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Contracting Employee Involvement: An Analysis of Bargaining over Employee Involvement Rules for a Societas Europaea

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Abstract

Following a slow start, the European Company (Societas Europaea – SE) has become a popular legal form amongst European firms. It is rendered attractive by corporate governance features such as the contractual freedom of capital and labor to design a firm-specific employee involvement regime. By analysing what has been settled for in such agreements, we investigate whether national mandatory employee involvement rules are efficient and which factors impede firm-specific bargained-for solutions.

Keywords: European Company, Societas Europaea, employee involvement, contractual negotiations, contract governance
JEL Classifications: J5, D23, K31

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Contracting Employee Involvement: An Analysis of Bargaining over Employee Involvement Rules for a *Societas Europaea*[*]

Horst Eidenmüller,[**] *Lars Hornuf*[***] *and Markus Reps*[****]

Abstract

Following a slow start, the European Company (Societas Europaea – SE) has become a popular legal form amongst European firms. It is rendered attractive by corporate governance features such as the contractual freedom of capital and labor to design a firm-specific employee involvement regime. By analysing what has been settled for in such agreements, we investigate whether national mandatory employee involvement rules are efficient and which factors impede firm-specific bargained-for solutions.

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I. Introduction

Since 2004, businesses in Europe have the opportunity to incorporate as a European Company (*Societas Europaea*, hereinafter SE). After a slow start, the SE has become fairly popular. By the end of 2010, approximately 700 SEs had been incorporated, mostly in Germany and the Czech Republic (ETUI 2011). The reasons for this popularity of the SE corporate form in general and amongst German and Czech firms in particular are manifold (Eidenmüller et al. 2009a; Ernst & Young 2009: 208-38; Eidenmüller and Lasák 2011). Clearly important are

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certain governance features of the SE such as the option available to founders to choose between a one-tier and a two-tier corporate structure. Another relevant governance feature is the SE regime on employee involvement. In many Member States of the European Union, some form of employee involvement in the management of public corporations is mandatory. Such employee involvement may take the form of information and consultation rights. However, it may also include participation rights such as seats on the administrative or supervisory board of the corporation. In Germany, for example, one-third (one-third participation) and even 50 percent (parity co-determination) of the supervisory board members of a joint stock corporation (*Aktiengesellschaft*) must be employee representatives if the firm employs more than 500 and 2,000 workers, respectively.[1] Now, if such a company merges with a company from another European Member State and forms an SE, under the applicable European rules, negotiations on the employee involvement regime must take place, and shareholders/management may strike a bargain with labour on a new regime that may well look very different from the one in place before the transaction. Hence, the SE is based on freedom of contract with respect to a fundamental corporate governance feature, namely employee involvement in the management of the firm.

Experiments in social reality are generally rare. That firms can choose applicable governance rules on employee involvement by negotiating an individual agreement is so far a unique experiment in the realm of corporate law. As is well-known, there is an old and still unresolved debate about whether mandatory employee involvement rules such as the German rules on employee participation are efficient or not (Fleischer 2004: 537-39; Gorton and Schmid 2004; Fauver and Fuerst 2006). The opportunity to renegotiate these rules when setting up an SE opens up another possibility to study this problem empirically. *Prima facie*, the fact that capital and labour may diverge from the existing mandatory regime by contract should allow them to negotiate a more efficient outcome compared to the rules applicable prior to an SE's formation. However, not observing such a departure must not be taken as conclusive evidence for the efficiency of the status quo: bargaining impediments such as high transaction costs might eat up any cooperative surplus that would, in principle, exist.

In this paper, we attempt to study these questions by analysing a data sample of 14 employee involvement agreements of SEs incorporated in Germany and 1 from Austria. We further extend our analysis by investigating a sample of 45 German SE formations documented by

[1] Secs. 1(1), 7(1) German Co-Determination Act (*Mitbestimmungsgesetz*); Secs. 1(1), 4(1) German One-Third Participation Act (*Drittelbeteiligungsgesetz*).

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Rose and Köstler (2011), which helps us to check the robustness of our findings. It appears that creative agreements on consultation and information rights are widespread, indicating severe inefficiencies of the legal status quo with respect to such rights. Agreements on participation rights that depart from the status quo are rarely concluded. However, the evidence does not suggest that this is because the existing regime is optimal. Rather, endowment effects and reputation costs play an important role: trading participation rights for other benefits is an anathema for employee representatives as they perceive such trade as a dramatic loss that must be avoided. Conversely, shareholders and management refrain from pressing for such trades, as curbing employee participation rights, even by agreement, would be perceived as a signal detrimental to firm value by the general public, i.e. imposing a significant reputational sanction on the firm.

The policy implications of these finding are straightforward: there are no compelling arguments that could justify a mandatory employee involvement regime. Such regimes should only comprise statutory default rules that can be contracted away by the parties if they so wish. Hence, the European model for the SE should be taken up by those Member States that, until now, have mandatory regimes on their books. With respect to the European legislature, certain amendments to the regulatory framework governing SEs are suggested that aim at reducing potential impediments to the bargaining process.

This study seeks to contribute to the literature on regulatory competition with respect to corporate governance issues (Hopt and Leyens 2004; Jungmann 2006; Johnston 2009: 177-213): the SE is an alternative model to Member States' laws and the company law forms provided therein. The special feature with respect to employee involvement lies in the fact that it is freedom of contract that makes corporate governance arbitrage possible. Hence, the study also seeks to contribute to the emerging field of 'contract governance' (Möslein and Riesenhuber 2009). Finally, the results of the study should also be of interest for those in charge of company law policy-making at the European and at the Member States' level.

Section II briefly describes the statutory framework for the negotiations on employee involvement when setting up an SE. Section III presents theoretical conjectures on the bargaining process and its results. It confronts these conjectures with the empirical data. In Section IV, some policy recommendations are developed. Section V concludes.

II. Employee Involvement in the European Company

The legal framework in place moulds the bargaining process and the parties' non-agreement alternatives, thus casting a 'shadow of the law' over negotiations and creating certain bargaining chips (Mnookin and Kornhauser 1979: 968-69). Against this background, we introduce the SE's employee involvement regime by describing who negotiates on behalf of whom and the scope of the negotiations (Section II.1). Also, we briefly present the SE regime's main features relating to the negotiation procedure and outline the parties' non-agreement alternatives (Section II.2).

Employee involvement in the SE is governed by the provisions of Directive 2001/86/EC[2] (hereinafter SE-Dir.) and the national transposition laws. The SE-Dir. supplements Regulation 2157/2001/EC[3] and rests on two 'pillars': information and consultation rights of the employees on the one hand and direct involvement in managerial decision-making by the right to influence the selection of the members of the SE's supervisory (two-tier system) or administrative organ (one-tier system) (hereinafter board-level participation) on the other hand.[4]

1. Negotiating Parties and Scope of Negotiations

Addressing the issue of arrangements for employee involvement during the formation of an SE is a prerequisite for its registration (Davies 2003b: 79). After the participating companies have decided on a route of establishment and a governance structure for the SE, negotiations with employee representatives shall commence as soon as possible. However, while the management (two-tier structure) or administrative boards (one-tier structure) of the founding companies are already in existence, the employee representatives have yet to be selected. Party to the negotiations on behalf of the employees is a so-called Special Negotiating Body (hereinafter SNB). The seats on the SNB are to be allocated in proportion to the number of employees employed in each Member State by the founding companies and concerned subsidiaries. It is comprised of at least 10 members[5] and, pursuant to the majority of the Member States' transposition laws, trade union representatives may become members

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2 Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, O.J. 2001 (L 294) at 22.

3 Council Regulation 2157/2001/EC of 8 October 2001 on the Statute for a European company (SE), O.J. 2001 (L 294) at 1.

4 A detailed account on the SE-Dir.'s employee involvement regime and the parties' non-agreement alternatives is provided in the Annex to this paper.

5 E.g. in case of Allianz SE, the SNB consisted of 30 members from 24 countries speaking 12 different languages (Hemeling 2011:46).

(Synthesis Report 2008: 67).[6] Negotiations may last up to 6 months.[7] The negotiation period can be extended by agreement up to a total of 1 year.

The SE-Dir. aims at granting the parties negotiating freedom to work out a firm-specific set of rules for the SE in formation (Davies 2003a: 70, 77). However, there is still dispute about the permissible scope of matters that can be covered by an agreement, especially with respect to certain issues of board-level participation as outlined below. Moreover, there is one important exception to this general freedom: in the case of an SE established by transformation, any agreement shall provide for at least the same level of employee involvement as compared with the one existing within the company to be transformed into an SE. Further, the SE-Dir. stipulates that certain issues be specified in an agreement, such as its scope, date of entry into force, its duration, and circumstances that trigger renegotiations (Oetker 2008: 992-93). Any agreement concluded can be characterised as a collective contract *sui generis* (Rieble 2008: 79).

With respect to employee involvement's first 'pillar', namely information and consultation rights, the SE-Dir. contains a bundle of matters concerning the establishment of an external representative body – usually termed SE works council – that exercises such rights on behalf of the employees. If such a representative body is set up, its composition, functioning, the number of its members, the allocation of seats on it, the frequency of meetings, its financial and material resources, and the procedure for its information and consultation in particular must be addressed in the agreement (Rieble 2008: 97). However, the catalogue neither mandates specific contents regarding the enumerated issues nor is it conclusive (Synthesis Report 2008: 34). Notwithstanding the above, the parties are not obliged to establish a representative body as long as they agree upon implementing any other procedure for employee information and consultation on the transnational level (such as regular hearings or a consultative committee) and specify the functioning thereof (Oetker 2008: 993-94; Rieble 2008: 76, 97).

