, and verifiable and should enable comparisons across the EU.

It is understandable and necessary that, in the process of proposing and adopting legislation on sustainability reporting, EU institutions balance various costs that sustainability reporting requirements will have on European companies. These include increased administrative burdens and costs in the form of data collection, staff training, third party evaluation and assurance, etc. Nevertheless, the fear of cost should not lead to legislation of a kind that would prevent any serious achievements in the field of sustainability reporting and jeopardise sustainable development in general. Leaving disclosure of non-financial information voluntary or limiting this obligation to large companies only or to general non-financial information that need not be externally verified would indicate that the EU is not seriously committed to sustainability. On the other hand, costs of high standards in relation to non-financial reporting can be alleviated if one considers that publishing costs can be reduced if templates are offered. Furthermore, after the first year of reporting the costs of maintaining the reporting activities are no longer substantial. In response to the Commission’s public consultation, contributions

from Member States with more extensive requirements did not report that these lead to excessive administrative burdens. Moreover, companies should regard sustainability reporting as something that may benefit themselves, much the same as financial reporting does, and see the benefits of data collected for better risk control, cost management and better overall definition of corporate strategies. Consequently, although flexibility is an important aspect to be considered when preparing any legislation, in the context of sustainability reporting legislation it should not be to the level that sustainability itself would be at risk.

Furthermore, it makes sense to support integrated reporting, as this could contribute significantly to mainstreaming environmental and social issues and raise awareness about the links between financial and non-financial information. This would give a holistic view about a company's activity and help stakeholders realise that the financial results of a company are only one part of its impacts. The EU should also work in close cooperation with the International Integrated Reporting Council (IIRC) and in the future potentially endorse standards on integrated reporting adopted by the IIRC.

As the Commission's Expert Group found, 'better disclosure of social and environmental information could enhance the accountability of enterprises, and consequently contribute to greater public trust in business'. In order to stabilise the EU economy such public trust is imperative.

*'There is nothing more wasteful than wasting a crisis'*  
Rahm Emanuel

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# Chapter 15

## ETUC for strengthening employee involvement

Wolfgang Kowalsky and Claudia Menne<sup>1</sup>

### 1. Introduction

Since its foundation, the ETUC has supported and promoted workers' involvement in the sense of workers' information (one-way communication from management/employer), workers' consultation (two-way communication between management and workers' representatives) and workers' participation (board level representation).

Significant achievements at European level in terms of concrete workers' rights have been made, for instance, the 2001 Directive and Regulation on the European Company Statute [SE], the 2002 Directive establishing a general framework for employees' information and consultation, the 2009 Recast European Works Council Directive and, above all, acknowledgement in the Charter of Fundamental rights (Art. 27) all grant European workers with substantial rights of information and consultation in companies' decision making processes and participation in the board.

And yet, this linear progress need not be taken for granted, as some current trends and initiatives on the one hand, and lack of initiative on the other hand, have put national legislations under pressure by facilitating "regime shopping" from companies at the expense of workers' rights.

This leaflet summarises two ETUC Resolutions adopted by its Executive Committee in 2011 and 2012 and presents the ETUC positions on current EU priorities with regard to company law and worker involvement:

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1. This text was printed as a separate ETUC brochure in May 2012. The authors would like to express their thanks to Aline Conchon, Séverine Picard and Sigurt Vitols for their support in preparing the text.

- Commissioner Barnier stated that *“Experience with recent negotiations on pending cases shows that Member States have difficulties to trust each other in matter of company law. Various simplification work and the SPE Statute offer striking examples”*.<sup>2</sup>

The ETUC argues that the simplification agenda must be replaced by a sustainable approach. Under the headline “minimizing the regulatory burden for small and medium-sized enterprises (SMEs) and adapting EU regulation to the needs of micro-enterprises” the European Commission has accelerated its efforts to deregulate a large part of the European economy. In the area of company law the Commission has proposed waiving requirements for SMEs (particularly for micro-enterprises). SMEs are estimated to account for approximately two thirds of private sector employment in the EU, thus the potential impact of deregulation on employment and working conditions is huge. The owners of many of these companies enjoy the privilege of limited liability, which limits the claims that employees and other stakeholders can make in the event of company failure. The ETUC is adamant that better regulation does not necessarily mean less regulation. Necessary safeguards and rights for workers and other stakeholders should not be abolished in the name of reducing costs.

