A FLEXIBLE MODEL FOR EFFICIENT EMPLOYEE PARTICIPATION IN UK COMPANIES*

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Abstract: Corporate contractarian literature dismisses employee participation as inefficient on the grounds that, if it were efficient, it would be voluntarily adopted widely. We argue that the scarcity of employee participation in the UK can be attributed to shareholder short-termism and behavioural biases and, therefore, that the question of its efficiency remains open for companies that want to explore this possibility. We thus propose a flexible approach that UK companies can follow to implement employee participation. Our approach takes into account the broader UK institutional framework by creating adaptable and long-term solutions for both listed and large private companies. We argue that the most pragmatic way to encourage efficient employee participation is through the introduction of formal employee advisory panels and, in the longer term, the proliferation of employee share ownership schemes coupled with special rights to appoint a number of directors in tandem with the size of employee share ownership.

Keywords: corporate governance, employee participation, employee share ownership schemes.

INTRODUCTION

The question of the role of employees[1] in corporate governance, and of employee representation on corporate boards in particular, is a politically sensitive one that has recently attracted regulatory attention and triggered a heated public debate in the UK[2]

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[1] Unless otherwise stated, all URLs were last accessed on 15 July 2019. In this paper, the term 'employee' will be used broadly to denote both employees and other workers. On the legal definition of employees, see *Autoclenz Ltd v Belcher* [2011] UKSC 41; and *Carmichael and Leese v National Power Plc* [1999] UKHL 47.

[2] The latest Labour Party Conference adopted a policy of mandating employee representation on the boards of large companies in the form of election of one-third of the board by employees. See A. Cowburn, 'Workers to make up one third of company board members under Labour, Jeremy Corbyn vows' *Independent* (London: 23 September 2018) https://www.independent.co.uk/news/uk/politics/jeremy-corbyn-workers-boards-labour-conference-one-third-union-a8550946.html. Shortly before becoming Prime Minister, Theresa May had also voiced her support for some form of worker representation on corporate boards. See N. Pratley, 'Theresa May's plan to put workers in boardrooms is extraordinary' The Guardian (London: 11 July 2016) https://www.theguardian.com/politics/nils-pratley-on-finance/2016/jul/11/theresa-may-plan-workers-boardroom-reform-extraordinary-tories

and the US.[3] Indeed, the revised edition of the UK Corporate Governance Code contains, for the first time, guidelines for companies to engage with their workforce and seek employee input on governance matters. Employee participation in corporate governance refers to a range of institutions, voluntary or legally mandated, that engage employees in corporate decision-making, such as works councils with co-decision powers on labour matters, advisory panels, information and consultation committees, employee share ownership schemes and board representation. Employee board representation can take the form of the election of a minority of directors, or of parity with the shareholders, and can be implemented either on a unitary board or at the supervisory board level in systems with a two-tier board structure.[4]

Taking into account the broader UK institutional framework, we argue that the most feasible way to encourage efficient employee participation is through the introduction of formal employee advisory panels and, in the longer term, the proliferation of share ownership by employees coupled with the right to elect a number of board members. The proposals that we formulate present a realistic and long-term vision of employee participation, aiming to prepare employees adequately for taking on greater responsibility and for a heightened role within corporate decision-making structures. Our approach relies on an incremental participation model, whereby employees should first be given a dialogue channel through advisory panels to gain adequate experience before appointing board members. By advancing this proposal we aim to bestow a new purpose to corporate law as enabler of greater change in hybrid governance without disrupting shareholder based governance and undermining labour law mechanisms to protect employees.

The paper is structured as follows. The first part examines the theoretical advantages and disadvantages of employee participation, and addresses the law and economics argument that we can deduce the inefficiency of employee participation from the absence of its widespread voluntary adoption by companies. It is argued that the

[3] In the US, the debate revolves around reducing income inequality. US Senator Elizabeth Warren put forward the Accountable Capitalism Act, section 6 (b) 1 of which provides that employees of large corporations with total annual revenue of at least $1 billion elect at least 40% of board. The Act is available at: https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act.pdf.

[4] In Germany, for instance, large companies must have a two-tier board and employees elect, depending on the size of the workforce, one third or half of the members of the supervisory board. For a doctrinal analysis and critique of the German two-tier board, see K.J. Hopt, 'The German Two-Tier Boar Experience, Theories, Reforms' in K.J. Hopt, H. Kanda, M.J. Roe, E. Wymeersch and S. Prigge (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford: OUP, 1998); M. Roth, 'Corporate Boards in Germany' in P. Davies, K. Hopt, R. Nowak and G. van Solinge, *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Oxford: OUP, 2014) 256.

relative scarcity of employee participation in the UK corporate sector can be attributed to shareholder short-termism and behavioural biases,[5] thus allowing for the possibility that employee participation is efficient, at least for some if not all companies. The second part analyses the specificities of the UK framework that would justify our flexible and incremental approach to match its pragmatic and efficient normative elements. It also aims to advance the argument that our proposals should go beyond the distinction between listed and large private companies since both types of companies provide a sufficient rationale for employee participation and board representation. Our proposals are therefore suitable for adoption by both listed and large private companies and can serve as a guide for future legal and regulatory reforms.

The third part identifies possible strategies to implement employee participation and board representation, taking into account the broader UK corporate governance framework, history of industrial relations and level of diffusion of share ownership. It is argued that transposing the German system of mandatory works councils and board codetermination would not be appropriate, but rather that the preferable way forward would be a more flexible approach, implemented in two phases. The first phase would entail large companies setting up permanent employee advisory panels. The second phase would involve the adoption of rights for employee-shareholders to elect a proportion of directors that would reflect their total stake in the company. The fourth part addresses potential critiques related to the risks of 'tokenism' and scholarly arguments that demand more drastic and less flexible solutions.

THE CORE LAW AND ECONOMICS ARGUMENT AGAINST EMPLOYEE PARTICIPATION AND ITS LIMITATIONS

The effects of employee participation can be seen in three areas, namely: (a) employee motivation; (b) employee skills and expertise; and (c) efficiency of the governance of the firm. The first two areas concern labour productivity in a strict sense, while the third refers to the overall efficiency of the organisational structure of the firm.

[5] A behavioural bias refers to the deviation of human behaviour from what is expected under assumptions of perfect rationality.

The economic advantages and disadvantages of employee participation in theory

In terms of employee motivation and skills, labour participation can theoretically bring several economic advantages.[6] Being represented in decision-making increases the legitimacy of managerial decisions and thus can enhance employee motivation. At the very least, it reduces the chances that employees will be severely dissatisfied which can lead to industrial disputes. Especially, if the type of participatory structure includes an element of profit-sharing for employees, such as performance-related remuneration or share ownership schemes, employees face incentives to be as productive as possible to maximise the firm's output.[7] Conversely, if there are no such structures and there is strong security of tenure, an opposite effect can also arise in terms of motivation with employees slacking and making suboptimal efforts.

Assuming that participation enhances security of tenure, it is reasonable to expect that it will lead to a workforce with enhanced skills for two reasons. First, employees, expecting that they can work for the firm in the long term, are more likely to make firm-specific investments in developing skills and acquiring knowledge that is only (or primarily) valuable to the particular firm.[8] Second, security of tenure leads to employees working on average for longer periods of time for the same employer, which normally leads to the acquisition of higher-level skills, both firm-specific and generic. This correlation is due to company investment in training and professional development opportunities that has also been highlighted by CEO associations, denoting the significance of employee skills development as an indicator of corporate social performance.[9]

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[6] For an overview, see P. Davies, 'Efficiency Arguments for the Collective Representation of Workers: A Sketch' in A. Bogg, C. Costello, A.C.L. Davies and J. Prassl (eds), *The Autonomy of Labour Law* (Oxford: Hart Publishing, 2015).

[7] For instance, in Germany collective bargaining has in the last two decades led to agreements whereby part of employees' income depends on individual performance and part on company performance, including payment in shares. See G. Jackson, M. Hopner and A. Kurdelbusch, 'Corporate Governance and Employees in Germany: Changing Linkages, Complementarities, and Tensions' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005) 106 – 112.

[8] See e.g. M.M. Blair and L.A. Stout, 'A Team Production Theory of Corporate Law' (1999) 24 *The Journal of Corporation Law* 751, 763 – 771.

[9] For example, the World Economic Forum's International Business Council has integrated a set of 'Skills for the Future' metrics, such as average hours of training and expenditure per person as a key non-financial performance indicator: World Economic Forum, 'Toward Common Metrics and Consistent Reporting of Sustainable Value Creation' (2020) 9, available at https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation.

Nevertheless, it could be argued that employees might be more benefitted in welfare terms with transferable – rather than firm-specific – skills, which are dominant in certain occupational labour markets as this would increase their ability to take advantage of external labour markets. Although we are not agnostic of the merits of transferable skills, we support the obtention of firm-specific skills as a means to unblock the potential of some employees to engage in governance and create long-term ties to corporations. In an ever-increasingly malleable working environment, driven by transferable skills and the facilitation of changing employment positions, employees might nurture a short-term employment mentality that is inherently detached from the engagement in governance activities and the overall improvement of specific firms. The serious and chronic problem of UK industrial relations, exemplified by the lack of trust between employers and employees, and the excessive reliance on the external labour market, rather than on the internal labour market of each firm, is a characteristic example in this sense.[10]

The most complex area where employee participation has an impact is the quality of governance. On the positive side, the involvement of employees can lead to better-informed decision-making and thus improve strategic management. This is because employees are internal stakeholders who have special knowledge about the firm. Moreover, as employees' investment in the firm is not diversified, they have stronger incentives than dispersed shareholders to monitor management diligently and to constrain managerial agency costs.[11]

On the negative side, law and economics scholars have asserted that employee participation in corporate governance reduces economic efficiency. They argue that due

[10] As Blyton and Turnbull put it, 'The short-term horizon of most flexibility strategies in the UK reflects a broader preoccupation with the short rather than the longer term, and in particular the primacy of short-term financial performance as the measure of organisational success. […] The (over-)reliance on markets rather than institutions lies at the heart of poor productivity performance and many of the deleterious outcomes of employee relations in the UK (e.g. low wages, income inequality, the under-provision of training and low trust relations between management and employees).' P. Blyton and P. Turnbull, *The Dynamics of Employee Relations* (London: Palgrave Macmillan, 3rd edn, 2004) 364. See also A. Pendleton and H. Gospel, 'Markets and Relationships: Finance, Governance and Labour in the United Kingdom' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005).