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6 E.g. in cases where at least two members of the SNB are to be selected from Germany, every third member shall be a trade union representative. For the purpose of the negotiations, the SNB can also request external experts to assist it with its work. Such experts may be present at negotiation meetings in an advisory capacity. In general, any expenses related to the functioning of the SNB must be borne by the founding companies. However, the great majority of the Member States have used an option contained in the SE-Dir. to limit the funding to cover only one expert (Ernst & Young 2009: 44; Fulton 2006: 40).

7 Note that the SNB may unilaterally decide not to open negotiations or to terminate ongoing negotiations. Then, the SE-Dir.'s statutory default employee involvement regime (the so-called standard rules) does not apply and the SE is not governed by any system of board-level participation. The practical relevance of this option is little since it is unlikely that the SNB will forgo the prospect of board-level participation as a bargaining chip without any consideration.

Concerning the second 'pillar' of employee involvement, arrangements for board-level participation are optional: existing participation rights can, in principle, be reduced or even completely abolished. However, if the parties agree upon some form of board-level participation, the proportion of employee representatives on the respective board, the procedure for their selection, and their rights and obligations must be addressed since these issues are instrumental in making the agreement operational (Oetker 2008: 995). However, the parties' autonomy to negotiate 'participation' is limited. Matters that fall within the domain of the supervisory or administrative board to organise its own affairs[8] are beyond the scope of the negotiations (Habersack 2006: 347-50, 354; Schäfer 2008: 31). The SE's board model (one-tier or two-tier) and the precise size of the corresponding supervisory or administrative organ have, in any case, to be specified unilaterally by the shareholders in the SE's statutes (Habersack 2006: 351-53; Henssler and Sittard 2011a; Oetker 2008: 998; Schäfer 2008: 32-33).

2. Negotiations and the 'Shadow of the Law'

The aforementioned 'shadow of the law' is − with respect to employee involvement − not only determined by the SE-Dir.'s provisions on the negotiation procedure and its statutory default employee involvement regime (the so-called standard rules) (Davies 2003a: 77-78). Also important are other fall-back options which the founding companies can pursue in the case of failure to reach agreement. The parties' non-agreement alternatives may significantly impact on the outcome of negotiations (Bühring-Uhle et al. 2009: 26-30; Mnookin and Kornhauser 1979: 997). In the following, this 'shadow' is briefly described.

The protection of the status quo ante, i.e. the employees' vested rights before establishment of an SE, is a pervasive policy of the SE-Dir.: firstly, the mechanisms of the SE-Dir. ensure that at least some kind of procedure for information and consultation of the employees with respect to transnational matters will apply to any SE with employees (Davies 2003a: 71-73). Secondly, in the case of an SE established by transformation, there is no scope at all for a reduction of board-level participation if the transforming company is subject to any participation rights (Davies 2003a: 79-80). Thirdly, supermajority requirements for decision-making of the SNB apply under certain circumstances as a 'safeguard' for the employees' interests in cases where participation rights are envisaged to be lowered or even completely abolished.

[8] Such as the election of the chairman and deputy chairman or the formation and composition of committees.

Finally, if the parties fail to reach an agreement within the negotiation period, the standard rules come into play as a fall-back regime if the competent organs of the founding companies wish to continue with the registration of the proposed SE. The standard rules prescribe a procedure for information and consultation of employees through an external representative body that must be set up and outline its composition, functioning, and competences. With respect to board-level participation, this form of involvement is required in cases where certain thresholds relating to the prevalence of employee participation in the founding companies and being dependent upon the chosen route of formation are exceeded.[9] Irrespective of such thresholds, the SNB can invoke the standard rules on board-level participation by making a corresponding unilateral decision by the absolute majority of its members.[10] Hence, only in cases where none of the participating companies has been subject to national board-level participation regimes, the SE too is not required to be governed by any such system (Davies 2003a: 73). If participation is mandatory, under the standard rules, the most stringent form to be found among the founding companies must be implemented.

As a consequence of the foregoing account, employees' vested rights appear to be the 'reference point' for negotiations on employee involvement. This is particularly true with regard to the position of employees in cases where the founding companies are governed by national participation regimes: here, the members of the SNB can be expected to press for further rights since they can invoke the standard rules and, thus, the most stringent participation system in place unilaterally.

However, different routes to achieve certain goals are instrumental in assessing the strength of the bargaining position of each party.[11] As far as the founding companies are concerned, curbing mandatory board-level participation as provided for by certain Member States has been found to be one of the main drivers for SE incorporations. Eidenmüller et al. (2009a) showed that this is especially true with respect to Germany's far-reaching co-determination system.[12] German medium-sized firms anticipating a (significant) growth of their workforce can 'freeze' the existing level of board-level participation (i.e. no or one-third) before reaching a statutory threshold (e.g. more than 2,000 employees trigger parity co-

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9 As already mentioned, however, in the case of an SE established by transformation, board-level participation is mandatory and continues to apply if the transforming national company was subject to any form of employee participation.

10 However, such a decision would have no implications if none of the participating companies had been governed by participation rules prior to the SE's registration.

11 For a survey of co-determination arbitrage opportunities, see Gelter (2010: 810-18).

12 *See supra* Section I.

determination) simply by reincorporating as an SE (Eidenmüller et al. 2009a: 6). This can be done since the SE-Dir.'s standard rules focus on the participation level in place at the time of formation and do not provide rules for changes with respect to participation subsequent to the SE's registration (Ernst & Young 2009: 246-47). Further, under the standard rules regime, the participating shareholders can reduce the size of the administrative and supervisory board, respectively, and the composition of employee representatives on the respective board will be internationalised. From a shareholder/management perspective, this may be considered to be an advantage: *divide et impera*.

In addition, mandatory employee participation at board level may be bypassed by choosing a foreign limited liability corporate form for a firm operating mainly or completely in a Member State different from its country of registration. Also, the establishment of holding structures may render national provisions on mandatory board-level participation inapplicable. Finally, opportunities to mitigate or even completely abolish board-level participation are offered by effecting a cross-border merger pursuant to Directive 2005/56/EC[13] (hereinafter Tenth Dir.) and the national transposition laws. Under its regime, e.g. a German company that is co-determined may reduce the participation level to one-third by merging into a British public limited company (plc), and it could even achieve the complete abolishment of participation rights by a subsequent domestic merger (Henssler 2011b: 9-10; Teichmann 2007: 96).

All in all, then, it would be a deficient account of the parties' bargaining strength to point only to the fact that labour's non-agreement alternative is to have the strongest involvement regime implemented that had been in place prior to an SE's formation. There are various courses of action that do allow the shareholders/management of the participating companies to reduce the employee participation level in case no 'satisfactory' agreement with labour can be reached.

III. Opportunities and Obstacles to Efficient Bargaining

1. Bargaining over Employee Involvement and the Coase Theorem

In the following Section we examine what can be learned from the Coase theorem with respect to the efficiency of the SE bargaining solution and more generally national employee

[13] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies ('Tenth Company Law Directive'), O.J. 2005 (L 310) at 1.

involvement regulations. When Coase wrote his landmark article *The Problem of Social Cost* in 1960, he was mainly concerned with a classical microeconomic question: should the state regulate producers who only consider their own private costs but not the costs they impose on others? In other words, should the government mitigate social costs by forcing producers to internalise them? Pigou (1938) offered a first solution to this issue, when he proposed that a tax equal to the amount of externalities would be the appropriate policy measure, as producers would, as a result of taxation, lower their output to the socially desirable level. By contrast, Coase stressed the reciprocal nature of the problem. Who should bear the social costs was for him not a matter of justice but pure efficiency. In his analysis governmental intervention appeared superfluous since he could demonstrate that the ultimate allocation of resources of individuals who can bargain at no cost is efficient independent of the initial provision of entitlements (Coase 1960: 8).

However, the application of the Coase theorem extends far beyond the analysis of production activities. Jensen and Meckling (1979: 474) use a Coasian framework to study board-level participation. They argue that if board-level participation is beneficial to shareholders and employees, a mandatory employee involvement regime would be dispensable as both parties would agree voluntarily on such a regime.

Even though Jensen and Meckling's argument is theoretically very appealing, it can hardly be tested in social reality as both settings are not observable *ceteris paribus*. The possibility to bargain over employee involvement rules when setting up an SE therefore represents a unique experiment to study the efficiency of an otherwise mandatory legal regime. That is because the SE-Dir. not only enables shareholder/management and employee representatives to negotiate a firm-specific employee involvement agreement. The enactment of the directive also constitutes a regime switch from mandatory legal rules towards agreements negotiated in the 'shadow of the law'. Thus, if we observe SE employee involvement agreements which do not simply replicate the SE-Dir.'s statutory default regime, national employee involvement rules applicable prior to the SE's formation can be considered inefficient.