- Commissioner Barnier called for *“progress towards a more long-term approach of our economy: we need to reduce harmful, short-termist tendencies. Sound corporate governance can help achieve this”*.<sup>3</sup>

The only way to such a *sound corporate governance is the strengthening of worker involvement* since workers have the greatest interest in the long-term sustainability and growth of their company. European Works Councils, Transnational Company Agreements and Board-Level Employee Representation already play a fundamental role in this regard. Realizing this concept of a “sustainable company” requires fundamental changes in our legal and regulatory framework. Company law needs to take the long-term interests of workers and other stakeholders into account, not just the interests of shareholders. The transparency of compa-

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2. Opening speech at the conference on “European Company Law: the way forward”, Brussels, 16 May 2011 [our own translation].

3. Opening speech at the XI European Corporate Governance Conference, Warsaw, 15 November 2011.

nies, particularly with regard to their social and environmental impact, needs to be improved through binding standards for disclosure.

## A key question of the twenty-first century: better workers' participation in sustainable companies

The question of industrial or social democracy is a key question of the twenty-first century and the future of Europe. If the European integration continues to be perceived as doing damage to Social Europe, as stirring Europe in permanent austerity governance, it will generate an unprecedented anti-European backlash in many Member States. The financial crisis led to a power shift from democracy towards financial industry. It is time to shift it back: The way must be paved for a new era of more democracy at the workplace, stronger industrial policy, and stronger workers' participation rights. This objective is an ambitious one and will not be reached within a few months but it should be possible to introduce a new momentum into these developments. And the ETUC believes that there is a strong momentum for strengthening workers participation in Europe.

Trade unions have a fundamental interest in promoting more democracy at the workplace and sustainable EU governance. The coming years will be difficult for workers. The current economic context leads to more frequent changes in company strategies, including greater recourse to restructuring. Workers and their representatives must be given a place and a voice in these strategic decisions.<sup>4</sup>

Reforming European company law in the interests of workers and other stakeholders will not be easy. The ideologies of shareholder value and regime competition have fundamentally shaped the EU company law *acquis*. But the financial crisis has clearly demonstrated the need for change.

Overall, the ETUC recommends *a more sustainable approach in relation to workers involvement in European company law*. As business is increasingly becoming global, the European Union must reflect if

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4. See ETUC Resolution "Anticipating change and restructuring: ETUC calls for EU action" of 6-7 March 2012 and ETUC Resolution "Workers participation at risk: towards better employee involvement" of 8 December 2011 and ETUC Resolution "The Future of European Company Law: towards sustainable governance" of 7 March 2012.

and how a sustainable streamlining of employees' involvement can be achieved. Such reflection should not be geared towards downsizing existing national provisions but rather to see how the Union can promote competitive and socially responsible European company forms. This work should be done in view of going from a defensive to a more offensive strategy.

The rules of financial capitalism are global, yet, the applicable standards on workers' participation are still shaped at national level. As business goes global and ignores national boundaries, a rethinking of the role of workers' involvement in companies must be shaped at European level. An elaborated ETUC proposal for European standards for information and consultation rights as well as worker participation should help prevent that registration and localisation of the company seat can be organised with a view to avoid workers' participation. A good starting point for this work is the fact that employee influence is now a fundamental right under the Treaty (TFEU).

## Addressing the failures of corporate governance

The shareholder value paradigm has dominated policy debates and company law for more than two decades in Europe and much of the rest of the world. For the ETUC this shareholder short-termism model is one of the major causes of the crisis. It creates powerful incentives to create shareholder value by externalising costs onto society; it favours excessive risk-taking and myopic management decisions by insisting that shareholder value ought to be the only goal pursued by corporate management.