[11] On the possibility that capital and labour can form an 'accountability coalition' against management, see G. Jackson, M. Hopner and A. Kurdelbusch, 'Corporate Governance and Employees in Germany: Changing Linkages, Complementarities, and Tensions' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005) 94 – 96 and 98 – 99.

to transaction costs[12] and governance costs[13] having more than one class of individuals with governance rights is inefficient. This is because the board of a company where another class of stakeholders has voting rights, alongside shareholders, would not be able to function efficiently due to the conflicts of interest of the two (or more) classes.[14] Decision-making would be slowed down and the flow of information from management to the board would be disrupted.[15] Also, they argue that efficiency dictates that the class that has governance rights must also bear the residual risk of the firm. On this basis, one must reject employee participation in the corporate governance of corporations other than in the form of voluntary employee share ownership schemes whereby employees are granted ordinary shares with no special voting rights. Of course, this does not negate the possibility that, on some occasions, employees are the optimal class to control the firm and bear the residual risk, as is evidenced by the predominance of professional partnership firms in legal and accounting services.[16]

Elevating the debate on the well-established arguments around 'governance' and 'contract' solutions for corporate constituency rights, it has been asserted that contractual protection needs to be complemented by governance mechanisms for shareholders as equity providers since they cannot be completely protected via contractual means.[17] Exclusive shareholder representation in corporate governance is thus desirable since it offers the optimal organisational structure. This theory also implies that all other corporate constituency contracts are complete. Nevertheless, applying *mutatis mutandis* the concept of incomplete contracts on the employment relationship, as initially envisaged by

[12] See O.E. Williamson, *The Economic Institutions of Capitalism* (New York, The Free Press, 1985) and O.E. Williamson, 'Corporate Governance' (1984) 93 *Yale Law Journal* 1197. See also the seminal work of Coase: R.H. Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.

[13] See H. Hansmann, 'Ownership of the Firm' (1988) 4 *Journal of Law, Economics, and Organisation* 267; H. Hansmann, 'When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy' (1990) 99 *Yale Law Journal* 1749; and H. Hansmann, *The Ownership of Enterprise* (Cambridge, MA: Harvard University Press, 1996).

[14] Hansmann, 'Ownership of the Firm' (n 13 above) 278 – 280.

[15] This is supported by evidence on the poor performance of publicly traded companies that are controlled by employees via share ownership. See O. Faleye, V. Mehrotra and R. Morck, 'When Labor Has a Voice in Corporate Governance' (2006) 41 *Journal of Financial and Quantitative Analysis* 489.

[16] For a detailed discussion of law firms as labour-owned firms, see D. Kershaw, 'No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance' (2002) 2 *Journal of Corporate Law Studies* 34, 58 – 60.

[17] Hansmann, 'Ownership of the Firm' (n 13 above); Z. Adams and S. Deakin, 'Corporate Governance and Employment Relations' in Jeffrey N. Gordon and Wolf-Georg Ringe (eds.) *The Oxford Handbook of Corporate Law and Governance* (Oxford: OUP, 2018) 1038.

Coase,[18] employment contracts are inherently incomplete.[19] Therefore, the need for governance mechanisms involving employees – which will form part of a hybrid governance model – becomes apparent but at the same time creates an intra-firm tension with shareholders who perceive their rights as being restricted.

As Kershaw demonstrates, neither transaction costs nor governance costs analysis leads to an inevitable logical conclusion that shareholder ownership is more efficient than employee ownership or hybrid arrangements.[20] Determining the optimal ownership structure depends on weighting the following factors: governance costs, communication and information costs, lock-in costs, employee monitoring costs and managerial agency costs.[21] It follows that theoretical economic analysis cannot in itself establish that shareholder voting rights must be exclusive. Institutional arrangements where governance rights are shared between shareholders and employees may be more efficient for some firms, depending on the actual trade-offs between the various relevant costs involved.[22]

Deducing the inefficiency of employee participation from its scarcity

Determining the optimal structure for each firm and for the economy overall is therefore an empirical matter. However, it is a matter that cannot be conclusively answered by reference to available empirical evidence.[23] The inconclusive nature of empirical studies

[18] According to Coase, 'It is this right of control or interference, of being entitled to tell the servant when to work (within the hours of service) and when not to work, and what work to do and how to do it (within the terms of such service) which is the dominant characteristic in this relation and marks off the servant from an independent contractor, or from one employed merely to give to his employer the fruits of his labour': R.H. Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386, 404.

[19] See S. Deakin & F. Wilkinson, 'Labour Law and Economic Theory: A Reappraisal' in G. De Geest, J. Siegers and R. van den Bergh (eds.), *Law and Economics and the Labour Market* (Edward Elgar, 1999). See also M.T. Moore and M. Petrin, *Corporate Governance: Law, Regulation and Theory* (London: Palgrave Macmillan, 2017) 140 – 142.

[20] Ibid, 38 – 42 and 54 – 60.

[21] Ibid, 58.

[22] Ibid, 49 – 53.

[23] There are conflicting studies on the economic impact of German co-determination. Gorton and Schmid found a negative impact. G. Gorton and F. Schmid, 'Capital, Labour, and the Firm: A Study of German Codetermination' (2004) *2 Journal of the European Economic Association* 863. Baums and Frick found that it had no effect. T. Baums and B. Frick, 'Co-determination in Germany: The Impact on the Market Value of the Firm' presented at *Employees and Corporate Governance* (New York: Columbia University Law School, 1996). Fauver and Fuerst concluded that codetermination is conducive to higher firm market value up to a certain level, but that this level is probably below the one mandated by German law. L. Fauver and M.E. Fuerst, 'Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards' (2006) 82 *Journal of Financial Economics* 673. FitzRoy and Kraft found that codetermination has led to higher labour productivity. F. FitzRoy and K. Kraft, 'Co-determination, Efficiency and Productivity' (2005) 43 *British Journal of Industrial Relations* 233. For a systematic review of the

allows for an argument that is derived from observed business practice. The economic analysis of corporate law, assuming that equity capital markets are informationally efficient, argues that employee participation in the governance of public listed companies must be inefficient because otherwise it would be adopted voluntarily by most, or at least by some, companies. It follows that employee participation must be inefficient, from the shareholders' perspective.[24] Any firms adopting sub-optimal governance structures would be at a competitive disadvantage and would therefore be less likely to survive and thrive, and therefore market competition ensures that the governance structures that prevail are optimal. Assuming that there are no externalities and other forms of market failure, the structure that maximises shareholder wealth will also be socially optimal. This argument underpins academic analyses regarding transactions costs and governance costs, as business practice is used as the arbiter of which way trade-offs go.[25] In the same vein, Hansmann and Kraakman argue that the shareholder-oriented model of corporate governance is superior to all alternative models, including the labour-oriented model which includes employee board representation.[26]

Before engaging with this argument, it is expedient to explain the process by which the capital market is claimed to ensure the optimality of prevailing governance structures. According to the strong form of the efficient market hypothesis, the price at which a listed share trades reflects all relevant information, public and private.[27] This includes the company's long-term prospects and the quality of its governance structures. Rational investors can thus rely on the share price and its movement to deduce information about the issuing company and make decisions to purchase, retain or sell shares in the issuing company. The outcome of this situation is that the shares of companies with governance structures that fail to maximise their long-term profitability

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empirical literature, see J.T. Addison, *The Economics of Codetermination: Lessons from the German Experience* (New York: Palgrave Macmillan, 2009); and B. Frick and E. Lehmann, 'Corporate Governance in Germany: Codetermination, and Firm Performance in a Stakeholder Economy' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005).

[24] Jensen and Meckling have expressed this argument most vividly: 'If co-determination is beneficial to both stockholders and labour, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily. The fact that stockholders must be forced by laws to accept co-determination is the best evidence we have that they are adversely affected by it.' M.C. Jensen and W.H. Meckling, 'Rights and Production Functions: An Application to Labor-managed Firms and Codetermination' (1979) 52 *Journal of Business* 469, 474.

[25] See Hansmann, 'Ownership of the Firm' (n 13 above) and Williamson (n 12 above).

[26] See H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89(2) *Georgetown Law Journal* 439, 444 – 446.

[27] On this, see the seminal work of Fama, esp. E.F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *The Journal of Finance* 383.

will trade at a discount. This increases such companies' cost of capital (and thus constrains their ability to grow) and makes them more susceptible to hostile takeovers. In the long term, the discipline of the capital market (cost of capital) and of the market for corporate control causes companies with sub-optimal governance structures to fail or to be taken over. It follows that listed companies that survive in countries with an active market for corporate control (such as the UK)[28] have optimal governance structures.[29] If such companies do not put in place systems of employee participation and board representation, it is because such institutions are value-decreasing in the long term, and therefore imposing them by law – or even setting them as the default position[30] – would be inefficient.

One counterargument that has been proposed against the above position is that employee participation is value-decreasing for shareholders but is socially optimal, as it brings larger benefits to employees. So, the total surplus created by companies (the 'corporate pie') will grow but shareholders will receive a smaller slice than before, as the proportion of the surplus that goes to the employees grows more than the growth of the surplus. This is because, typically, employee participation both increases the joint surplus created by firms, due to higher productivity, and enables employees to appropriate a larger portion of the surplus.[31] In other words, even if employee participation leads to a net reduction in long-term shareholder wealth, it can still be socially preferable, provided that the benefits it brings to employees and others exceed the cost it entails for shareholders.[32] It follows that the level of employee participation which is optimal for

[28] In the UK, once a *bona fide* takeover offer is imminent, the directors of target companies are not allowed to take any steps that could frustrate the takeover without the *ad hoc* consent of the shareholders. See City Code on Takeovers and Mergers, Rule 21.1. The Code is underpinned by the Companies Act 2006, Part 28.

[29] For a critical analysis of the corporate contractarian assumption that investors act as rational selectors of optimal corporate governance norms, see M.T. Moore, 'The Modern Company and Quasi-Public Power' in B. Choudhury and M. Petrin (eds), *Understanding the Company: Corporate Governance and Theory* (Cambridge: CUP, 2017) 88 – 91.

[30] This is because it would cause unnecessary transaction costs for companies to opt out of the default regime.