However, such a conclusion is not without its difficulties. As Cooter and Ulen (2008: 85) have pointed out, various commentators formulate the Coase theorem in different ways. Namely, it can be argued that the main insight from the Coase theorem is not that the ultimate allocation of resources of individuals who can bargain at no cost is efficient, but rather that the rule of law is in fact decisive because transaction costs are rarely negligible. The

subsequent analysis therefore proceeds in two stages. In a first step, we will specify the factors that may theoretically reduce the cooperative surplus and thus prevent an agreement on employee involvement. In a second step, we then analyse whether bargaining over employee involvement in fact lifts some hidden value (compared to mandatory national employee involvement regimes).

2. Possible Obstacles to an Efficient Bargaining Solution

Bargaining failure may result from multiple factors. In this Section, we investigate the most relevant aspects theoretically impeding an SE agreement on employee involvement: strong non-agreement alternatives, transaction costs, reputation costs, agency costs, and endowment effects.

Non-Agreement Alternatives

When parties engage in negotiations, they will not just consider the bargaining stakes on the table, but think about their best alternatives to a negotiated agreement as well (Nash 1953: 130; Fisher et al. 1991: 97-106). As mentioned above, the outcome the substantive law imposes if no agreement is reached gives the parties bargaining chips which will affect the final content of a negotiated agreement. The stronger the best alternative to a negotiated agreement of one side is (assuming the other side has a weak alternative to a negotiated agreement), the better this party will do in the negotiations. Moreover, the stronger the non-agreement alternatives of both sides are, the smaller the overall bargaining range is and the less likely an agreement becomes (Bühring-Uhle et al. 2009: 26-30).

With regard to the negotiations on SE employee involvement, the best alternatives to an agreement vary significantly among the two parties. Employee representatives seem to have very strong alternatives to a negotiated agreement, as the standard rules of the SE-Dir. are applicable if negotiations fail to produce a solution. Consequently, information and consultation rights will apply in any case. Likewise board-level participation automatically becomes effective in default of agreement if certain thresholds are met. The most stringent form of participation existing in the founding companies thus seems to establish a floor that the SNB will or should not give up without good reasons, i.e. concessions of equal economic value. Further, if the SE is established by transformation, all aspects of employee involvement automatically continue to hold for the SE.

The fact that the standard rules of the SE-Dir. preserve the status quo might, however, also provide the participating firms' shareholders/managers with rather strong alternatives to a negotiated agreement. As Eidenmüller et al. (2009b: 849) have shown, many German firms that anticipate a (significant) growth of their workforce simply reincorporate as an SE with the purpose to 'freeze' the current level of board-level participation (i.e. no or one-third participation). Moreover, some decisions can also be made unilaterally by the shareholders such as implementing a one-tier or two-tier board structure or reducing the number of members serving on the supervisory board. Finally, as already described in Section II.2, attractive alternatives to a negotiated agreement might also result from the Tenth Dir. on cross-border mergers.[14]

In sum, it appears that the non-agreement alternatives of both parties are rather strong with respect to board level participation in particular. Hence, striking an agreement on employee involvement with respect to participation issues should be infrequent as the cooperative surplus probably is not large.

Transaction Costs

One possible obstacle to an efficient bargaining solution, which was already envisaged in the seminal work by Coase, are transaction costs. Coase argued that if the transaction costs of reaching an agreement completely consume the cooperative surplus, parties will abstain from negotiating an agreement in the first place. In the realm of the SE it could therefore be claimed that the sometimes substantial costs of a corporate merger or of setting up the SNB will render an agreement on employee involvement impossible, in particular if the SE has multiple establishments abroad and the SNB's composition is very sophisticated (multiple national procedures on how employees are delegated to the SNB). By contrast, Johnston (2009: 262) argues that if the management decided to set up an SE, the bargaining procedure is a necessary legal requirement and associated transaction costs cannot prevent the commencement of negotiations on employee involvement (as they must have been considered by the management beforehand and should therefore be treated as sunk costs).

To make a clear-cut prediction on whether transaction costs impact on the bargaining solution, one has to differentiate between the general transaction costs of setting up an SE and the transaction costs specific to the bargaining process, as only the latter will affect an agreement on employee involvement. Transaction costs relevant to the bargaining process

[14] *See* for details Section V of the Annex to this paper.

may occur because of expenses stemming from '[…] negotiations leading up to a bargain, to draw up the contract, to undertake the inspections needed to make sure that the terms of the contract are being observed, and so on' (Coase 1960: 15). Moreover, since the bargaining chips outlined in Section II had not been well-established when the SE legislation became effective, the bargaining range might have been narrowed down because of legal uncertainty. If the full range of the bargaining space is unknown to the parties, they obviously cannot exploit it.

However, there are also good reasons why transaction costs specific to the bargaining process might be fairly low by now. According to the SE-Dir., the substantive costs of the bargaining process have to be borne by the company.[15] Employees will thus mainly have to invest in legal knowledge and negotiation skills. The SE-Dir. has opened the way to allow external experts, such as trade union members, to advise employee representatives. Furthermore, both bargaining partners may request funds from the European Commission, which promotes seminars, training programmes, studies, and grants financial support to enhance best practice and capacity building.[16] Finally, legal uncertainty surely has declined compared to 2004 since all affected parties have had some time to learn more about the legal environment surrounding the negotiations.

To sum up, the insights from the Coase theorem about the efficiency of negotiations are only applicable if there are no or only negligible transaction costs. More precisely, an efficient agreement on employee involvement in the SE will only be reached if transaction costs are lower than the cooperative surplus which the parties can achieve by negotiating a contract. The most significant costs to an agreement should result from legal uncertainty. However, these costs have been diminishing over time and are nowadays probably fairly low. We therefore hypothesise that transaction costs should not eat up the (potential) cooperative surplus from an agreement on employee involvement and thus should not amount to a serious obstacle to such an agreement.

Reputation Costs

Apart from the costs associated with negotiating a contract, reputation costs can be another possible explanation why the bargaining range for an agreement on employee involvement might be narrowed down. Large and medium-sized firms are often subject to sophisticated

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15 *See supra* note 6.

16 The corresponding budget heading is 04.030303.

media coverage. When an SE is formed, the media and capital markets watch the relevant steps of the management often very closely. As Eidenmüller et al. (2010: 46) and Lamp (2011: 22) have argued, incorporating as an SE might have a significant impact on firm value. Substantial changes due to an agreement on employee involvement are therefore very likely to have a similar effect.

Even though the content of an employee involvement agreement will often be treated as confidential, major modifications such as the abolishment of board-level participation cannot be concealed. If the media and capital markets regard such a bargaining solution as harmful to the firm, management and employees will not settle for such a contract in anticipation of the respective media response. As a consequence, the potential bargaining space shrinks. On the other hand, a complete breakdown of the negotiations and the resulting implementation of the standard rules is equally unlikely since this might be considered a signal of bad corporate governance. Accordingly, one would expect a tendency towards negotiated agreements on employee involvement which entail no bargaining solutions that could be considered unacceptable to the larger public.

Agency Costs

Another obstacle to an agreement on employee involvement might be agency costs as described by Jensen and Meckling (1976: 308-10). Both negotiating partners represent different principals. The management negotiates on behalf of the firm's owners and depends on the shareholders' mandate or approval with respect to agreements concluded. The members of the SNB represent the general workforce and, if union members participate in the SNB, also trade unions. If the interests of the acting agents diverge from those of their principals, an efficient bargaining solution might not be feasible.

One possible agency conflict arises if union members formally negotiate on behalf of employees, but *de facto* simultaneously also on behalf of the trade unions they represent. If, for instance, a potential agreement reduces the existing parity co-determination to one-third participation and grants employee representatives in return access to foreign establishments, the agents of trade unions might not have the mandate to negotiate such a contract since their principals rule out the deal for ideological reasons. On the other hand, even though the interests of shareholders and management are sometimes misaligned with respect to performance and compensation, it is *per se* not clear whether this also holds for the negotiations leading up to an agreement on employee involvement.

Summing up, the cooperative surplus which can be negotiated by the members of the SNB and the competent organs of the founding companies might be curbed by the preferences of certain '*de facto* principals'. Such agency conflicts are most likely to originate from ideological restraints of trade union representatives.

Endowment Effects

Another obstacle to efficient bargaining, which was not discussed by Coase (1960), stems from behavioural anomalies. With regard to negotiations on employee involvement it seems very plausible that endowment effects play a major role. As Rehberg (2008: 49) pointed out, labour law is the result of a long-standing struggle for employee and trade union rights. Giving up those endowments may be perceived as a strong loss for employee representatives and in particular trade union members. Loss aversion may also be the most convincing explanation for endowment effects (Eidenmüller 2005: 131). It can theoretically be derived from a value function which is concave for gains and convex for losses (Kahneman and Tversky 1979: 279). Loss aversion also creates a status quo bias (Tversky and Kahneman 1991: 1042-44). If individuals – possibly under the influence of 'framing effects' (Plous 1993: 97) – consider departing from the status quo as a strong loss, they are reluctant to deviate from such a reference point. Hence, the SNB and the competent organs of the founding companies may prefer the standard rules instead of negotiating an innovative agreement on employee involvement as the status quo has some inherent value to them. Moreover, Kahneman et al. (1990: 1342) found empirical evidence for instant endowment effects, verifying that individuals do not even need to habituate to something to perceive its loss stronger than its gain.