For the ETUC, the answer to shareholder economy and short-termism is to safeguard and develop employee involvement rights and practice in all kind of companies. The lesson of the crisis is to develop workers' involvement on all levels. A stronger participation of workers in strategic business decisions which are often taken at European or global level is necessary and the current crisis must be considered as opportunity to strengthen worker involvement to strengthen the long-term viability and sustainability of companies. A corporate law that gives control rights by default exclusively to shareholder exposes executives to strong pressure to maximise returns to shareholders in the short term. Managerial autonomy is one of the mechanisms to govern an enterprise in the interest of all stakeholders.

## Workers' involvement at risk

In the “Work Programme 2012” of the Commission published on 15 November 2011 the COM outlines three roadmaps. One of these proposals features the revision of the Directive 2001/86/EC on *employee involvement in the European Company* (*Societas Europaea*, henceforth: SE): “The initiative would aim to bring about simplification”. The “main problems” which this initiative intends to address are “in particular the rules on employee involvement”, “the scope of the ‘before and after’ principle”, “double requirements when a European Works Council already exists”.

The second roadmap is on the *Statute for a European Company* (SE): the Commission is reflecting on possible amendments to the SE-Statute in view of legislative proposals in 2013 with the scope to “entail simplification and reduction of administrative burdens”.

The third roadmap schedules a consultation on the Revision of Directive 2003/72/EC on *involvement of employees in the European Cooperative Society* (*Societas Cooperativa Europaea*, henceforth SCE) in 2013. The objective is to assess whether existing arrangements on employee involvement “may be considered responsible for a very small take up of this legal framework and identify any feasible possibilities for simplification”. Both issues are dealt again under the “simplification” agenda. *The ETUC will not accept that workers involvement is sacrificed on the altar of the “better regulation” – or a highly ideological internal market agenda.*

In the field of company law, the guiding principle anchored in the SE and SCE Directives, according to which companies are not allowed to make use of European legislation so as to reduce or circumvent existing national participation rights, is losing ground. Provisions related to the negotiation of board-level employee representation in the cross-border merger (CBM) Directive already presented a cutting back compared to the SE pattern. A similar assessment could be drawn about the proposal for a European Private Company (SPE) and doubts are legitimate as regards the forthcoming proposal related to the cross-border transfer of companies' registered office.

The SE-Directive has set a political precedent. For the SE a historic compromise around the involvement of workers was found after 30 years of

discussions and negotiations. The ETUC considers this compromise as the *benchmark* for any EU legislation touching upon board level representation and a step towards a European minimum standard on participation rights which now has to be taken as basis for a deepening and an extension of those rights, for promoting board level representation in the 16 EU Member States where such systems exist (AT, CZ, DE, DK, ES, FI, FR, GR, HU, IE, LU, NL, (NO,) PT, SE, SI, SK) and in European legal entities. Employee involvement in the decision making process at company level is a central component of the European social model.

So far the EU has adopted a rather disjointed *acquis* concerning employee involvement. It presupposes existing national systems of employee involvement. What is needed is common requirements for employee involvement.

## Activities on European level and next steps for the ETUC

*The ETUC calls for a radical change of approach in EU policy.* EU company law should focus on promoting a coherent, sustainable and forward-looking corporate model, including an EU framework instrument on workers' involvement. Major questions can also be raised about the real purpose and effect of the current better regulation / simplification agenda. The European Commission after the consultation on corporate governance in 2011 now launched another one on company law in 2012. It is not clear in which direction the Commission will go, but there is enough evidence that simplification and flexibility are still high on the agenda. It must be clear for the Commission that workers' right to information and consultation within the undertaking is considered a fundamental right according to Article 27 of the EU Charter of Fundamental Rights (CFREU). The Commission has not only to respect but also to promote these rights (Article 51(1) CFREU). Article 152 TFEU which has been introduced by the Lisbon Treaty as the main improvement in the Social policy Title requires the Union (and its institutions) to promote the role of Social Partners at EU level and to "facilitate dialogue between the social partners, respecting their autonomy".