[31] See e.g. R. Freeman and E. Lazear, 'An Economic Analysis of Works Councils' in J. Rogers and W. Streeck, *Works Councils: Consultation, Representation and Cooperation in Industrial Relations* (Chicago, IL: University of Chicago Press, 1995) 29.

[32] This applies the criterion of Kaldor Hicks efficiency. See J. Hicks, 'The Foundations of Welfare Economics' (1939) 49 *The Economic Journal* 696; and N. Kaldor, 'Welfare Propositions in Economics and Interpersonal Comparisons of Utility' (1939) 49 *The Economic Journal* 549. See also D. Marsden and A. Canibano, 'An Economic Perspective on Employee Participation' in A. Wilkinson, P.J. Gollan, M. Marchington and D. Lewin (eds), *The Oxford Handbook of Participation in Organisations* (Oxford: OUP, 2010) 141 – 142.

shareholders is lower than the level which is optimal for society. In fact, distributive matters are primarily the role of collective bargaining rather than of employee-elected directors.[33] However, it is true that employee participation can lead to wealth redistribution to employees due to increased job security and professional development.

Still, the surplus distribution argument fails to explain why companies do not voluntarily introduce participation structures that would ensure that the surplus is shared in a way that both shareholders and employees benefit compared to the position they would be in if no participation structure were in place. This could be done by ensuring that shareholders retain overall control of the company, for instance, by allowing employees to elect a minority of the board and retaining the right of shareholders to dismiss all directors. It therefore remains necessary to explain why employee participation does not occur frequently on a voluntary basis to defeat the law and economics argument.

Explaining the absence of widespread voluntary employee participation

We submit that the explanation for the relative scarcity of endogenously created employee participatory institutions lies in shareholder myopia and short-termism. From the perceptive of listed companies, such short-termism could not conceivably be a problem if investors in the capital markets behaved as expected by the strong form of the efficient capital markets hypothesis,[34] according to which share prices reflect all relevant information about companies.[35] The semi-strong version of the efficient markets hypothesis, that posits that share prices reflect all publicly available information, is not fundamentally incompatible with the existence of short-termism, but limits its scope only to non-public information about the future prospects of companies. In other words, if a company used employee participation, its share price was depressed as a result, and it had strong profitability prospects due to the benefits of participation, some investors would

[33] In Germany, for instance, codetermination did not lead to an increase in labour costs. See FitzRoy and Kraft (n 23 above) 373.

[34] See in general E.F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383; and R.J. Gilson and R.H. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549.

[35] For early refusals of the possible existence of short-termism, see P. Marsh, *Short-Termism on Trial* (Institutional Fund Managers' Association, 1993) and M.C. Jensen, 'Some Anomalous Evidence Regarding Market Efficiency' (1978) *6 Journal of Financial Economics* 95.

act as arbitrageurs and bet on the increase of its share price, thus eventually correcting the market price, as other investors would imitate the arbitrageurs.

There is, however, considerable evidence that investors in equity markets can be myopic and that shareholder short-termism can prevent the market price of shares from reflecting the long-term value of companies.[36] In general, discounting the value of future benefits is rational up to an extent, in view of the limited lifespan of individuals. However, behavioural economic research has established that most individuals are irrationally short-termist, as they apply a hyperbolic discount rate to future gains.[37] Thus investor biases are likely to be systematic and not self-correcting. If investors place an irrationally discounted value to future gains and thus concentrate unduly on short-term gains, market discipline will penalise companies that adopt strategies or governance structures that are optimal in the long term but profit-decreasing in the short term.[38] As a result, prevailing corporate governance structures will be biased in favour of short-term gains and need not be optimal. In particular, Moore and Walker-Arnott identify two forms of investor short-termism: speculative trading (including high frequency trading) and earnings-based investment.[39]

Admittedly, there is still no academic consensus on the degree of severity of the problem of short-termism in capital markets. Roe, writing from a US perspective, recently argued that, although there has been a dramatic rise in share trading, as anticipated by those believing that short-termism drives capital markets, the predicted negative impact of short-termism on corporate R&D[40] investment has not materialised.[41]

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[36] This has led formerly unwavering supporters of efficient markets to adopt more nuanced views. See e.g. M.C. Jensen, 'Agency Costs of Overvalued Equity' (2005) 34 *Financial Management* 5; and R.J. Gilson and R.H. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' in J. Armour and J.A. McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford and Portland, OR: Hart, 2006). For an overview of available evidence on the informational efficiency of capital markets, see A. Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford: OUP, 2000).

[37] See e.g. D. Laibson, 'Golden Eggs and Hyperbolic Discounting' (1997) 112 *The Quarterly Journal of Economics* 443. For a concise discussion of prospect theory in behavioural economics research, see A. Kokkinis, 'Exploring the Effects of the 'Bonus Cap' Rule: the Impact of Remuneration Structure on Risk-Taking by Bank Managers' (2019) *Journal of Corporate Law Studies* 167, 179 – 182.

[38] Even shareholders who are aware of the fact the share prices are overvalued due to short-term gains, may still retain their shares and ride the bubble with a view to selling their shares before the bubble bursts. See K. Greenfield, 'The Puzzle of Short-Termism' (2011) 46 *Wake Forest Law Review* 627, 636.

[39] See M.T. Moore, and E. Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 *Journal of Law and Society* 416, 424 – 427.

[40] This stands for 'research and development'.

[41] M.J. Roe, 'Stock Market Short-Termism's Impact' (2018) ECGI Working Paper N° 426/2018 http://ssrn.com/abstract_id=3171090.

This is substantiated by evidence on extensive R&D investment by US tech-oriented companies, such as Amazon, Apple, Facebook, Google, and Microsoft.[42] However, most of these companies are controlled by their founders, often through devices such as dual-class shares,[43] and thus are not typical 'Berle and Means corporations'[44] where share ownership is dispersed and separated from control which lies with the board. It is evident that the R&D investment preferences of controlling shareholders are likely to be long-term-oriented and having control, these individuals are likely to resist short-termist pressures from the market. At any rate, our analysis is focused on the UK where there is extensive evidence of decreasing R&D investment[45] and of costly equity market short-termism.[46]

Arguably, employee participation is a typical example of a governance structure that incurs considerable upfront costs (setting up the structure and adapting to the new way of making decisions), while its benefits only materialise in the long term. It takes time for employees to develop firm-specific skills, to change their mentality in favour of stronger motivation and to become effective corporate governance actors. Furthermore, as short-termist shareholders tend to focus on the fluctuation of the share price rather than on analysing the fundamental features of companies, they are unlikely to engage with the governance needs of each individual company.[47] Employee participation is likely to be beneficial for many but not for all companies, and therefore assessing whether its introduction would be desirable for a given company requires close engagement. Instead,

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[42] See ibid, 28 – 30.

[43] Bezos has voting control of approximately 16% of Amazon's shares, while Google, Facebook, LinkedIn Groupon, Snap, Trip Advisor and Zynga are controlled by their founders through dual-class share structures, i.e. shares carrying multiple votes. For a critique of perpetual dual-class shares, see L.A. Bebchuk and K. Kastiel, 'The Untenable Case for Perpetual Dual-Class Stock' (2017) 103 *Virginia Law Review* 585.

[44] This term refers to Berle and Means' groundbreaking 1932 empirical study. See A. Berle and G Means, *The Modern Corporation and Private Property* (rev edn, New York, NY, Harcourt, Brace & World, 1967).

[45] See J. Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report' (2012) [1.8] https://www.gov.uk/government/news/kay-reviewpublishes-report-on-uk-financial-sector.

[46] For instance, Davies *et al* conclude that there is 'a quantitatively significant degree of short-termism in capital markets, whether measured by the cost of capital or investment intentions'. See R. Davies, A.G. Haldane, M. Nielsen and S. Pezzini, 'Measuring the Costs of Short-Termism' (2014) 12 *Journal of Financial Stability* 16, 25.

[47] Empirical studies conducted in the past are not conclusive as to whether shareholder activism is crucial to improving companies' performance or simply irrelevant. Regardless of the negative or positive effect of this kind of activism, it could be said that in theory it is preferable to have a certain amount of indirect pressure from asset managers or asset owners of the shares, which will possibly alert the company's management and avert certain deficiencies in conducting business: S.L. Gillan and L.T. Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 *Journal of Applied Corporate Finance* 55; R. Romano, 'Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance' (2001) 18 *Yale Journal on Regulation* 174.

UK investors tend to promote uniform standards of good governance across the sector, without due regard to the individual governance needs of each company.[48] One of the major viaducts of lack of investor engagement and short-termism is the long chain of intermediation and, especially, the fixation of pension fund and investment fund trustees with prevailing investment practices, [49] including passive investment, high-frequency trading and earnings-based investment.

A further reason that explains investor negativity to employee participation is the status quo bias. This is a well-documented phenomenon whereby consumers are unlikely to deviate from default options to the effect that their ultimate choice is heavily influenced by the way the default option is set.[50] In our context, the default option is exclusive shareholder voting rights with no employee participation.[51] Bias in this context can be particularly strong due to the combination of the status quo bias with the endowment effect, that is, the irrational overvaluing of things to which individuals feel entitled.[52] As the default option is one where a form of "ownership right" is assigned to investors they will have the tendency to overvalue it and thus be reluctant to "sell" parts of it, even if doing so would be economically beneficial.

A counterargument could be drawn from the fact that employee participation is also rarely observed in large private companies that are not exposed to capital market short-termism. But such companies are also not exposed to capital market discipline so there is no reason to assume that their governance structure is optimal in the first place. In any case, short-termism also affects companies supported by private equity, in view of the not so long investment horizons and the fact that it is common for these companies to be eventually (re-)admitted to trading on the stock exchange, which means that the

[48] On this, see M.T. Moore, 'Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance' (2009) 9 *Journal of Corporate Law Studies* 95. On the broader issue of lack of shareholder engagement with investee companies, see B.R. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 *Modern Law Review* 985.

[49] This is partly due to their fiduciary duty to exercise prudence and partly to their business models. On this, see R.M. Barker and I. H.-Y. Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Cheltenham: Edward Elgar, 2017) 93 – 102.

[50] On this, see R. Korobkin, 'The Status Quo Bias and Contract Default Rules' (1997) 83 *Cornell Law Review* 608, esp. 625–47.

[51] Nothing in English company law prevents the articles of association of companies from assigning director appointment rights to employees. But section 168 of the Companies Act 2006, which is mandatory law, provides that any director can be removed by ordinary resolution of the members at any time.