With respect to SE agreements on employee involvement, other effects might even further exacerbate the problem of instant endowments. Kennedy (1981: 402) has shown that, under certain circumstances, it may feel worse to give up something compared to preventing the very same thing from taking place, as people might in the first instance conceptualise what happens as 'caused by their action'. Hence, abolishing mandatory board-level participation may be perceived wicked compared to not introducing it. Finally, it was Kelman (1979: 685) who argued that the allocation of a certain entitlement by the legal system might provide individuals with the feeling that they justifiably posses it. Such an effect might also be at work with respect to board-level participation.

Hence, endowment effects with regard to employee involvement could be especially strong in jurisdictions in which trade unions place a strong ideological emphasis on (mandatory) employee involvement and board-level participation. As a result, existing legal rules might be entrenched. Consequently, there will also be no bargaining solution even if individuals can negotiate at no cost, as endowment effects work towards bargaining failure.

3. Empirical Analysis

In this Section, the investigation turns to the issue of what has actually been settled for in SE employee involvement agreements. If we find contracts to deviate from mandatory national legal regimes, we consider this as evidence for the inefficiency of existing legal rules. By contrast, if no agreements have been reached, or if they simply replicate the legal regime in place prior to an SE's formation, the analysis above suggests two possible explanations for such an outcome. Either the existing legal rules are already efficient, or the various obstacles described in Section III.2 have prevented a bargaining solution.

Over the period from October 2004 to January 2011, approximately 700 SEs were established throughout Europe. Nevertheless, only 169 of these SEs were found to have business activities and more than 5 employees (Rose and Köstler 2011: 17). As the present survey was conducted over the period from June to September 2010, we requested 144 active SEs either to send us their agreement on employee involvement or to indicate whether such an agreement had not been concluded. Considering the delicateness of negations, it is not surprising that a majority of 99 firms did not respond to our request, while another 18 firms indicated that an agreement had been reached but the actual bargaining solution could not be made available for scientific evaluations. We furthermore found out that 11 SEs did not have an agreement on employee involvement for whatever reason. One firm stated that the SNB decided not to engage in negotiations. As a result, 15 firms agreed to send us their original agreement on employee involvement (*primary data sample*).[17]

This data sample consists of 14 German and 1 Austrian SE, which is not surprising given that half of the active SEs are located in Germany. Another potential reason why we did not

[17] Thanks to a comment made by Omri Ben-Shahar, we further investigated whether our survey suffers from a severe selection bias in a way that 'non-responses' indicate a particularly far-reaching agreement regarding co-determination. By talking to the interviewees again and checking the annual reports of their companies, we found that 14 out of the 18 firms, which could not make their agreement available to us, had not reduced the level of co-determination. Moreover, having checked the 99 firms which did not respond at all to our survey, we ascertained that most of them are small firms. Most likely they did not consider negotiations to be necessary. This is consistent with the findings of Eidenmüller and Lasák (2011: 8).

receive more employee involvement agreements from non-German firms could be that negotiations were often not undertaken in countries which do not have national mandatory legal rules on employee involvement, since management and employees considered negotiations superfluous. In the case of a British SE, this was also stated explicitly in the response letter to our enquiry. By contrast, as already mentioned, a couple of German firms indicated that they had negotiated an agreement but could not release the results as strict confidentiality had been agreed among the negotiating parties. We thus had to assure all companies that we would evaluate their agreements anonymously.

To check the robustness of our findings and to boost the representativeness, we also draw on data from Rose and Köstler (2011: 19) who analysed 45 German SE formations (*secondary data sample*).[18] Regarding this larger *secondary data sample*, in only 1 case no agreement was reached. In another 2 out of 45 cases, the SNB and the competent organs of the participating companies abstained from negotiating over employee involvement. This finding can be considered as a first hint that at least in Germany the parties to the bargaining process find it valuable to negotiate an agreement as compared to agreeing on the standard rules. However, to gain more certainty whether negotiations take place because mandatory legal rules are inefficient, we have to investigate what was actually agreed in those negotiations.

Information and Consultation Rights

In the following Section, we consider deviations from the rules that would apply if no agreement were reached as a novel and firm-specific bargaining solution. Put differently, any term in the agreements on employee involvement that does not replicate the SE-Dir.'s standard rules or the respective default rules of the German transposition law,[19] will be treated as a unique bargaining outcome.

By evaluating the data from the *primary data sample*, we find that the most substantial changes took place with regard to information and consultation rights. In two thirds of the negotiations, the parties agreed upon an extended membership period for the works council (often 5 instead of 4 years pursuant to German law). In some agreements, permanent works council mandates for representatives from establishments outside of Europe were recognised. Again, two thirds of the firms examine the composition of the works council now more

[18] Since Rose and Köstler (2011) report their data confidentially, we can neither aggregate the two samples nor exclude that there is a significant overlap.

[19] Act on Employee Involvement in an SE (*SE-Beteiligungsgesetz*, hereinafter SEBG).

frequently than required by the law (every year instead of every second year pursuant to German law).

Information and consultation rights were strengthened in four fifths of the cases as compared to what the SE-Dir. would provide for with respect to ordinary and *ad hoc* meetings. Additional topics became items of the consultation agenda such as issues touching upon human resources, labour law, worker safety, redundancy pay, and the environment. Two thirds of the agreements increased the frequency of the mandatory ordinary information and consultation meetings with the works council (two or three times a year instead of once a year pursuant to the SE-Dir.'s standard rules). By contrast, half of the agreements restricted the kind of corporate documentation that is made available to works council representatives (as compared to the SE-Dir.'s standard rules).

Around 40 percent of the agreements provide for a right of initiative, allowing the works council and the management to initiate cross-border projects with regard to diversity, health, equal opportunities, data protection, and training programmes. Furthermore, more than two thirds allow members of the works council to access foreign establishments. According to 80 percent of the agreements, trade union members may participate in works council meetings. In the same percentage of contracts, the parties agreed to renegotiate the employee involvement arrangement in case structural changes take place.[20]

While the above-mentioned features were negotiated very frequently in the *secondary data sample* too, some firms also agreed upon somewhat more exceptional issues. For instance, one SE found it beneficial to take out a directors' and officers' liability insurance for employee representatives serving on the supervisory board. The very same company also extended the scope of the negotiated agreement to countries having started EU accession negotiations but are not Member States of the European Union yet. Once firms get more experience in negotiating employee involvement agreements, we expect such creative bargaining solutions more frequently.

[20] It should be noted that the German transposition law requires renegotiations in cases where structural changes may negatively affect employees' rights – although the SE-Dir. does not provide for such rules. As the respective German provision lacks an enumerated list of instances that trigger this duty, there is still dispute about this question (cf. Nagel 2011). Therefore, defining such instances in employee involvement agreements appears to be sensible in order to obviate eventual legal uncertainty.

Board-Level Participation

With regard to board-level participation, the SE bargaining solutions are generally much more parsimonious. To the best of our knowledge, the existing level of board-level representation was extended in not a single agreement. In one case, potential board-level representation in a 7,000-employee company was traded for a social fund.[21] The fund was established to promote the interests of workers and had an initial volume of € 1 million. It is managed by two management representatives and one employee representative. Decisions must be taken unanimously though. The agreement on the social fund was reached by an absolute majority of 22 out of 25 votes. Two SNB members that voted against the agreement were trade union members, supporting our theoretical predictions outlined above, namely that endowment effects and agency conflicts play a pivotal role.

Apart from this, substantial changes only took place with regard to board structure and size. Even though such changes are formally beyond the scope of the negotiations – as they can be implemented unilaterally by the shareholders –, they may nevertheless be considered part of the deal struck by employee representatives and the management. Since management confronts employee representatives with a draft plan for the formation of an SE along with the draft terms of the SE's statutes before negotiations commence, employees may consider the reduction of the board size as a non-negotiable bargaining position for which they request consideration. It is therefore not surprising that many agreements on employee involvement explicitly state the size and structure of the board that was adopted by the management/shareholders. Rose and Köstler (2011: 17) documented that around one third of the active German SEs implemented the one-tier board structure, while Eidenmüller et al. (2009b: 849) found evidence that numerous German SEs also reduced the size of the supervisory board.

Preliminary Summary

As the evidence shows, even though all theoretical arguments discussed in Section III.2 work against a bargaining solution – they all narrow down the bargaining range –, we still observe such solutions in particular with regard to information and consultation rights. Hence, at least with respect to these issues, the pre-existing mandatory regime cannot be considered as being efficient. With regard to board-level participation, it is not clear whether we observe only few

[21] We do not exactly know why this comparatively large company had not had employee representation on the board. However, we must assume that there had not been any form of mandatory board-level participation under the respective Member Sates' provisions applicable to this company.

innovative solutions because the existing mandatory rules are efficient or whether other factors prevent the parties from finding a more efficient outcome.

Considering the theoretical obstacles to a bargaining solution, it appears that only some factors represent serious impediments to an efficiency enhancing employee involvement agreement. As described in the legal analysis in Section II, the non-agreement alternatives of both parties are rather strong. The empirical evidence furthermore shows that in particular non-German firms might favour the standard rules over a negotiated agreement, as we suspect that many of them abstained from striking a firm-specific contract. Likewise, German firms may consider the standard rules of the SE-Dir. with regard to board-level participation a very strong non-agreement alternative, which could explain why we do not see any bargained-for agreements in this realm. However, it must be mentioned that even though the bargaining parties' non-agreement alternatives may constitute a considerable obstacle to a bargained-for solution, they are not a factor that works against efficient bargaining. If the best alternatives to a negotiated agreement of the SNB and the competent organs of the founding companies are excellent, this simply means that there is no efficiency gain from negotiating an agreement as the status quo already represents an efficient regime.