Against this legal background, the Commission in particular is obliged to do all it can to improve the information, consultation and participation at the appropriate levels. Further, the EU should, according to the Treaty, support and complement the activities of the Member States in this

field and may to that end adopt minimum directives (Article 153 TFEU). The ETUC must stress these facts and convince the Commission that strengthening of employees' involvement is a step in the direction of less short-termism and less shareholder value, more stakeholder value and sustainability, in short: it would be a step towards a sustainable company. The Commission shouldn't look at companies as money-machines seeking the highest returns from global markets.

- The ETUC reiterates its demand for a meaningful consultation on policy orientation. A more active involvement on the part of European Social Partners in the shaping of EU company law policy would greatly contribute to unblock numerous deadlocks. Online consultations and Green Papers are not an adequate substitute for the specific consultation of the social partners, which is foreseen in the European Treaties.

The Commission must understand that the compromise found for the SE is a *yardstick* and that it was wrong not to respect this minimum standard in the cross-border mergers directive and the proposed Private Company Statute (henceforth SPE), both representing backward steps compared to the SE provisions. The Commission must come back on these and further issues: Problems with shelf SEs must be tackled and the question of employment growth as “structural change” which makes it necessary to renegotiate the participation rights. Forms of escape from co-determination (e.g. by choosing a legal statute provided by another Member State, such as the British public limited company statute), should no longer be possible; existing loopholes and bypass strategies must be addressed and tackled. The Treaty is clear on this issue and explicitly asks to “support and complement” and thus prevent circumvention of co-determination and other forms of workers participation: “*With a view to achieving the objectives of Article 151, the Union shall support and complement the activities of the Member States in the following fields: (e) the information and consultation of workers; (f) representation and collective defence of the interests of workers and employers, including co-determination (Article 153)*”.

The discussions on the proposed SPE Statute have further highlighted the need to ensure that businesses do not abuse the opportunities offered by the internal market to evade their legal obligations that would otherwise be applicable under national law. The ETUC is strongly opposed to the Commission's proposal for a *European Private Company*

*Statute.* Whilst the ETUC encourages initiatives that improve market conditions for businesses and welcomes any proposals designed to improve the market performance of SMEs, it is adamant that the flexibility of SMEs must not be enhanced to the detriment of workers' rights to sit on the Boards of their companies. It is crucial that the SPE Statute be accompanied by rules governing minimum standards on workers' involvement.

- It is not acceptable that the European Commission does not respect the minimum standard of worker participation as anchored in the SE and tries to dilute it further. The ETUC asks for the minimum standard of the SE being generalised to all other legal forms, the European Private Company, the cross-border mergers and the forthcoming 14th Directive on the transfer of seat. There is a real and unique chance to do some steps to extend this minimum standard on participation rights. Once the SE-provisions on workers participation established as minimum standard, there will be less ambiguity about the Commission position on workers involvement.
- The ETUC has to make sure that the compromise on workers' involvement in the SCE will not be questioned and that some general conclusions on the promotion of workers' involvement will be supported by the EP.
- The ETUC is renewing its call for an open debate on a *14th Company Law Directive on cross-border transfers of registered offices*, with a view to preventing the establishment of 'letterbox' companies. The ETUC will monitor closely the developments and try to make sure that the reference point will be the minimum standard anchored in the SE.

## Change the fundamental objectives of EU company law

However, Social Europe and a sustainable economy cannot be realized simply by hoping that the crisis will pass soon and the economic recovery will put us on the right path. The demands discussed above, together with the list in the annex of existing EU company law directives and where they need to be reformed, provide a roadmap for fundamental change in how our companies operate and are regulated. In order to achieve a democratic and social Europe, it is crucial that workers and their representatives are not excluded from the political process. The

relationship between companies and society has become unbalanced in favour of the former. But companies need to serve society, rather than society serving the shareholders. A proper balance can be achieved only by fully including trade unions in the process of change.