[52] For experimental evidence on this, see D. Kahneman, J.L. Knetsch and R.H. Thaler, 'Experimental Tests of the Endowment Effect and the Coase Theorem' (1990) 98 *Journal of Political Economy* 1325; and L. Babcock and G. Loewenstein, 'Explaining Bargaining Impasse: The Role of Self-Serving Biases' (1997) 11 *Journal of Economic Perspectives* 109.

expectations of the capital market remain relevant.[53] As far as family firms are concerned, another significant category of large private companies, the status quo bias and endowment effect can explain the rare adoption of employee participation.

In addition to the aforementioned investor mentality, we argue that the lack of a sound investment culture and of investment educational efforts[54] contributes inevitably to the furtherance of cognitive limitations, by further constraining market actors' capacity to conceive of employee participation as an opportunity to contribute to a company's long-term economic growth, including their own interests, and no longer as a costly scenario. Indeed, we believe that employee participation has not been accepted as legitimate practice by most UK companies due to the wider communication gaps between corporate constituencies and the lack of education in capital markets. Isolating economic interests and dissociating them from the workforce results in perceiving employee participation as limited to collective bargaining and ultimately irrelevant in the shaping of a corporate governance system. Moreover, investment trends have shown a shift towards sustainable finance, and they perceive income inequality and the lack of balance between management and workforce as a risk.[55] This new trend, coupled with strong public policy support both in the UK[56] and in the EU,[57] may thus trigger a real change in the way investors perceive employee participation and seek to convince investee companies to adjust to these new challenges.

While education[58] in capital markets may be viewed as an idealistic or utopic goal, we must remember that such markets are still composed of individuals who seek profit regardless of their position, responsibilities or power, as well as the possibility or willingness for interaction with other participants. If the market has become fragmented and interaction between actors remains – in many cases – dysfunctional, lawmakers must

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[53] For a discussion of private equity transactions, see L. Gullifer and J. Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Oxford and Portland, Oregon, Hart Publishing, 2015) ch 16.

[54] On this, see K. Sergakis, *The Law of Capital Markets in the EU* (London: Palgrave Macmillan, 2018) 13 – 14.

[55] See The Investment Integration Project, 'Why and How Investors Can Respond to Income Inequality' (2018) https://www.unpri.org/academic-research/why-and-how-investors-can-respond-to-income-inequality-/3777.article. See also Workforce Disclosure Initiative, 'Improving the Quality of Jobs: Pilot Year Report' (2018) https://shareaction.org/wp-content/uploads/2018/04/WDI-Pilot-Year-Report.pdf.

[56] Financial Conduct Authority, 'Climate Change and Green Finance' (2018) Discussion Paper 18/8 https://www.fca.org.uk/publication/discussion/dp18-08.pdf.

[57] D. Busch, G. Ferrarini and A. van den Hurk, 'The European Commission's Sustainable Finance Action Plan' (2018) https://ssrn.com/abstract=3263690.

[58] On investor education, see N. Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge: CUP, 2010) 374.

find ways to change the dynamics of this system and to place some common principles at the heart of the investment community. These principles should be the common perception of the primary purpose of capital markets, corporations and investment. Although the content of these principles continues to be hotly debated and a common solution to the satisfaction of all parties cannot easily be reached, the purpose of educational efforts will be to reorient their short-term goals for profit and show them that if they work collectively they may have a chance of achieving the same profit under a long-term perspective without compromising their position, while preserving the stability of the system since speculation would not be their unique goal in the market.[59] On the contrary, a reinterpretation of shareholder role within companies as the rational negotiators of a new bargain with employees would be necessary to accept the transition to a new state of affairs wherein employees will become a vital component for growing the corporate pie.

To sum up, the absence of employee participation from the majority of listed public companies in countries where it is not mandated by the law does not in itself establish that employee participation is inefficient. Short-termism and behavioural biases among investors prevent them from perceiving employee participation as a driver for growth of the 'corporate pie' which they would still be able to negotiate how to divide, without foregoing their prerogatives. This explains the reluctance of corporate managers to experiment with employee participation. At the same time, economic analysis suggests that there are normally strong benefits in combining control rights with a residual interest in the company, which points towards the merits of employee share ownership schemes. It is up to companies and their equity investors to assess whether employee participation would be beneficial for them and what would be the best means to implement it.

Qualitative arguments supporting the value of employee participation in the governance of modern UK companies

A system, such as the current UK one, that strongly protects shareholder interests via an active market for corporate control[60] and performance-based executive remuneration is

[59] On these new priorities, see K. Sergakis, 'Deconstruction and Reconstruction of the "Comply or Explain" Principle in EU Capital Markets' (2015) 5(3) *Accounting, Economics and Law: A Convivium* 233, 282.

[60] As Kershaw observes: 'Therefore, perhaps slightly counter intuitively, an effective market for corporate control unhindered by anti-takeover defences and anti-takeover statutes may be more conducive to employee strategic representation.' Kershaw (n 16 above) 53.

more likely to be improved by the introduction of employee participation than a system of weak shareholders. This is because the financial incentives created by the market for corporate control and executive remuneration closely align the behaviour of managers with the interests of shareholders. Such structures are likely to be sufficient to entice investors to invest even without exclusive voting rights. Conversely, the absence of labour participation in the present system leads to a high risk of opportunistic behaviour against employees, which will lead to reduced firm-specific investment and productivity.[61] In other words, while shareholders were weak, takeovers were rare and executive remuneration was not tied to performance, the absence of labour participation was necessary to persuade investors to invest without demanding a prohibitively high premium. It was also unlikely to lead to negative outcomes in terms of productivity, due to the broad discretion enjoyed in practice by corporate boards to balance the interests of capital and labour.[62] At present, however, the increased safeguards provided to shareholders make labour participation both more feasible and more beneficial.

In parallel, given that collective labour law functions as a substitute for labour participation in corporate governance, the benefits of introducing labour participation are reduced. This was arguably the case in the UK until the 1980s when strong trade unions and extensive coverage of collective bargaining agreements provided some safeguards for employees to make firm-specific investments in the absence of board representation. However, in recent years trade union membership and collective bargaining coverage in the UK have reduced dramatically, and they currently stand at 26% and 29% respectively.[63] It follows that the potential economic significance of labour participation in corporate governance for the UK economy has increased and is continuing to increase in tandem with the weakening of unionised labour.

An additional argument concerns the nature of work that most workers provide now compared to a few decades ago. If the output of work is easy to measure, it is easy

[61] Indeed, Deakin and others conclude that the UK corporate governance framework constrains managers' ability to make credible long-term commitments to employees, which undermines the development of effective labour-management partnerships unless a critical mass of institutional investors take a long-term perspective. See S. Deakin, R. Hobbs, S. Konzelmann, and F. Wilkinson, 'Partnership, Ownership and Control: The Impact of Corporate Governance on Employment Relations' (2002) 24 *Employee Relations* 335.

[62] In the UK and the US, this period lasted from the end of World War II until the mid-1970s, when the current outsider system emerged. On this, see A. Dignam and M. Galanis, *The Globalisation of Corporate Governance* (Surrey: Ashgate, 2009) 221 – 227.

[63] These data was taken from a specialist website created by ETUI: http://www.worker-participation.eu/National-Industrial-Relations/Countries/United-Kingdom.

for management to ensure that workers are optimally productive by setting up appropriate individualised incentives. If, however, the nature of work is such that its outcome is hard to value and to apportion to individual workers, monitoring by management becomes very difficult. In such circumstances, employee participation can act as a powerful incentive to maximise productivity, which can be more cost-effective than monitoring and individual assessment. Arguably, work in recent years has become more creative and intellectual capital is the main competitive advantage for successful companies.[64] This suggests that in the modern economy, which is dominated by the services sector and where the majority of work is creative and collaborative, the benefits of labour participation have increased compared to the post-war manufacturing-based economy.[65] In many specialised services, the quality of work is difficult to observe externally by anyone who does not have the same level of skill as the worker, at least without spending a disproportionate amount of time scrutinising the output.

Finally, it must be noted that a significant potential benefit of employee participation, namely, increased labour productivity, is particularly important for the UK economy, which suffers from a long-term lag in productivity compared to other major economies.[66] Indeed, in 2016, UK hourly labour productivity was significantly lower than in Italy, Germany, France and the US. It was at a par with Canada and in excess of Japan's productivity.[67]

However, some proponents of shareholder-based governance have argued that, even if this type of governance may not always be superior to alternatives, it is definitely necessary for radical innovation.[68] It would thus appear that hybrid governance hampers such innovation because employee governance rights may block decisions, such as

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[64] S.M. Jacoby, 'Corporate Governance and Employees in the United States' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005) 45 – 46.

[65] This argument is consistent with the rationale of arguments in favour of a stakeholder approach in the era of the knowledge economy. See e.g. T. Clarke, 'The Stakeholder Corporation: A Business Philosophy for the Information Age' (1998) 31 *Long Range Planning* 182.

[66] According to some accounts, the cost to the UK economy of the lack of 'clear corporate purposes that unite all stakeholders in common goals and values' amounts to £130 billion per year. See Big Innovation Centre, 'The Purposeful Company: Interim Report' (2016) 4 http://biginnovationcentre.com/purposeful-company

[67] Office for National Statistics, *International comparisons of UK productivity (ICP), final estimates: 2016* (2018) https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/internationalcomparisonsofproductivityfinalestimates/2016.

[68] F. Belloc, 'Law, Finance and Innovation: The Dark Side of Shareholder Protection' (2013) 37(4) *Cambridge Journal of Economics* 863; A. Shleifer and L. Summers, 'Breach of Trust in Hostile Takeovers' in A. Auerbach (ed.) *Corporate Takeovers: Causes and Consequences* (Chicago, IL: University of Chicago Press, 1988).

massive redundancies that are occasionally necessary for firms to be able to adjust to fast-paced market changes. Hybrid governance may also render shareholders subject to potential opportunism by employees.[69] Nevertheless, the persistence of founder-entrepreneur majority voting control in many high-tech innovative companies[70] undermines the argument that capital markets, associated with external investor discipline, promote radical innovation. If the founders of such companies opt for insulating their business strategy from short-term market pressures that may result in high turnover in their workforce, they contribute indirectly towards security of employment and the development of firm-specific skills. The ensuing benefits on employees engaging with companies in the long-term under such conditions denotes the possibility of a harmonious symbiosis between radical innovation and hybrid governance.