With regard to transaction costs, the general costs of setting up an SE have in some cases been excessive (e.g. € 95 million in case of Allianz SE). The average set-up costs – including tax and legal advisor costs, translation costs, and registration costs – have so far amounted to approximately € 784,000 though (Ernst & Young 2009: 240). Most of these costs should, however, be taken into account beforehand and thus not render negotiations impossible. Our empirical analysis provides evidence that negotiation-specific costs do not completely eat up the cooperative surplus, as in the area of consultation and information rights elaborate agreements were reached. That there are severe negotiation-specific transaction costs which only apply to issues of board-level participation seems highly unlikely. Hence, transaction costs do not appear to be a major obstacle to efficient bargaining.

Reputation and agency costs were both shown to have an impact on the bargaining solution. When interviewing legal counsels of some well-known SEs, it was noted that more extensive agreements were out of scope as the management feared a fierce negative response by the media. On the other hand, there is also anecdotal evidence that union representatives who simultaneously negotiate on behalf of both employees and trade unions might have no

mandate to negotiate particular contracts on behalf of the latter principal. Deviating from the status quo may in such cases be impossible for ideological reasons.

Finally, endowment effects apparently constitute a serious obstacle to a bargaining solution. Possessing a certain right may increase its value to the owner and in this way reduce the cooperative surplus. Negotiating employee representatives seem to perceive that they justifiably posses a certain entitlement which was previously allocated to them by the legal system. Moreover, abolishing board-level participation is perceived as more wicked compared to not introducing it. The analysis of 15 employee involvement agreements as well as another sample of 45 agreements suggests that in not a single case existing board-level participation was abolished, reduced or extended, while information and consultation rights were extensively modified at the same time. This finding may be considered as strong evidence for endowment effects working against bargained-for solutions in the realm of board-level participation. While such behavioural anomalies can illustrate why there are rarely any agreements on board-level participation, they cannot be considered an obstacle to efficient bargaining. After all, it is not clear whether higher offer prices due to the endowment effect do or do not reflect the 'true' preferences of the individual.

IV. Policy Recommendations

Negotiating employee involvement when setting up an SE has produced some innovative and creative outcomes especially with respect to information and consultation arrangements. By contrast, contracting employee participation on boards has been much less frequent. Whether this is because existing arrangements are efficient or because there exist certain bargaining impediments, must be considered an open question. It seems plausible that endowment effects, agency issues, and reputation costs in particular play a significant role and prevent employee representatives from trading participation rights and shareholders/managers from pressing for such trades.

What policy recommendations can be derived from this assessment? The European Union currently undertakes a review process of the SE Statute (cf. European Commission 2008). Clearly, there are no convincing arguments why the principle of bargaining over employee involvement when setting up an SE should be called into question – allowing capital and labour to customise a particular involvement regime has been and still is a sound policy choice: the experience so far demonstrates that one law might never fit all firms and that

allowing the affected parties to negotiate has the potential to create value at least in some cases. Hence, the 'bargaining model' should also be adopted with respect to the *Societas Privata Europaea* if ever this European company law form sees the light of the day.[22] However, one might think of suggesting that the bargaining process itself should be facilitated by reducing certain impediments that prevent the parties from reaching an efficient outcome in a particular case. However, it is difficult to see how this could be done sensibly.

Transaction costs do not play a prominent role anyway, and they are further reduced over time as parties learn about the process and routines are established that are followed in practice. Legal uncertainty thereby has diminished and continues to do so. However, there was and is a dispute about the scope of agreements concluded, i.e. about what exactly can be contracted and what not. The problem stems in part from the fuzzy nature of the term 'involvement', i.e. which issues can still be said to exhibit the necessary connection with the employees' involvement in firm decision-making. This is especially the case with respect to board-level participation. Matters that fall within the exclusive domain of the supervisory or administrative board to organise its own affairs are beyond the scope of negotiations. The same holds for issues that can be decided unilaterally by the shareholders in the SE's statutes. It surely would help the negotiating parties if the European legislature were to provide more and precise guidance on this issue, e.g. by extending and refining the existing list of issues enumerated in the SE-Dir. that shall and can be negotiated. Further, when specifying the permissible scope of involvement agreements, the European Union should extend this scope where feasible, especially in the area of consultation and information rights. In this realm in particular, the contracting practice demonstrates the potential of creative and innovative agreements to lift hidden value.

Agency issues play a role in the bargaining process in so far as union members might press for retaining participation rights for ideological reasons even though employees would be better off if trades provided other benefits to them. This point is related to the two other factors that have been found to impact on the bargaining process and outcome: endowment effects and reputation costs. Both suggest and explain that we do not observe much contracting with respect to participation rights. However, that does not necessarily imply that

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[22] The Council of the European Union discussed in its 3094th meeting (30 and 31 May 2011) a compromise proposal introduced by the current Hungarian Presidency for a regulation on a European private company. The compromise text failed to secure the required unanimity; it was not approved. As to the state of play, *see* Council of the European Union, Press Release PRES/11/146 of 30 May 2011, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=PRES/11/146&format=HTML&aged=0&language=en&guiLanguage=en.

the status quo is inefficient and that steps should be undertaken to modify the factors that explain the persistence of the default regime. As to endowment effects, the legal order has necessarily to specify fall-back positions if the parties do not agree. Reversing the endowments in the context of SE formations would amount to stipulating that if the parties fail to agree, there will be no participation rights. That surely is a legislative possibility, but it would not be warranted on efficiency grounds (apart from being politically unfeasible). It would only change the bargaining chips of the parties and improve the non-agreement alternatives of the shareholders/managers. In a similar vein, reputation costs that might prevent shareholders/managers from pressing for a radical departure from a high level of participation cannot be characterised as impediments to a more efficient bargained-for solution. Hence, changing the default regime is not a policy option that is suggested by the (empirical) findings of this paper.

However, support for such a move can be derived from the regime of the Tenth Dir. on cross-border mergers that established a distinctly different default system with respect to employee involvement. As has already been mentioned in Section II.2 and is discussed in detail in the Annex to this paper, this mechanism can be used to reduce the level of employee participation in a German *Aktiengesellschaft* from parity co-determination to one-third participation on the SE's supervisory board – a route that would not be feasible under the SE-Dir.'s statutory default regime if an SE were formed straight away. Harmonising default rules along the lines of the more recent regime of the Tenth Dir. would reduce these frictions and level out the non-agreement alternatives of the shareholders/managers.

Turning to the policy choices of the European Member States, the recommendations that can be derived from the foregoing analysis are much more clear-cut. Bargaining over employee involvement rules has shown to produce at least some remarkable improvements compared to the status quo. Such bargaining has become possible because mandatory rules of European Member states have been relegated to the status of default rules if an SE is set up. Are there any compelling reasons to make employee involvement rules mandatory in the sense that they establish inalienable rights which the employees cannot give up? The answer to this question is a clear no. If the bargaining process is structured by the law such that the employees receive all the necessary information to make sensible and informed choices, and if the employees are represented by trained and experienced negotiators – both requirements are fulfilled under the SE regime –, there are no reasons to assume that bargaining failure is likely and a case for mandatory rules could be made.

Hence, European Member States providing for mandatory employee involvement regimes have good reasons to consider switching to a bargaining regime such as the one set up by the SE rules in order to open up the possibility for capital and labour to contract for a more efficient involvement framework. This is especially true with respect to those Member States, such as Germany, that have an extremely rigid and far-reaching participatory regime that many would think is likely not to be the most efficient solution available. Hence, there is a clear case for more freedom of contract and contract governance at least with respect to these Member States (Bachmann et al. 2009; Henssler 2011b: 14-15).

V. Conclusion

After a slow start, the SE has become quite popular among European firms as a company law form. One reason for its success is the corporate governance flexibility that it offers. Firms can choose between a one-tier and a two-tier structure, and they can craft their own forms of employee involvement: the SE has given capital and labour contractual freedom to agree on firm-specific rules with respect to information, consultation, and participation of employees in the governance of the firm. The evidence available so far demonstrates that the relevant actors make use of this contractual freedom. Operating SEs have in some cases designed creative regimes for employee information and consultation, and at times, though less frequently, they have also redesigned existing employee participation structures. If the latter happens, it always amounts to some lowering of participation levels that had been in place prior to an SE's formation.

That the involved parties agree on customised employee involvement regimes is a clear sign for inefficiencies in the status quo and of a potential cooperative surplus that can be lifted through a negotiated solution of the issues at stake. It is also a convincing argument for allowing the parties to deviate from the status quo, i.e. for stipulating that the existing involvement regimes of the Member States shall be default regimes only once an SE is set up. Member States with mandatory participation regimes for their domestic corporate forms should therefore seriously consider switching to a default mode that would allow labour representatives to deviate from the status quo if they perceive this to be in the interest of the firm's employees.