Instead of promoting a harmonising approach, the Commission is pursuing a regulatory competition agenda (based on basic minimum requirements at EU level and a mutual recognition principle). By introducing a 1 euro minimum capital requirement and very light registration requirements, the Commission's proposal for a European Private Company illustrates well this minimalist approach.

The consequences of this regulatory competition agenda run against the spirit of European integration. National company laws, where they provide for fairness and social justice, are under the fire of EU law and the pressure is increasing towards more regime competition amongst company laws to provide the highest corporate benefits.

The ETUC considers it unacceptable for EU law to promote a race to the bottom agenda. A major change of approach is urgently needed so as to restore the fundamental objectives of sustainable EU company law: to prevent regime competition and to promote a forward looking model at EU level taking into account the necessity of high level of quality employment and social progress.

## Preventing regime competition

The ETUC believes that increasing company mobility can be beneficial to the European economy to the extent that it responds to justified business needs, linked to genuine organisational reasons. But cross border mobility cannot be treated as an end in itself, which means that EU law must put in place the necessary safeguards to prevent the setting up of artificial structures, such as “letter box companies”, designed to evade the applicable national rules.

The choice of the *place of registration* is an important step in the life of businesses as it determines the main national regime applicable to the company. However, the dominant philosophy is to allow companies to establish their registration seat in a different Member State than the place of real business. For the ETUC, this artificial division has no justi-

fication under EU law. It leads to regime competition for all the wrong reasons, including in particular tax optimisation and circumventing existing workers' rights.

*Against this background, the ETUC considers that the 'real seat' principle should be a core principle of EU company law.* The ETUC therefore urges the EU legislator to devise the appropriate rules so as to ensure that the registration place is linked to the place of main business.

Furthermore, the ETUC is increasingly concerned by *transfers of registered offices* in the Union. European Court of Justice rulings have made such transfers very problematic, in particular from a regime competition point of view. In the absence of an express will from the EU legislator, the Court has strengthened the possibility for companies to choose the corporate regime of any Member State.

There have been initiatives to approve a specific company law Directive dealing with such transfers (the '14th company law Directive'). The ETUC is very conscious of the fact that such a Directive would lead to an increase of cross-border transfers within the Union, with the accompanying risks of delocalisation and watering down of workers' rights. A number of safeguards are therefore indispensable so as to limit transfers of registered offices to cases of justified business needs, linked to genuine organisational reasons. In particular, the following pre-conditions are essential for ETUC support for a 14th Directive:

- As highlighted above, the 'real seat' principle is indispensable;
- There must be a meaningful information and consultation procedure about the proposed transfer. Effective sanctions must be put in place so as to guarantee the respect of this obligation;
- The provisions governing workers' involvement (information, consultation and participation) must be in line with the mechanism of the SE Directive.<sup>5</sup>

*A substantial capital base* for companies is considered to provide a basic level of protection for workers and other stakeholders when companies run into financial difficulties. Currently however, with the exception of financial companies and public limited companies, there is no EU level

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5. Directive 2001/86/EC supplementing the statute for a European company with regard to the involvement of employees

minimum capital requirement. This has allowed a “race to the bottom” between Member States, many of which have been lowering capital requirements in an attempt to attract foreign business. *The EU should impose a minimum capital requirement for all kinds of companies which will provide a reasonable level of protection to workers and other stakeholders if the company they are working for or doing business has financial problems.*

## Promoting a coherent and sustainable model

Overall, the ETUC considers it necessary to start discussions on a *framework instrument on workers’ involvement*. The exercise should not be about rethinking national models on information, consultation and participation but to build a sustainable European company law model. Any company which decides to benefit from the provisions of European company law (e.g.: a European Company, a European Cooperative Society, a European Private Company, a company moving across the EU in line with the cross border merger Directive etc.) should at the same time adhere to certain shared values.<sup>6</sup>

Furthermore, the large EU company law acquis is disjointed. In their quest for the ‘lightest regime’, companies are not only able to pick and choose national legal forms; they can also put EU instruments in competition with each other.