It is therefore unsurprising that in recent years there has been an increasing interest on behalf of firms and regulators in employee participation. For instance, Andy Haldane, the Bank of England executive director for financial stability, has argued that putting workers on boards would be economically beneficial, and that employee-owned firms perform better than corporations.[71] Furthermore, a recent policy report issued by ICAEW argues that employee directors would add value to UK companies by providing valuable information to the board, supporting long-term thinking, boosting employee morale, enhancing wider stakeholder engagement, and improving board behaviour.[72] Indeed, it must be noted that employees would be likely to use corporate governance voice also to exert pressure on companies towards adopting ethical corporate behaviour, as indicated by recent employee-driven campaigns involving large US technology companies such as Google.[73] The purpose of the rest of this article is to canvass a workable model that UK companies can adopt in order to implement meaningful employee participation.

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[69] H. Shadab, 'Innovation and Corporate Governance: The Impact of Sarbanes–Oxley' (2007) 10(4) *University of Pennsylvania Journal of Business and Employment Law* 955.

[70] See footnotes 42 and 43 and accompanying text.

[71] P. Aldrick, 'Bank of England's Haldane Supports Workers on Boards' The Times (London: 28 September 2018) https://www.thetimes.co.uk/article/bank-of-england-s-haldane-supports-workers-on-boards-xc3jxqr9v.

[72] ICAEW, 'How Employee Directors Add Value' (2018) https://www.icaew.com/-/media/corporate/files/technical/corporate-governance/connect-and-reflect/how-employee-directors-add-value.ashx

[73] See S. Shane and D. Wakabayash, "The Business of War': Google Employees Protest Work for the Pentagon' *The New York Times* (New York, NY, 4 April 2018).

THE ROLE OF LABOUR IN UK CORPORATE GOVERANCE: EVOLUTION AND RECENT DEVELOPMENTS

To design a pragmatic model for employee participation in UK companies it is pertinent to understand the relevant broader features of UK corporate governance and the history of ideas around employee participation in the UK. It is generally recognised that developed market economies can be categorised as either liberal market economies (notably the US, the UK and Canada) or coordinated market economies (notably Germany, Japan and the Nordic countries).[74] In terms of corporate governance, liberal market economies are characterised by diffuse share ownership, deep capital markets, an active market for corporate control and shareholder value maximisation, underpinned by strong legal protection of investors.[75] Coordinated market economies are characterised by concentrated ownership, heavy reliance of corporations on bank lending, a relatively inactive market for corporate control and balancing the interests of all stakeholders.[76]

The starkest difference between the two models is perhaps in the role of labour, which in Anglo-American corporate governance is viewed as external to the firm, whereas in central European corporate governance is viewed as internal. Since the 2008 global financial crisis, interest in the continental European model of corporate governance has increased both in the UK and internationally, while at the same time the Anglo-American model has been under heavy criticism on account of its undue emphasis on short-term profitability at the expense of economic and social sustainability.[77] Dignam and Galanis, for instance, conclude their comparative study of the Anglo-American (external) and central European (internal) models by speculating that the latter may now

[74] For a comparative analysis of German and UK capitalism, see S. Vitols, 'Varieties of Capitalism: Comparing Germany and the UK' in P.A. Hall and D. Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: OUP, 2001).

[75] The question remains whether protective corporate and securities laws are a determinant of diffuse share ownership or a consequence of it. The former view is supported by R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 'Corporate Ownership Around the World' (1999) 54 *Journal of Finance* 471. Roe has also argued that employee participation is harmful for shareholders and therefore that in countries with mandatory employee participation separation of ownership from control cannot occur, as concentrated ownership counterbalances the strength of labour. See M.J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (Oxford: OUP, 2003). The latter view is taken by B.R. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford: OUP, 2008) 33 – 40.

[76] See Dignam and Galanis (n 62 above) ch 2.

[77] For an overview of recent critical UK corporate law and governance literature, and a radical critique of the current system, see L.E. Talbot, 'Trying to Save the World with Company Law? Some Problems' (2016) 36 *Legal Studies* 513. See also C. Meyer, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* (Oxford: OUP, 2013).

have a chance of resisting convergence pressures by globalised markets due to the reduced credibility of the Anglo-American model as a result of the crisis.[78]

Historical evolution of ideas surrounding employee participation in the UK

UK firms have traditionally been highly reluctant to consider employee representation at board level.[79] Rather, labour has long been seen as external to the corporation and the relationship between employees, on the one hand, and shareholders and management, on the other, has historically been highly adversarial and organised around collective bargaining and industrial action.[80]

In the UK, until the 1970s the labour movement and Labour Party did not focus on the possibility of labour participation in corporate governance, as their preferred course was nationalisation of large companies, which would have made participation redundant.[81] This changed in 1975 when the Labour government appointed a committee to examine employee representation on boards. The committee was chaired by Lord Bullock and produced its final report in 1976.[82] Consistent with the prevailing political context of the 1970s, the Bullock Report was framed in terms of industrial democracy and democracy at the workplace rather than economic efficiency and business expediency, although considerations of efficiency were also prominent in the committee's deliberations.[83] The committee did not manage to reach consensus. The members who represented employers' associations disagreed with other members and refused to sign off on the report. They were in favour of encouraging companies to engage with employees and, where appropriate, put in place board representation for employees, but firmly against any mandatory legal rules forcing companies to have

[78] Dignam and Galanis (n 62 above) 413 – 419.

[79] For a brief discussion of early exceptions to this trend, see n 85 below.

[80] The dominance of the adversarial model of industrial relations is evident in Moore's analysis. See M.T. Moore, 'Reconstituting Labour Market Freedom: Corporate Governance and Collective Worker Counterbalance' (2014) 43 *Industrial Law Journal* 398.

[81] For a detailed account of the views of Labour thinkers, politicians and trade unions on industrial democracy until the 1970s, see B. Clift, A. Gamble and M. Harris, 'The Labour Party and the Company' in J. Parkinson, A Gamble and G. Kelly (eds), *The Political Economy of the Company* (Oxford and Portland, OR: Hart Publishing, 2000) 54 – 76.

[82] Department of Trade, *Report of the Committee of Inquiry on Industrial Democracy* (Cmnd 6706, 1977). Thereafter abbreviated as the 'Bullock Report'.

[83] Bullock Report 22 – 23 but also 45 – 46. For a contemporary discussion of the concept of democracy in the workplace, see R. Archer, 'Freedom, Democracy, and Capitalism: Ethics and Employee Participation' in A. Wilkinson, P.J. Gollan, M. Marchington and D. Lewin (eds), *The Oxford Handbook of Participation in Organisations* (Oxford: OUP, 2010).

employee representation on their boards.[84] A different approach was taken by the Industrial Participation Association, which was in favour of legally mandating companies to negotiate with their workforce for a given period of time in order to reach an agreement on employee representation. Failing agreement, they proposed that the law should, by default, impose the election of one-third of the board by the employees.[85]

Conversely, trade union representatives were supportive of employee board representation, cautioning, however, that such a system must not undermine collective bargaining and that representation must be achieved through the unions.[86] Eventually, the committee's report recommended a system quite similar to German full-parity codetermination, but insisted on the merit of unitary boards. Under the committee's recommendations, boards would consist of equal numbers of shareholder and employee representatives, plus a component of neutral directors who would be co-opted by the two groups.[87] The neutral directors would not exceed one-third of the board and their number would be odd so that the total number of board members would be odd. The size of the board would depend on the size of each company's workforce, as shown in Table 2 below. The negative stance of several trade unions and the equanimity of the Labour government of the time meant that these proposals were never implemented.[88]

An initial assessment of this historical account of employee representation in the UK shows the considerable disparity of opinions, not simply between politicians and stakeholders, but also amongst stakeholders themselves. The resistance to achieving a commonly shared solution inevitably has cultural roots, by determining each party's idiosyncrasies and beliefs in relation to employee participation. Our proposals reflect these features by arguing that such discrepancies have become economically costly and inefficient. In order to maximise the economic benefits of employee participation for companies, we propose two steps that will allow for a gradual elevation of mentalities across the board: the introduction of formal advisory panels, and the subsequent appointment of employees to the board via employee share ownership schemes. At the same time, the public policy emphasis on shareholder value maximisation since the 1980s

[84] Bullock Report 30 – 33.

[85] Bullock Report 32.

[86] According to the TUC, 'Another source of concern was that board representation might conflict with the traditional role of trade unions, which is seen as one opposing management in collective bargaining, not collaborating with it on the board.' Bullock Report 39.

[87] Bullock Report 98 – 101.

[88] For a detailed discussion of the politics surrounding the abandonment of the Bullock Report, see Clift, Gamble and Harris (n 81 above) 78 – 80.

can be explained by the emergence of UK occupational pension funds and other domestic institutional investors as major shareholders, a trend now partially reversed.[89]

Table 1. Recommended board structure by the Bullock Report

	Employee representatives	Shareholder representatives	Max. neutral directors	Max. board size
2,000 - 9,999 employees	4	4	3	11
10,000 - 24,999 employees	5	5	5	15
25,000 or more employees	7	7	7	21

As a result, in the UK, there has never been any compulsory legal requirement for companies to have employee representation on the board. Of course, there have historically been several cases of voluntary adoption of employee board representation, particularly by nationalised corporations.[90]

Legal framework facilitating employee share ownership

Instead, since the 1980s, UK policy has focused on employee share ownership,[91] as an alternative to direct participation in corporate governance.[92] The law grants considerable tax advantages to employees who own shares via an eligible scheme. This evidently

[89] For an in-depth exploration of the politics surrounding the trend of increased share ownership by occupational pension funds in the 1970s and 1980s, see A. Davies, 'Pension Funds and the Politics of Ownership in Britain, c. 1970–86' (2019) 30 *Twentieth Century British History* 81.

[90] An example of this was the British Steel Corporation where three ordinary employees were chosen randomly to sit on the boards of some of the four main subsidiaries of the group. A qualitative study on worker participation in the British Steel Corporation from 1969 to 1971 found that worker directors did not feel that they had been influential and that the main impact of their involvement was that many of them stopped complying with their line managers' instructions. See P. Brannen and others, *The Worker Directors* (London: Hutchinson & Co, 1976) 141 – 184. More recently, FirstGroup plc has had one worker director since 1989.