As in the US, there is a growing literature in Europe on horizontal regulatory competition in corporate law, i.e. on the competition for charters between the European Member States

(Eidenmüller 2011: 716-19). A special feature of the European regulatory framework is that – with the SE – the European market for 'legal products' has been enriched by a genuinely European legal form. Thus, the horizontal regulatory competition has been supplemented by vertical regulatory competition between the European Member States and the European Union. In principle, there is nothing to be said against the enrichment of horizontal regulatory competition by vertical competition on the part of the European Union (Eidenmüller 2011: 744-45). After all, 'consumers' of legal products have one more option from which to choose. In the case of the SE, the choice opportunity has the potential to cure certain corporate governance inefficiencies associated with mandatory employee involvement regimes in the laws of some of the European Member States. This potential is a function of the contractual freedom that the SE corporate form offers in this respect. Hence, 'contract governance' in the SE is the driving force behind the beneficial effects of vertical regulatory competition between the European Union and its Member States.

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Annex

In this Annex, the regulatory framework for employee involvement when setting up an SE in general and the negotiation procedure in particular (parties to the negotiations, scope of the negotiations, etc.) are described in detail. Also, the non-agreement alternatives of the parties are spelled out precisely.

I. Regulatory Framework for Employee Involvement

Employee involvement in the European Company (*Societas Europaea*, hereinafter SE) is governed by the provisions of Directive 2001/86/EC[23] (hereinafter SE-Dir.) supplementing Regulation 2157/2001/EC[24] (hereinafter SER).[25] The SE-Dir. has been transposed into legislation of the Member States.[26] Employee involvement as a generic term rests on two 'pillars' (cf. Art. 2(h) SE-Dir.): firstly, there are information and consultation rights of the employees with respect to matters concerning the SE. Secondly, there is the direct involvement in managerial decision-making by the right to influence the selection of the members of the SE's supervisory (two-tier system) or administrative organ (one-tier system) (hereinafter board-level participation).[27] The distinction between these two forms of employee involvement is crucial: as further developed below, they are, to a certain extent, dealt with differently in the SE-Dir. Furthermore, seen from the perspective of the Member States, procedures for information and consultation of employees are much more widespread than mandatory board-level participation (Davies 2003a: 70).

The scope of applicability of the SE-Dir. and its links to national as well as other European laws on employee involvement are set out in Art. 13 SE-Dir. It stipulates that national provisions on board-level participation other than the provisions transposing the SE-Dir. into national legislation do not apply to SEs in any case (Art. 13(2) SE-Dir.). With respect to information and consultation rights, one has to distinguish between the sources of rules other than those provided for by the SE-Dir.: on the one hand, the European Works Council Directive[28] and its national transposition laws are not applicable, except for the cases where a decision pursuant to Art. 3(6) SE-Dir.[29] is made (Art. 13(1) SE-Dir.). On the other hand, existing information and consultation rights provided for by national legislation[30] continue to operate at the firm level within each country irrespective of the SE-Dir.'s provisions (Art. 13(3)(a) SE-Dir.). As a consequence, this may entail the persistence of such structures of employee information and consultation in the SE in place prior to its registration (Art. 13(4) SE-Dir.). The distinction between the applicability of national arrangements for and the SE-Dir.'s system of information and consultation regarding specific matters of concern for employees can be drawn by making reference to Recital 6 of the Preamble and Part 2(a) of the Annex to the SE-Dir. as follows: the responsibility of the SE's so-called representative body (usually named SE works council) shall be limited to matters of a transnational nature, i.e. those management decisions that affect the interests of the SE's employees in more than one Member State (Davies 2003a: 71-72; Rieble 2008: 99).

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23 Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, O.J. 2001 (L 294) at 22.

24 Council Regulation 2157/2001/EC of 8 October 2001 on the Statute for a European company (SE), O.J. 2001 (L 294) at 1.

25 *Cf.* Arts. 9(1)(a), 1(4) SER.

26 In the case of Germany: Act on the Implementation of the SE (*SE-Ausführungsgesetz*, hereinafter SEAG) and Act on Employee Involvement in an SE (*SE-Beteiligungsgesetz*, hereinafter SEBG). An overview of the national legislation transposing the SE-Dir. is provided by the Synthesis Report 2008: 5-11.

27 As to the definitions provided by the SE-Dir., *see* Art. 2.

28 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), O.J. 2009 (L 122) at 28. It took effect on 6 June 2011 and repealed Council Directive 94/45/EC of 22 September 1994, as amended, O.J. 1994 (L 254) at 64.

29 *See infra* Section II of the Annex.

30 *Cf.* 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, O.J. 2002 (L 80) at 29.

II. Primacy of and Parties to the Negotiations

Pursuant to Art. 12(2) SER, an SE may not be registered unless one of the three following conditions with respect to employee involvement has been met:[31]

(i) an agreement on arrangements for employee involvement between the competent organs of the participating companies and the employee representatives has been concluded (Art. 4 SE-Dir.); or
(ii) the employee representatives have taken a decision not to open negotiations or to terminate negotiations already commenced (Art. 3(6) SE-Dir.); or
(iii) the period for negotiations pursuant to Art. 5 SE-Dir. has expired without an agreement, resulting in the application of the standard rules for employee involvement as laid down in the Annex to the SE-Dir.

The issue of employee involvement comes to the fore after the participating companies have decided on a route of establishment and a governance structure for the SE in formation. Then, it is incumbent upon the competent organs of the founding companies to take the necessary steps – notably the provision of necessary information – to open negotiations with employee representatives as soon as possible (cf. Art. 3(1) SE-Dir.). While the competent organs of the participating companies, namely their management or administrative boards, are naturally already in existence,[32] the employee representatives have yet to be selected. Party to the negotiations on behalf of the employees is the so-called Special Negotiating Body (hereinafter SNB). The procedure for the selection of its members is laid down in Art. 3(2) SE-Dir. According to this provision, the seats on the SNB are to be allocated in proportion to the number of employees employed in each Member State by the founding companies and concerned subsidiaries. For this purpose, one seat shall equal 10 percent, or a fraction thereof, of the total number of employees employed by the proposed SE and its concerned subsidiaries (Art. 3(2)(a)(i) SE-Dir.). Hence, the SNB is comprised of at least 10 members. However, the actual members to be selected from the respective Member States are chosen according to the rules set out in their transposition laws (Art. 3(2)(b) Subpara. 1 SE-Dir.). Member States may provide that trade union representatives may become members of an SNB regardless of whether they are employees of a participating company or concerned subsidiary (Art. 3(2)(b) Subpara. 2 SE-Dir.). With a few exceptions, the Member States have used this option (Synthesis Report 2008: 67).[33]

As already mentioned, addressing the issue of employee involvement during the formation of an SE is a prerequisite for its registration (Davies 2003b: 79). Yet there are exceptions: negotiations need not take place if neither the founding companies and concerned subsidiaries nor the proposed SE has any employees or at least not as many as needed to establish the SNB (Henssler 2011b: 9).[34] In all other cases, negotiations shall commence as soon as the SNB is established.

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[31] However, there is one exception to this 'three-condition test'. Art. 7(3) SE-Dir. contains an option which allows Member States not to apply Part 3 of the SE-Dir.'s standard rules in the case of an SE established by merger. In such a case, an SE may not be registered unless either an agreement on employee involvement, including the issue of participation, pursuant to Art. 4 SE-Dir. has been concluded or none of the participating companies has been governed by participation rules prior to the registration of the SE (Art. 12(3) SER). The practical relevance of Art. 7(3) SE-Dir. is slight, however: only approximately one third of the Member States have made use of this option (Ernst & Young 2009: 44).

[32] The SE-Dir. does not provide for arrangements to establish a uniform negotiating body that negotiates as an agent on behalf of the founding companies. Hence, making the necessary arrangements is left to the competent organs of the participating companies (Rieble 2008: 82-83).

[33] E.g. in cases where at least two members of the SNB are to be selected from Germany, every third member shall be a trade union representative pursuant to Secs. 6(3), 8(1) Cl. 2 SEBG.

[34] This is typically the case with respect to SEs being formed as 'shelf' companies, understood as companies that have neither business activities nor employees and are for sale. However, it is well established that negotiations must be conducted where the proposed SE does not have any employees, but the founding companies have (Henssler 2011b: 9). If even the founding companies lack employees, negotiations would be pointless. In such rare cases, the issue of employee involvement and, thus, the establishment of the SNB

Notwithstanding the primacy of negotiations, the SNB may unilaterally decide not to open negotiations or to terminate ongoing negotiations pursuant to Art. 3(6) SE-Dir**.** If such a decision has been made, the standard rules do not apply (Arts. 3(6) Subpara. 1, 7(1)(b) second Indent SE-Dir.).[35] Hence, the SE will not be governed by any system of board-level participation. However, as to information and consultation rights, the European Works Council Directive and its national transposition laws are applicable (Art. 13(1) Subpara. 2 SE-Dir.). Furthermore, as in any other case of establishment, existing arrangements for information and consultation provided for by national legislation continue to operate.[36]

In the absence of such a decision of the SNB, counting from the day of the SNB's establishment, negotiations may last up to six months (Art. 5(1) SE-Dir.). However, the parties can agree on extending the negotiation period for up to a total of one year (Art. 5(2) SE-Dir.). For the purpose of the negotiations, the SNB can request external experts such as representatives of trade unions to assist it with its work. Such experts may be present at negotiation meetings in an advisory capacity (Art. 3(5) SE-Dir.). While in general any expenses related to the functioning of the SNB must be borne by the founding companies, the majority of the Member States have used the option contained in Art. 3(7) Subpara. 2 Cl. 2 SE-Dir. to limit the funding to cover only one expert (Fulton 2006: 40). Regarding dispute resolution during the negotiations, it is at the parties' discretion to initiate mediation proceedings for resolving conflicts. However, in case of failure to reach agreement, they must not pursue any form of arbitration that would lead to a binding decision made by a third party (Rieble 2008: 96).