Considering the current approach to EU company law, the ETUC is of the view that a codification of EU company instruments is a perilous exercise, which may have damaging consequences. There is, however, a clear need to create in the short term *more convergence between the various EU company law Directives*. For instance:

- The Takeover Directive 2004/25/ contains very weak provisions on workers’ involvement. This Directive must therefore be reviewed with a view to align its provisions on workers’ rights with other pieces of the Community *acquis*.
- The relevance of the distinction between listed companies and private companies which is currently made by EU law must be

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6. Directive 2001/86/EC supplementing the statute for a European company with regard to the involvement of employees.

reassessed. For instance, the protection afforded by the transfer of undertakings Directive 2001/23/EC must also be available to workers in listed companies.

- The worker involvement provisions in the cross border merger Directive 2005/56/EC must be aligned to those of the SE Directive 2001/86/EC.
- Whenever a company envisages relying upon an EU company law instrument, there should be a mandatory assessment of the impact on workers (merger, division, transfer of registered office, takeover, etc.).
- Similarly, where new EU company law initiatives are being envisaged, the ETUC urges the Commission to reflect carefully on a coherent approach. The SPE proposal in its current form should be withdrawn as it creates intolerable competition with both the SE legislation and national company laws. Also, the provisions in the existing *acquis* must serve as a point of departure for an initiative on cross border transfer of registered seats.

## Auditing and reporting

The financial crisis demonstrated once again that *auditing* firms fail to adequately play the role of “gatekeepers” that they are supposed to. The extent to which companies and financial institutions receiving a “seal of approval” from an auditing firm ran into difficulties in the crisis and thereafter shows that this failure was systematic rather than exceptional. Core causes of this failure include: significant conflicts of interest through the simultaneous provision of auditing firms of both auditing and certain types of consulting services, an oligopoly among large auditing firms, flaws in current accounting standards, and a focus on historical (rather than forward-looking) performance and on data of interest mainly to shareholders.

The Commission’s recent proposals on auditing<sup>7</sup> need revision in order to achieve a number of goals: encouraging a forward-looking focus which includes a judgment of key risks and the sustainability of the business strategy, inclusion of more information relevant for workers and other

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7. Proposed Regulation on statutory audit of public interest entities (COM (2011) 779 final) and Proposed Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (COM (2011) 778 final)

stakeholders, respect for two-tier board systems and access to audit reports in different national systems of worker involvement in the EU, and removing conflicts of interest that would endanger independence in the auditing process, in order to discourage a rubber-stamp approach to auditing.

The current regime of *company reporting* is characterized by a focus on listed companies and the needs of their shareholders. Workers and other stakeholders need and should receive the relevant information, such as financial information, and the social and environmental impact of companies. In the rare cases where information is disclosed, it is frequently done so without reference to external standards. Furthermore, when disclosure is done on a “comply or explain” basis, explanations are frequently lacking or inadequate. The lack of adequate information to workers and other stakeholders, especially in smaller sized companies, can prevent the detection of financial difficulties in the company. The spirit of the general framework Directive on information and consultation (Directive 2002/14/EC) must be respected.

The ETUC judges the current disclosure regime as “poor” and *demand*s reporting by a larger spectrum of companies (nonlisted as well as listed, and not only large companies) on the basis of common standards which allow comparisons over time and between companies. Mechanisms for improving the credibility of this information include external auditing and trade union verification (e.g. of labour standards in supply chains).