[91] For a general discussion, see E. Kaarsemaker, A. Pendleton and E. Poutsma, 'Employee Share Ownership' in A. Wilkinson, P.J. Gollan, M. Marchington and D. Lewin (eds), *The Oxford Handbook of Participation in Organisations* (Oxford: OUP, 2010).

[92] For a discussion of employee share ownership plans in the US, see S.M. Jacoby, 'Corporate Governance and Employees in the United States' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005) 45, 53 – 54.

incentivises employees to opt into such schemes and companies to use them. Although a detailed doctrinal examination of the relevant legal rules falls beyond the scope of this paper,[93] it is pertinent to provide an overview of available schemes. Share Incentive Plans (SIPs) constitute the main available channel to grant shares to employees. If such shares are kept for five years, there is no liability for income tax and national insurance contributions on their value. Shares under SIPs may be granted in four ways. Employers may grant free shares up to £3,600 in any tax year. Employees can purchase shares out of their salary (called partnership shares) up to the lower of either £1,800 or 10% of their income during the given tax year. If employees purchase partnership shares, employers can match them with up to two free matching shares for each partnership share. In addition, employees can buy more shares using the dividends they receive from free, partnership or matching shares, provided that the rules of the employer's scheme allow that.[94] Furthermore, employees can take advantage of the Save As You Earn (SAYE) scheme to save up to £500 a month for either three or five years, and at the end use the savings and interest to buy shares at a previously agreed price, without having to pay tax for the difference between what they pay for their shares and their value at the time of purchase.[95]

It is also worth noting that special company law rules in the areas of capital raising and maintenance facilitate employee share ownership schemes. The Companies Act 2006 defines an employees' share scheme as 'a scheme for encouraging or facilitating the holding of shares in or debentures of a company by or for the benefit' of any employees or former employees of the company and its subsidiaries and their close family members.[96] The term employees also covers directors.[97] Shares allotted under such schemes are exempted from the normal requirement for shareholder authorisation to allot new shares,[98] from shareholders' pre-emption rights,[99] and from the requirement that 25% of the value of the shares allotted by a public company must be paid-up.[100] The

[93] Such beneficial treatment was introduced by the Finance Act 1972 and strengthened by subsequent Finance Acts in 1973, 1978, 1980 and 1984. For an in-depth evaluation of such schemes and the effects of favourable tax treatment, see R. Richardson and A. Nejad, 'Employee Share Ownership Schemes in the UK – an Evaluation' (1986) 24 *British Journal of Industrial Relations* 233.
[94] Information is taken from https://www.gov.uk/tax-employee-share-schemes.
[95] Ibid.
[96] Companies Act 2006, s 1166.
[97] Companies Act 2006, s 676.
[98] Companies Act 2006, s 549 (2).
[99] Companies Act 2006, s 566.
[100] Companies Act 2006, s 586 (2).

provision of financial assistance for the purchase of shares under an employees' share scheme is also permitted.[101]

The Corporate Governance Code 2018 regime on engaging with the workforce

In terms of a direct employee voice in corporate governance, the matter returned to the government's agenda in 2016 when Theresa May became Prime Minister. Despite the Prime Minister's prior statements on the matter, the UK government refrained from supporting any hard law rules requiring listed companies to put in place a system of participation, but rather, it highlighted the importance of encouraging firms to 'gather the views of the workforce' in flexible ways. Indeed, following a government policy paper,[102] the Financial Reporting Council (FRC) made changes to the UK Corporate Governance Code, with effect from 1 January 2019.

The new edition of the Code requires companies to engage with their workforce by using one – or a combination – of the following methods.[103] First, having a director appointed from the workforce of the company. Second, establishing a formal workforce advisory panel. Third, designating one of the non-executive directors as responsible for liaising with workers and gathering their views. Evidently, the latter option is less onerous than the other two and, in any case, the new provision is only applicable on a comply-or-explain basis.[104] In particular, any companies refusing to adopt one of the three recommended methods of engagement will have to explain what alternative methods they have in place, and why they believe them to be effective. Therefore, listed companies remain free to design the process by which they engage with employees as they think fit, provided that investors are satisfied with the explanation offered.

[101] Companies Act 2006, s 682 (2) (b).

[102] See Department for Business, Energy and Industrial Strategy, 'Corporate Governance Reform: The Government Response to the Green Paper Consultation' (2017) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf.

[103] UK Corporate Governance Code 2018, Provision 5. See also Financial Reporting Council, 'Proposed Revisions to the UK Corporate Governance Code' (2017) https://www.frc.org.uk/getattachment/f7366d6f-aa57-4134-a409-1362d220445b/;.aspx.

[104] On this principle, see A. Keay, 'Comply or Explain: In Need of Greater Regulatory Oversight?' (2014) 34(2) *Legal Studies* 279; K. Sergakis, 'EU Corporate Governance: A New Supervisory Mechanism for the 'Comply or Explain' Principle?' (2013) 3 *European Company and Financial Law Review* 394; P. Sanderson, D. Seidl and J. Roberts, 'Applying the 'Comply-or-Explain' Principle: Discursive Legitimacy Tactics with regard to Codes of Corporate Governance' (2012) *Journal of Management and Governance* 1.

It follows that the effectiveness of the new provision of the Code will depend on whether there is sufficient market pressure on companies to comply with it, expressed both via *ex ante* (engagement and other activism strategies) and *ex post* (reputational sanctions and other social enforcement) measures. Empirical evidence on the efficiency of market pressure in the area of issuer disclosure of compliance with corporate governance code provisions can be particularly useful in this context. Indeed, taking as a case study the use of the 'comply or explain' principle by issuers, investors who receive the related information tend to remain apathetic even if the company does not provide sufficient explanation for non-compliance with a code, especially in cases where its operations are profitable.[105] This apathy towards 'non-compliance' – which only transforms itself into interest when corporate strategies create losses – is an alarming message for the usefulness and overall impact of social enforcement, based on the example of the perception of the 'comply or explain' principle.

Applying *mutatis mutandis* the empirical evidence to the employee representation issues and the three options given above, we could argue that, if potentially harmed investors are solely concerned about avoiding the losses arising from not following any of the employee engagement options, and if the concerned issuers are sanctioned at the social level only when their actions harm investors, then social enforcement loses its importance in this context. Indeed, actors will be unlikely to react unless their own financial interests are harmed, notwithstanding the presence of an event that should in theory trigger a negative reaction. The reprioritisation of investor strategies therefore lies in understanding the need to react to all infringements, even when investors themselves are not directly harmed, and to avoid adopting a single-minded view of such violations.

As far as investors are concerned, establishing a dialogue with the workforce is not a matter that is directly in their interests, contrary to other measures such as having independent board committees or separating the roles of chairman of the board and CEO.[106] There are reasons to doubt the emphasis that institutional investors will place on demanding compliance in this area.[107] Conversely, it is conceivable that the growing trend

[105] S. Arcot, V. Bruno and A.F. Grimaud, 'Corporate Governance in the UK: Is the Comply or Explain Approach Working?' (2010) 30 *International Review of Law and Economics* 99. See also I. MacNeil and X. Li, 'Comply or Explain: Market Discipline and Non-Compliance with the Combined Code' (2006) 14 *Corporate Governance: An International Review* 486.

[106] For a brief case study on the insistence of institutional investors on the separation of the roles of CEO and board chairman, see Moore (n 48 above) 102 – 104.

[107] For a similar argument relating to institutional investor stewardship duties, see B.R. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 *Modern Law Review* 985.

towards socially responsible investment and the integration of environmental, social and governance (ESG) criteria in investment strategies may lead to increased interest in encouraging companies to take more inclusive approaches to corporate governance and to focus on social sustainability, which includes dialogue with employees.[108] More recently, the Investment Integration Project published a report highlighting the risks deriving, *inter alia*, from deficiencies in employee relations that can further exacerbate income inequality and also lead to investor losses.[109] Employee disenchantment may very well become a real economic risk that will alarm investors and will incentivise them to exert pressure on companies to address it in a meaningful way. The report further mentions that investors can contribute to a system that encourages a balance between cost controls and responsibility towards the workforce with the aim of promoting productivity, equality and company reputation.[110] This assessment of the importance of establishing responsibility towards the workforce is perfectly aligned with our proposals that aim, to enhance corporate productivity and the quality of decision-making by reinforcing employees' role in decision-making processes.

Companies may, of course, instrumentalise this investment sustainability trend by seeking to capitalise on its attractiveness and emerging popularity, by choosing one of the three options in a purely 'formalistic compliance' mind-set, without truly engaging with employee representation matters. Even if such concerns are realistic, we argue that instrumentalisation-driven actions are better than no actions at the company level and that employees will still benefit from being given a communication channel with the company board. It is their gradual empowerment and potential to further increase their importance within companies that should neutralise these concerns.

One useful source of insight regarding the attitude of management and the City professional community towards the matter is the responses to the recent FRC consultation on the amendment of the Code.[111] Unsurprisingly, most companies and

[108] An overview of sustainable investing can be found at Global Sustainable Investment Alliance, 'Global Sustainable Investment Review' (2014) www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf.

[109] Due to the detrimental effects of income inequality, such as populism, political extremism, financial and social instability, and reduced economic growth. See TIIP, 'Why and How Investors Can Respond to Income Inequality' (2018) https://www.unpri.org/academic-research/why-and-how-investors-can-respond-to-income-inequality-/3777.article.

[110] Ibid, 9.

[111] All responses can be found online at: https://www.frc.org.uk/consultation-list/2017/consulting-on-a-revised-uk-corporate-governance-co.

professional associations are on the surface supportive of establishing meaningful dialogue with employees, but at the same time they are keen to retain maximum flexibility in designing relevant systems and processes and are concerned with the language of the proposed amendment to the Code, which they consider to be too prescriptive.[112] Nevertheless, the business community's broad support for the idea of employee engagement as an element of good corporate governance is in itself significant and marks a major change in attitudes towards this issue.

Employee participation's scope: Growing importance of large private companies

In recent times, employee participation in the UK has attracted a lot of regulatory attention given the employee status within listed companies which, besides its protection by labour law, is not recognised under a participatory corporate decision-making role, given the historical reasons mentioned earlier in this article. In parallel, arguing for employee participation and board representation in large private companies has not preoccupied either the academic literature or policy makers to any great extent. This is because such companies have been regarded as not needing wider participatory employee representation or involvement. This is due to traditional arguments related to the predominant role of shareholders within companies with concentrated ownership, the absence of capital market features and legal constraints, and the lesser importance of private companies, for the wider economy and society, compared with listed ones.