The SNB, in general, takes decisions by an absolute majority of its members, provided that such a majority also represents an absolute majority of the employees (Art. 3(4) SE-Dir.). Each member has one vote. However, a supermajority of the votes of two thirds of the members of the SNB representing at least two thirds of the employees and representing employees employed in at least two Member States is required in two cases:

(i) the SNB unilaterally decides not to open or to terminate ongoing negotiations (Art. 3(6) Subpara. 2 SE-Dir.); or
(ii) the parties envisage an agreement that would result in a reduction of participation rights compared to the highest level of participation existing within the founding companies if, in the case of an SE formed by merger, participation rules cover at least 25 percent, or if, in the case of an SE established by setting up a holding company or by forming a subsidiary, participation rules cover at least 50 percent of the overall number of employees of the participating companies (Art. 3(4) SE-Dir.).

III. Scope of Negotiations

The SE-Dir. aims at granting the parties negotiating freedom to work out a firm-specific set of rules for the SE in formation (cf. Arts. 3(3), 4(1) through (3) SE-Dir.; Davies 2003a: 70, 77). The negotiation procedure and the arrangements for implementing employee involvement are governed by the transposition law of the Member State in which the (proposed) SE's registered office is located (Arts. 6, 7(1) Subpara. 2 SE-Dir.). Any agreement concluded can be characterised as a collective contract *sui generis* (Rieble 2008: 79). The contractual freedom of the parties is limited in one important respect: in the case of an SE established by transformation, any agreement shall provide for at least the same level of employee involvement compared to the one existing within the company to be transformed into an SE (Art. 4(4) SE-Dir.). However, instead of negotiating employee involvement, the parties may, in any case, by agreement decide to apply the standard rules in part or in total (Arts. 4(3), 7(1)(a) SE-Dir.).

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come again to the fore at the time the 'shelf' company is 'activated', i.e. starts carrying out business activities and hiring employees (cf. Recital 18 of the Preamble and Art. 11 SE-Dir.).

35 However, such a decision cannot be taken in the case of an SE established by transformation, where the transforming company is subject to board-level participation (Art. 3(6) Subpara. 3 SE-Dir.).

36 *See supra* Section I of the Annex.

The applicable regulatory regime provides what must, what may, and what must not be covered by an agreement. Art. 4(2) SE-Dir.[37] stipulates that certain issues have to be specified. To begin with issues that concern employee involvement in general, any agreement must address its scope, date of entry into force, its duration, and cases in which renegotiations should take place (Art. 4(2)(a), (h) SE-Dir.; Oetker 2008: 992-93). Another important issue which equally concerns both 'pillars' of employee involvement is structural changes subsequent to the SE's registration such as domestic mergers. The SE-Dir. does not provide rules for those events and mentions 'structural changes in an existing SE' only in Recital 18 of its Preamble.[38] Even if national transposition laws address such instances,[39] elaborating during the negotiations upon the issues of structural changes and/or a growing workforce may be sensible in order to obviate eventual legal uncertainty.

Turning to employee involvement's first 'pillar', namely information and consultation rights, the catalogue of Art. 4(2)(b) through (e) SE-Dir. contains a bundle of matters concerning the establishment of an external representative body (usually an SE works council) that exercises such rights on behalf of the employees. If such a representative body is set up, its composition, functioning, the number of its members, the allocation of seats on it, the frequency of meetings, its financial and material resources, and the procedure for its information and consultation in particular must be addressed in the agreement (Rieble 2008: 97). However, the catalogue neither mandates specific contents regarding the enumerated issues ('without prejudice to the autonomy of the parties') nor is it conclusive (Synthesis Report 2008: 34).[40] Notwithstanding the above, the parties are not obliged to establish a representative body as long as they agree upon implementing any other procedure for employee information and consultation on the transnational level (such as regular hearings or a consultative committee) and specify the functioning thereof (cf. Recital 6, Art. 4(2)(f) SE-Dir.; Oetker 2008: 993-94; Rieble 2008: 76, 97).

Concerning the second 'pillar' of employee involvement, arrangements for board-level participation are optional (cf. Art. 4(2)(g) SE-Dir.): any existing participation system can, in principle, be reduced or even completely abolished. However, if the parties agree upon some form of board-level participation, the issues enumerated in Art. 4(2)(g) SE-Dir. – namely the proportion of employee representatives on the respective board, the procedure for their selection, and their rights and obligations – must be addressed because they are instrumental in making the agreement operational (Oetker 2008: 995). Again, the enumeration is not conclusive (cf. Art. 4(2)(g) SE-Dir.: 'including'), so that the question arises which further issues with respect to board-level participation may be specified in an agreement.

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37 National legislation mostly opted for an almost verbatim transposition (Synthesis Report 2008: 34).

38 However, the SE-Dir. requires in Part 1(b) Subpara. 2 of its Annex that the composition of the representative body shall be adapted to take account of changes occurring within the SE, its subsidiaries, and establishments.

39 E.g. in Germany, renegotiations are required according to Sec. 18(3) SEBG in cases where structural changes may negatively affect employees' rights. However, a significantly growing workforce, e.g. due to acquisitions of other companies or establishments, is not considered to trigger this provision (Rieble 2008: 105).

40 Therefore, with respect to information and consultation, provision can also be made for the procedure for the selection of the employee representatives, further requirements for the eligibility of candidates (e.g. as to their qualification, experience), whether external trade union representatives can be selected, *ad hoc* meetings in case of extraordinary instances significantly affecting employees' interests, the place of the body's meetings, the term of office of its members, office facilities and staff, interpreting and translation services, funding (e.g. to cover expenses for travel and external experts), granting of further rights to employee representatives (such as unconditional access to all establishments, training schemes, more extensive protection against dismissal as compared to the protection provided by the national legislation in force in the country of employment, compensation for any 'detriments' resulting from the performance of their duties; cf. Art. 10 SE-Dir.), a definition of their obligations (e.g. a preciser or more stringent definition regarding confidentiality as compared to Art. 8(1) SE-Dir. and the respective transposition laws) − to name but a few issues.

Direct employee involvement in managerial decision-making on the board level implicates (as opposed to arrangements for information and consultation of employees through an external body) that employee representatives become part of organs within the corporate structure. This puts any arrangement concerning board-level participation in tension with the principle of charter autonomy.[41] Two propositions can be made in this respect. Firstly, the scope of charter autonomy is a limiting factor to the parties' negotiation autonomy with respect to issues of board-level participation. Only such issues can be part of an agreement which could also be addressed by the SE's statutes (Habersack 2006: 348; Schäfer 2008: 29-30). According to this proposition, matters that fall within the domain of the supervisory or administrative board to organise its own affairs are beyond the scope of negotiations. To exemplify this by SE's domiciled in Germany (and thus by reference partially being subject to German stock corporation law), the election of the chairman and deputy chairman, the formation and composition of committees, the right of the supervisory organ to make certain transactions of the management organ subject to its authorisation[42] cannot be dealt with in an agreement (Habersack 2006: 347-50, 354; Schäfer 2008: 31).

According to the second proposition, the parties' negotiation mandate is not as broad as the range of matters that could be addressed by the SE's statutes. In its Arts. 2(k), 4(2)(g), the SE-Dir. grants the parties the autonomy to negotiate 'participation'. Hence, the content of the agreement may only include arrangements that are essential to furthering employees' influence in the SE's affairs through representatives at board level (Habersack 2006: 350-51; Schäfer 2008: 28-29). This principle may be illustrated by the choice of a board model (one-tier or two-tier pursuant to Art. 38(b) SER) for the SE: this important decision for the corporate structure is not related to board-level participation and can, in any case, be taken unilaterally by the shareholders (Habersack 2006: 351; Oetker 2008: 998). Furthermore, transactions of the management requiring authorisation by the supervisory organ or an express decision by the administrative organ (as to be provided for by the SE's statutes pursuant to Art. 48(1) Subpara. 1 SER) do not exhibit the necessary direct connection with board-level participation and, therefore, are beyond the scope of negotiations (Habersack 2006: 354; Rieble 2008: 100). By the same token, this holds true for some further issues related to the functioning of the supervisory or administrative organ such as frequency and durations of meetings or working language, even if these issues could, as under German stock corporation law, be addressed by the statutes (Habersack 2006: 347, 350-54). Turning to the size of the supervisory or administrative organ, this issue must be specified in the statutes pursuant to Arts. 40(3), 43(2) SER and in accordance with the respective Member State's transposition laws. Even in the case of an SE formed by transformation, it is well established that only the proportion of employee representatives on the board shall be retained, but not necessarily the size of the organ (cf. Arts. 3(4) Subpara. 2, Part 3(b) Subpara. 1 in connection with Part 3(a) Cl. 2 of the Annex to the SE-Dir.; Rieble 2008: 98; Eidenmüller et al. 2009a: 8). Against this background, the precise size of the board can also not be dealt with in an agreement (Habersack 2006: 351-53; Henssler and Sittard 2011a; Schäfer 2008: 32-33).