Annex 1 The weaknesses of the current EU company law *acquis*

References	Topics	ETUC comments*
Directive 2009/109/EC	As part of the simplification initiative, under certain conditions reduces reporting and documentation requirements in case of divisions and mergers	Reporting and documentation requirements in general need to be strengthened, particularly regarding information and consultation rights for workers
Directive 2007/63/EC	Extends option for shareholders for an exemption from requirement for an independent expert's report contained in the cross border merger directive to purely domestic mergers	<ul style="list-style-type: none"> <li>- Rights to an independent expert's report should be extended to employees</li> <li>- Other information and consultation rights should be strengthened</li> </ul>
Directive 2007/36/EC	Shareholders' rights	<ul style="list-style-type: none"> <li>- Shareholder responsibilities should be defined, not just shareholder rights</li> <li>- The voting records of investors should be made publicly available</li> <li>- Accountability should be ensured along the investment chain, so that investment managers and proxy agencies act in the interests of ultimate owners .</li> <li>- Enough transparency should be created so that companies can identify their shareholders, including those with short interest and borrowed voting rights.</li> </ul>
Directive 2006/68/EC	Formation and capital of public limited liability companies	Provisions on minimum capital requirement need to be strengthened.

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\* NB: all Directives which relate to company strategy and restructuring should contain a provision requiring a thorough impact assessment of the proposed measure on the workforce.

References	Topics	ETUC comments*
Directive 2005/56/EC	Rules on cross-border mergers	<ul style="list-style-type: none"> <li>– Workers' rights need to be aligned to the provisions of the SE Directive. In particular, provisions on information and consultation must be included and the provisions on participation must be identical to those of the SE Directive</li> <li>– Requires impact assessment of envisaged financing for the merger</li> </ul>
Directive 2004/25/EC	Rules for takeover bids	<ul style="list-style-type: none"> <li>– Requires stronger rights for workers, including in particular application of the transfer of undertakings Directive, and meaningful information and consultation about the proposed take over</li> <li>– Requires more transparency on the take over procedure</li> <li>– Require prior impact assessment of the take over</li> </ul>
Directive 2003/58/EC	Modernization of the Accounting Directives	More transparency should be required in the form of binding standards for social and economics reporting, not just reporting on financial performance.
Directive 2001/86/EC	SE directive	<ul style="list-style-type: none"> <li>– Phenomenon of shelf SEs should be investigated,</li> <li>– Adaptation clause needs to be included so that negotiations on workers' involvement are triggered in case of significant change in the size and/ or repartition of the workforce</li> <li>– Requires setting of a register at EU level, which would allow more transparency regarding business activities and the size of the workforce</li> </ul>

\* NB: all Directives which relate to company strategy and restructuring should contain a provision requiring a thorough impact assessment of the proposed measure on the workforce.

References	Topics	ETUC comments*
Eighth Council Directive 84/253/EEC	Auditing	<ul style="list-style-type: none"> <li>– Requires removing of conflict of interest of auditing firms with both auditing and consulting business</li> <li>– Access of employee representatives to auditing reports</li> <li>– Requires forward-looking statements</li> </ul>
Seventh Council Directive 83/349/EEC Fourth Council Directive 78/660/EEC	Accounting	<ul style="list-style-type: none"> <li>– Must be more stakeholder oriented</li> <li>– Access of employee representatives to the information</li> </ul>
Sixth Council Directive 82/891/EEC	Division of companies	<ul style="list-style-type: none"> <li>– Requires reference to transfer of undertakings directive</li> <li>– Requires prior impact assessment</li> </ul>
Directive 2011/35/EU	Mergers of public limited liability (amends 3rd directive)	<ul style="list-style-type: none"> <li>– Requires reference to transfer of undertakings directive</li> <li>– Requires prior impact assessment</li> </ul>
Second Council Directive 77/91/EEC	Formation and capital of public limited liability companies	Requires strengthening minimum capital requirement
Directive 2009/101/EC	Registration/power of organs/nullity	<ul style="list-style-type: none"> <li>– More transparency in registration and basic company information</li> <li>– Improve access to (European) business register</li> </ul>
Directive 2001/23/EC	Information and consultation on proposed transfer of undertakings + prohibition of changes in work conditions, including dismissals, for reasons directly connected to the transfer	Requires extending the scope to cases of shares sales, division of companies, mergers of public limited liability companies

\* NB: all Directives which relate to company strategy and restructuring should contain a provision requiring a thorough impact assessment of the proposed measure on the workforce.

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