Nevertheless, such arguments have gradually lost momentum in the UK in light of serious corporate scandals in the private sector that blatantly revealed the economic and social impact of private companies' activities,[113] similarly to that of listed companies. It has now become apparent that the risks for employees are the same in both types of companies; this fact should serve as the normative justification for further reflection on the employees' role in decision-making processes to minimise detrimental corporate practices at their expense.

[112] That being said, some influential investors, such as BlackRock, expressed a negative view. They cautioned that: 'However, it is important that we highlight our concerns with employee representation in the UK model. The unintended consequence of mandating stakeholder representation on boards is the creation of separate classes of directors, thereby creating special interest groups. This may undermine the effectiveness of the board as it may curtail the ability of the board to fulfil its duty in the event that different stakeholders' interests are deemed to be in conflict.'

[113] The most notable example is the collapse of British Home Stores that led, *inter alia*, to the loss of 11,000 jobs. See Work and Pensions and Business, Innovation and Skills Committees, 'BHS' HC (2016-17) 54.

In the UK, the first sign of regulatory attention towards large private companies came in 2016 in a government policy paper.[114] A subsequent policy paper followed,[115] enabling the Department for Business, Energy and Industrial Strategy to set up a Coalition Group under the chairmanship of Mr James Wates.[116] The Coalition's mission was to consult on and lead the formation of the first set of corporate governance principles applicable to such companies. The Wates Principles were made public in December 2018,[117] and adopting these principles will be one way for companies to comply with the new legal requirements for corporate governance reporting for companies that either employ more than 2,000 employees or have both a turnover exceeding £200 million and a balance sheet exceeding £2 billion.[118]

In relation to the specific matter of employee participation in large private companies, Principle 6 'Stakeholder Relationships and Engagement' acknowledges that corporate boards are responsible for overseeing meaningful engagement with stakeholders, including employees, and for having regard to their views when making decisions. Principle 6 does not make specific reference to, nor does it dictate, any particular employee participation means. Instead, it refers in general terms to the need to develop a range of formal and informal dialogue channels between employees and senior management. Furthermore, it indicates that private companies are encouraged to have regard to the FRC's Guidance,[119] which includes, *inter alia*, the possibility to opt for one

[114] Department for Business, Energy and Industrial Strategy, 'Corporate Governance Reform Green Paper' (2016) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf.

[115] Ibid.

[116] The members of the Group were the FRC, British Private Equity and Venture Capital Association, the Climate Disclosure Standards Board, the Confederation of British Industry, ICSA: the Governance Institute, the Institute of Business Ethics, the Institute of Directors, the Institute for Family Business, the Investment Association, and the Trade Union Congress.

[117] FRC, 'The Wates Corporate Governance Principles for Large Private Companies' (2018) https://www.frc.org.uk/getattachment/31dfb844-6d4b-4093-9bfe-19cee2c29cda/Wates-Corporate-Governance-Principles-for-LPC-Dec-2018.pdf.

[118] Companies (Miscellaneous Reporting) Regulations 2018 (SI 2018/860). It should be mentioned that, contrary to other voluntary codes in the EU dealing with corporate governance requirements in private companies (e.g. Belgium, Italy and Slovenia), the Wates Principles constitute the first code with legal backing, testifying to the UK's political determination to move forward towards a generally-accepted need for the normativisation of corporate governance principles applicable to large private companies. For an overview of other national corporate governance codes applicable to private companies, see K. Sergakis, 'Written Response to the Wates Principles Public Consultation' (2018) https://www.frc.org.uk/getattachment/fa65a859-8322-4735-a588-858931f50fe4/Konstantino-Sergakis-response;.aspx.

[119] FRC, 'Guidance on the Strategic Report' (2018), 8.21

of the three options initially offered by the CG Code. Of course, these three options remain purely at the companies' discretion, as is the case with their eventual decision to adhere to the Wates Principles.

The type of market pressure that may apply to listed companies cannot be expected in large private companies that are also encouraged to adopt one of the three options, insofar as such companies do not have a dispersed investor base and are not required to comply with the specific requirements of capital markets. Nevertheless, there are other actors who regularly interact with large private companies (suppliers, third parties, NGOs and other stakeholders) and who could certainly exert pressure on such companies to take a more active stance on employee representation matters, as a result of the increased social awareness around employee representation issues.

Indeed, the distinction between listed and private companies may have started breaking down given the decreasing number of listings and the overall concerns raised about the capacity of stock markets to offer liquidity but not to help companies raise substantial capital that prompt companies to go private.[120] If such a distinction is gradually fading away, we could therefore argue that corporate governance requirements between listed and private companies could be merging in the future. Focusing on employee participation, it becomes rather irrelevant to employees and other stakeholders whether they are affected by the activities of a private or a listed company. Of course, some considerations that affect the rationales for employee participation will continue to differ to a certain extent.[121] Nevertheless, we argue that our proposals (which will be developed further in the next section) are suitable to both types of companies since they

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https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf.

[120] In the last two decades, the number of non-financial companies choosing IPOs and the average amount of equity raised have significantly declined. The amount of capital raised via listings has also declined, triggering an ongoing debate on the importance of capital markets for offering access to equity finance and their overall impact on innovation, productivity and economic growth: for an extensive analysis, see OECD, 'OECD Business and Finance Outlook 2016: Changing Business Models of Stock Exchanges and Stock Market Fragmentation' (2016) 132 https://www.oecd.org/daf/ca/BFO-2016-Ch4-Stock-Exchanges.pdf; B. Cournède, O. Denk and P. Hoeller, 'Finance and Inclusive Growth' (2015) OECD Economic Policy Papers, No. 14 http://www.oecd.org/eco/monetary/finance-growth-inequality.htm. On an early study examining the relationship between delistings and corporate governance standards, see S. Thomsen and V.F. Bonito, 'Delistings in Europe and the Costs of Governance' (2007) https://ssrn.com/abstract=986603.

[121] For example, dispersed versus concentrated ownership and the ensuing principle–agent problems and the need to balance different interests expressed by shareholders and stakeholders that may have a different weight and impact on companies and depending on their status.

aim to enable efficient employee participation at various levels within decision-making processes with sufficient flexibility.

It is worth noting that the UK is not the only 'shareholder primacy' oriented capitalist system that emphasises the need to hold large private companies to higher corporate governance standards, *inter alia*, via the employee participation route. Employee participation is gaining momentum in the US as one of the most cost-efficient means to reduce income inequality, and it is very interesting to note that the criterion for inclusion in the Act is not the company's status as listed or private, but its annual revenue.[122] Moreover, in Germany, codetermination rules are triggered by the size of the workforce irrespective of whether the company is listed or not.[123] Regulatory and political attention, therefore, seems to have shifted towards large companies' impact on stakeholders and society at large, and employee representation has become one means to ensure a sounder corporate governance system.

A PATHWAY FOR UK COMPANIES TO FOSTER EMPLOYEE PARTICIPATION AND BOARD REPRESENTATION

This section seeks to review ways in which large UK companies can efficiently implement employee participation and board representation. The point of departure is that although market failure (shareholder short-termism) *prima facie* justifies legal intervention to encourage employee participation, legal intervention often leads to greater costs than those it seeks to remedy. In light of the risk of unintended consequences and the lack of conclusive empirical evidence that employee participation is economically beneficial in general, we do not advocate for any legal or regulatory reforms at this stage. Our proposals are intended to be considered by UK companies, institutional investors, trade unions and professional organisations and seek to facilitate the voluntary adoption of employee participation schemes. The experience that will be gathered from such schemes, their level of adoption by companies, and the outcome of future empirical studies in the area should inform law making in the longer term.

[122] See Warren (n 3 above).

[123] Full parity codetermination applies to companies with 2,000 employees or more, while one-third representation to companies having 500 – 1999 employees. See W. Streeck, *Social Institutions and Economic Performance: Studies of Industrial Relations in Advanced Capitalist Economies* (London: SAGE, 1992) 138.

The specificities of the UK corporate governance model

Comparative studies of national corporate governance systems have long established the complementarity between various institutions. For instance, employee codetermination, strong collective labour voice, reliance on bank finance, concentrated share ownership, small capital markets and redistributive pension systems in Germany support each other and constitute a workable system.[124] Transposing one element only to the UK system would be likely to fail or, in the best case, to not bring any positive consequences. In particular, the hostility of UK investors towards employee board representation combined with the adversarial culture of organised labour,[125] and the reliance of UK companies on capital market financing would lead to adverse unintended consequences if a system similar to the German one were imposed on large UK companies by law. Such consequences would probably include a reduction in investment in UK companies and companies moving their headquarters to and listing in other jurisdictions to evade the scope of application of the legal rules in question. Moreover, the German system is conducive to incremental innovation, which is valuable to firms producing complex manufactured products, whereas the UK system encourages radical innovation, albeit imperfectly due to short-term capital market pressures, as discussed above, which is essential for firms in the high technology and finance sectors. As the UK economy comprises mostly firms that engage in radical innovation, introducing German-style codetermination would disrupt their ability to innovate while at the same time it would take a long time, if ever, for manufacturing firms to develop sufficiently to fill the gap that would be left by the loss of innovative firms.[126]

This is not to say, however, that a corporate governance system must conform fully to the archetypes of either the Anglo-Saxon or German models. No doubt, several

[124] On the workable complementarity between the main elements of the German system, at least until globalisation pressures began in the 1990s, see Dignam and Galanis (n 62 above) 300 – 302.

[125] On this notion, see M.T. Moore, 'Reconstituting Labour Market Freedom: Corporate Governance and Collective Worker Counterbalance' (2014) 43(4) *Industrial Law Journal* 398. That being said, the current position of the Trade Union Congress (TUC) is in favour of mandatory employee representation on corporate boards in the form of electing one third of directors. See J. Williamson, 'All Aboard: Making Worker Representation on Company Boards a Reality' (TUC Economic Report Series 2016) https://www.tuc.org.uk/sites/default/files/All_Aboard_2016.pdf .