Thus, remaining issues that can be addressed and elaborated upon by the parties with respect to participation are, for instance, further requirements for the eligibility of candidates (e.g. as to their qualification, experience), their term of office in accordance with Art. 46(1) SER, the question of whether external trade union representatives can be selected, the allocation of seats on the respective board among the concerned countries, granting of further rights to employee representatives (e.g. more extensive protection against dismissal compared to the protection provided by the national legislation in force in the country of employment, training schemes and payment of wages for the time necessary to participate therein; cf. Art. 10 SE-Dir.), and definition of their obligations (e.g. a preciser or more stringent definition regarding confidentiality compared to Art. 8(1) SE-Dir. and the respective transposition laws) (Oetker 2008: 997-98; Rieble 2008: 101).

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41 Charter autonomy encompasses all issues that can be addressed by the provisions of the SE's statutes. Limits to charter autonomy follow from Art. 9(1)(b) SER and national equivalents, if any, pursuant to Art. 9(1)(c)(iii) SER (e.g. the German principle of *Satzungsstrenge* as stipulated by Sec. 23(5) German Stock Corporation Act [*Aktiengesetz*, AktG]).

42 The latter is only relevant if provided by national legislation transposing Art. 48(1) Subpara. 2 SER. This option has been introduced in Germany by Sec. 19 SEAG.

As a consequence of the foregoing account, certain matters enumerated in Art. 4(2) SE-Dir. must be addressed, not least because they are instrumental in making the agreement operational. If the parties fail to address and agree upon mandatory issues in the agreement, such matters will have to be covered by way of supplementary interpretation of the contract's language – if necessary, against the background of the standard rules (Rieble 2008: 98). On the other hand, when they, *vice versa*, address matters in the agreement that are beyond the scope of negotiations, such clauses are void. Resulting gaps are filled in by the standard rules (Rieble 2008: 98).

IV. Standard Rules

If the parties fail to reach an agreement on employee involvement, the standard rules come into play as a fall-back regime (Art. 7 and the Annex to the SE-Dir.). Neither of the parties can amend the content of the standard regime by unilateral decision (Davies 2003a: 77). Regarding information and consultation rights, Parts 1 and 2 of the Annex to the SE-Dir. apply in any case without any further requirements to be fulfilled, where both no agreement has been concluded within the negotiation period and no decision according to Art. 3(6) SE-Dir. has been taken if the competent organs of the founding companies wish to continue with the registration of the proposed SE (cf. Art. 7(1)(b) SE-Dir.). Parts 1 and 2 of the Annex prescribe a procedure for information and consultation of employees through an external representative body that must be set up. The standard rules outline its composition, functioning, and competences. For instance, the representative body shall meet with the competent organ of the SE at least once a year (Part 2(b) of the Annex). In exceptional circumstances affecting the employees' interests to a considerable extent (e.g. relocations, transfers, the closure of establishments or undertakings, collective redundancies), the body has to be informed and is entitled to request an *ad hoc* meeting with the management of the SE for purposes of information and consultation (Part 2(c) of the Annex). The costs of the representative body shall be borne by the SE, and the body may be assisted by experts of its choice (Part 2(f), (h) of the Annex).

Part 3 of the Annex to the SE-Dir. deals with board-level participation. It automatically applies in default of agreement when both the aforementioned requirements of Art. 7(1)(b) SE-Dir. and – this is the difference compared to information and consultation rights – the additional prerequisites pursuant to Art. 7(2) SE-Dir. are met. The latter are dependent upon the chosen route of formation and relate to the prevalence of employee participation in the founding companies prior to the SE's registration. In the case of an SE established by transformation, Part 3(a) of the Annex to the SE-Dir. is applicable if the transforming national company has been subject to any form of employee participation. When an SE is established by merger, the standard participation rules automatically apply if at least 25 percent of the total number of employees in all the founding companies have been covered by some form of participation under the respective national laws. In the case of an SE formed by setting up a holding company or by establishing a subsidiary, the threshold is 50 percent. Irrespective of these thresholds, Part 3 of the Annex can be invoked by a unilateral, absolute majority decision of the SNB (Art. 7(2)(b) second Indent, (c) second Indent SE-Dir.). However, such a decision would have no implications if none of the participating companies had been governed by participation rules prior to the SE's registration (Part 3(b) Subpara. 2 of the Annex to the SE-Dir.).

The main characteristics of the standard rules with respect to board-level participation may be briefly described as follows: in the case of an SE established by transformation, all aspects of employee participation having been applicable to the transforming national company continue to apply to the SE (Part 3(a) of the Annex to the SE-Dir.). With respect to all other routes to formation, an SE is only required to be governed by a regime of board-level participation if such a system had been present in at least one of its founding companies prior to registration (Part 3(b) Subpara. 2 of the Annex to the SE-Dir.). In these cases, the most stringent form of board-level participation to be found among the founding companies must be implemented (Part 3(b) Subpara. 1 of the Annex to the SE-Dir.). In any case, every member representing the interests of the employees on the board level shall have the same rights and obligations as the respective members on the part of the shareholders (Part 3(b) Subpara. 4 of the Annex). The provisions of Part 3(b) of the Annex apply by reference *mutatis mutandis* to an SE established by transformation (Part 3(a) Cl. 2 of the Annex to the SE-Dir.).

V. Other Fall-Back Options

The founding companies may capitalise on other fall-back options. Hence, it is necessary to outline some possible routes to mitigate or even completely avoid mandatory participation systems.

Mandatory employee participation at board level may be bypassed by choosing a foreign limited liability corporate entity that mainly or completely operates in a Member State different from its country of registration. For example, a foreign corporate entity, say a British public limited company (plc), having its *siège réel* (i.e. effective management) in Germany is not subject to the provisions on board-level participation mandatory for German corporate entities[43] (Eidenmüller 2007: 470-74, 478). The same holds true for combinations of foreign entities with domestic legal forms under German law, such as a German limited commercial partnership combined with a foreign corporate entity as the unlimited partner[44] (Henssler 2005: 332). In the same vein, the establishment of holding structures may render German provisions on mandatory board-level participation inapplicable.[45]

Opportunities to mitigate or even completely abolish prevailing board-level participation are also offered by effecting a cross-border merger pursuant to Directive 2005/56/EC[46] (hereinafter Tenth Dir.) and its national transposition laws. In contrast to the SE-Dir., arrangements for information and consultation are not addressed by the Tenth Dir. Moreover, negotiations with respect to board-level participation are not required to be conducted in every case when a cross-border merger is effected (Ernst & Young 2009: 217).[47] In cases where negotiations are mandatory and an agreement could not be reached within the negotiation period, the standard rules for participation automatically apply if at least 33 1/3 percent (as opposed to at least 25 percent in the case of an SE formed by merger) of the total number of employees in all the merging companies have been covered by some form of participation (Art. 16(3)(e) Tenth Dir.).

Further, the competent organs of the merging companies can opt without any prior negotiations to apply the standard rules contained in Part 3(b) of the Annex to the SE-Dir. as transposed into national legislation by the Member State in which the domestic corporate entity resulting from the cross-border merger is to have its registered office (Art. 16(4)(a) Tenth Dir.). In such a case, an SNB does not need to be constituted (Teichmann 2007: 92). Moreover, in the cases where the standard rules for participation apply, Member States may limit the proportion of employee representatives in the administrative organ (i.e. only in the case of the one-tier structure) to one-third or lower, the latter being dependent upon the prevailing level of participation prior to the merger (Art. 16(4)(c) Tenth Dir.). While Germany did not avail itself of this option, the United Kingdom introduced the one-third limit. As a consequence, a German company that is co-determined could reduce the participation level to one-third by merging into a British plc (Henssler 2011b: 9-10). Furthermore, the complete abolishment of participation rights could be achieved by a subsequent domestic merger if the company resulting from the cross-border merger has its registered office in a Member State that does not provide for any form of mandatory board-level participation (such as the United Kingdom) (Teichmann 2007: 96; Henssler 2011b: 10). However, Art. 16(7) Tenth Dir. requires in such cases that

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43 Under German law, in a joint stock corporation (*Aktiengesellschaft*) with more than 500 employees, one-third of the members of the supervisory board must be employee representatives (one-third participation pursuant to Secs. 1(1), 4(1) German One-Third Participation Act [*Drittelbeteiligungsgesetz*]). In a joint stock corporation with more than 2,000 employees, the quota is even 50 percent (parity co-determination pursuant to Secs. 1(1), 7(1) German Co-Determination Act [*Mitbestimmungsgesetz*]).

44 This construct is increasingly popular in Germany. Some notorious examples are Air Berlin PLC & Co. Luftverkehrs KG, H&M Hennes & Mauritz B.V. & Co. KG, Müller Ltd. & Co. KG, and Prinovis Ltd. & Co. KG.

45 E.g. the German mandatory participation regime does not cover foreign holding companies with German subsidiaries that keep their German workforce below the relevant thresholds (Henssler 2005: 332).

46 Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies ('Tenth Company Law Directive'), O.J. 2005 (L 310) at 1.

47 *Cf.* Arts. 16(1), (2) Tenth Dir., the lowest common denominator for triggering negotiations being that at least one of the merging companies is subject to some form of board-level participation.

vested rights be safeguarded for a period of three years with respect to a company resulting from a cross-border merger *and* operating under an employee participation system.

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