[126] For a review of the relevant literature, see H. Gospel and A. Pendleton, 'Corporate Governance and Labour Management: An International Comparison' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005) 15 – 16.

mixed approaches have been historically successful.[127] It follows that the traditional dichotomy between the two models is no more than a simplification, as the actual picture of national systems is much more complicated and varied.[128] There is, therefore, scope for a country that predominantly follows one system to adopt elements from the other system insofar as these elements are adapted to its broader institutional framework.[129] On this basis, it is argued that employee participation in the UK ought to take a distinct route reflecting its institutional framework, and that companies should implemented participation gradually.

Employee advisory panels

In the first place, it is necessary to shift corporate culture vis-à-vis labour participation and to foster constructive dialogue between corporate management and employees, and a more long-term stance by institutional investors which would view the workforce as a valuable corporate governance partner rather than as an adversary.[130] An existing institution that is meant to facilitate dialogue is the new employee advisory panels that the Corporate Governance Code and the Wates Principles recommend as one of the options for listed and large private companies, respectively, to engage with their workforce. Indeed, such panels have the potential to improve corporate decision-making through the inclusion of the employee perspective, and to enable employees and their representatives to develop the necessary skills to act as effective governance players.

[127] An example of that is the Dutch system combining a focus on shareholder value and active capital market with strong protection of labour. On this, see E. Poutsma and G. Braam, 'Corporate Governance and Labour Management in the Netherlands: Getting the Best of Both Worlds?' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005).

[128] For a critique of the traditional varieties of capitalism thesis and a more nuanced taxonomy of national corporate governance models in OECD countries, see G. Jackson, 'Towards a Comparative Perspective on Corporate Governance and Labour Management: Enterprise Coalitions and National Trajectories' in H. Gospel and A. Pendleton (eds), *Corporate Governance and Labour Management: An International Comparison* (Oxford: OUP, 2005).

[129] Germany, for instance, has adopted several features of the Anglo-American model since the 1990s which have shifted focus towards shareholder value. See Dignam and Galanis (n 62 above) ch 8. Nevertheless, codetermination still enjoys broad public support and collective bargaining has adapted to demands to link pay with performance.

[130] This would partially replicate the main institutional feature of systems with concentrated ownership and enable a meaningful dialogue between institutional investors, employee representatives and management.

Introducing such panels will also provide a useful disclosure framework for company directors to explain how they engage with employees.[131] Indeed, according to the new regulatory requirements, the directors' report must contain a statement in relation to the actions taken to introduce, maintain or develop arrangements for, *inter alia*, the systematic provision of information to employees, their regular consultation, and the achievement of a common awareness of all employees of the financial and economic factors that affect the company's performance. Additionally, the record must summarise how the directors have engaged with employees and how they have had regard to their interests and the effect of that regard, including on the main decisions taken by the company. We therefore argue that advisory panels can offer a breadth of information to directors so as to satisfy all the above-mentioned disclosure requirements and they fit perfectly with all these criteria and elements that portray engagement, holistic consideration of employee interests and increase of employee awareness. It is the unique feature of these panels, namely their capacity to combine engagement with education, that makes them stand out from the other two options offered to companies and that makes our proposal more convincing in this context.

An additional advantage of such panels derives from the fact that they allow for an indirect replication of the benefits of the dual board system, which is absent in the UK framework.[132] We argue that the proliferation of employee presence within decision-making processes is hampered by the presence of a unitary board structure. Indeed, the dual board system englobes the presence of employees more naturally since the supervisory board offers a distinctive opportunity for holistic and inclusive oversight of the company's management. In the unitary board structure, such features are absent and the forced inclusion of employees by interventionist norms may prove to be counterproductive. We therefore argue that advisory panels can replicate in some respects, in a modest but non-negligible fashion, the advantages of supervisory boards by engaging with the board of directors and by raising its awareness of issues related to the workforce and to stakeholders. The educational benefits will thus be shared amongst the board of directors and the advisory panel in the long run, preparing for the crystallisation of such benefits via the second phase of our proposals that relates to the appointment of employee representatives to the board.

[131] Companies (Miscellaneous Reporting) Regulations 2018 (SI 2018/860), Section 14.

[132] In view of the strong cultural bias against two-tier boards, we do not recommend the introduction of such structures in the UK by force of law.

However, notwithstanding these advantages, it may prove difficult for companies to make use of advisory panels, at least at the current stage, due to the general prevailing attitude towards employee participation.[133] There is no doubt that for a cultural shift to occur and for companies to accept the long-term benefits of advisory panels, appropriate incentives will need to be given so as not to convey the impression that these panels are actually a complex and strongly-binding engagement exercise. For such a transition to gain momentum, we therefore argue for maximum flexibility as regards the composition of such panels, the topics dealt with within such groups and the expectations for their interaction with the board.[134] Allowing such panels to evolve into dialogue venues within companies will gradually enable employees to gain familiarity with a series of topics and to become a vital part of the decision-making process within companies on a wider and more holistic scale. We argue that the advisory panels should be conceived and introduced as 'preparatory labs' for the creation of a new generation of employees that will be called upon to assume decision-making roles within companies in the future.

Aiming to reinforce this employee preparation phase, some companies may also want to combine such panels with the appointment of a non-executive director in direct contact with the advisory panel employee members. This additional communication channel may prove particularly useful to accelerate employees' familiarisation with decision-making challenges since the non-executive director will have the task of not only receiving feedback from the panel, but also providing assistance to prepare its members to take on more responsibility as board members in the future.[135]

Predicting the efficiency of such panels across the board within the UK business sector would be a particularly arduous task since their success will largely depend on the

[133] This opinion emerged at the seminar 'A Code of Corporate Governance for Large Private Companies' held at UCL on 7 November 2018 which brought together representatives from the FRC, TUC and academic researchers. To date, most companies who have started choosing one of the three options, preference is given to employee director (Capita plc, First Group plc, Mears Group plc and TUI plc) or non-executive director (Diageo plc, Hays plc, Legal & General plc, McKay Securities plc, Ted Baker plc and Sthree plc) appointments.

[134] Based on discussions we have held with various company secretaries, some companies may be willing to move towards the introduction of advisory panels under the condition that flexibility in respect of their formation, composition and role is kept. Consequently, it is not the advisory panel itself that may drive reluctance to adopt it at the company level, but the various criteria for its formation and ongoing role, as well as the expectations for its outcomes when it becomes operational. Therefore, maintaining flexibility is crucial to convincing companies to adopt such panels.

[135] On the combination of non-executive directors and advisory panels, see K. Sergakis, 'Proposed Revisions to the UK Corporate Governance Code: Written Response (2018) https://www.frc.org.uk/getattachment/c9b472f6-cabf-4e2f-a411-beaceaff6c79/Sergakis,-Dr-response;.aspx.

institutional safeguards, resources and support within each company. We therefore argue that, alongside flexibility, advisory panels would need to be given a clear and continuous operational mandate based on each company's profile, size and activities. We contend that it is this continuous mandate, alongside the flexibility provided in our proposed model, that can give a new impetus to corporate law so as to enable the workforce to contribute to governance. This mission is, in our view, not fully served by existing solutions provided under labour law, such as the EU law-derived Information and Consultation rights for employees.[136] Indeed, under these regulations, a dialogue between employees and companies may take place on an ad hoc – and not continuous – basis and is subject to a series of conditions.[137] It is worth noting, however, that these rights have rarely been invoked in the UK.[138] Our proposal aims to prolong the temporal dimension of employee engagement by creating a *continuum* within the dialectic between advisory panels and boards of directors.

Be that as it may, we find no antithesis between our proposal and labour law regulations since they serve different purposes and can operate in parallel dimensions for the holistic treatment of employee matters; advisory panels empower gradually employees towards high level hybrid governance and labour law participative forums aim to inform employees about matters of crucial importance with the aim to protect them.[139]

This corporate law based proposal will thus contribute to empowering employees towards higher participation standards within a primarily shareholder based governance model, while complementing the parallel labour law normative framework. It is this novel governance based approach, in line with the incomplete nature of employee contracts that renders corporate law a more suitable instrument to achieve incremental change in this area in the long-term.

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[136] Information and Consultation of Employees Regulations 2004 (SI 3426/2004), transposing 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 [2002] OJL80/29. For a discussion, see R. Gumbrell-McCormick and R. Hyman, 'Work Councils: The European Model for Industrial Democracy?' in A. Wilkinson, P.J. Gollan, M. Marchington and D. Lewin (eds), *The Oxford Handbook of Participation in Organisations* (Oxford: OUP, 2010).

[137] Such as the conditions for employee requests to negotiate an agreement in respect of information and consultation: single request of 10% of the employees as a minimum qualifying threshold or separate requests that cumulatively reach within 6 months the same representative threshold: Regulation 7, ibid.

[138] See K.D. Ewing and G.M. Truter, 'The Information and Consultation of Employees Regulations: Voluntarism's Bitter Legacy' (2005) 68 *Modern Law Review* 626.

[139] For example, according to the Information and Consultation of Employees Regulations, the employer must provide information on the businesses' activities and economic situation, the situation structure and probable development of the business and any anticipatory measures in the presence of a threat to employment and the decisions likely to lead to substantial changes in work organisation or in contractual relations: Regulation 20, ibid.

Departing from a formalistic interpretation of the role of advisory panels, in this article we aim to interpret their distinctive contribution within companies by focusing not on their mere existence but on their concrete operational framework. In order for their educational and preparatory role to be fulfilled, attention needs to be paid to their specific mandate within each company and to the annual dissemination of outcomes and good practices emerging from their operation. Notwithstanding the inevitably divergent disclosure of information in this particular context, interested parties will need to focus on the transformation of the corporate mind-set and on the familiarity that the members of the panel will report to have gained throughout this process.

Once employee panels have been adopted by many UK companies and provided that the experience of the corporate sector of their operation is positive, a future edition of the Corporate Governance Code could recommend listed companies to set up such panels. Doing so would proliferate their adoption and economic benefits, while at the same time preserving flexibility and recognising that, for some companies, employee advisory panels will not represent the most efficient structure.

Employee board representation

Companies that have successfully implemented the first phase of reform can proceed to the second phase. As employee share ownership schemes are an existing element of the UK framework, and in view of the benefits of combining governance rights with residual risk, it is submitted that an effective model would be based on granting the right to appoint a number of directors to employees once the employees of a company collectively cross certain thresholds of share ownership. The purpose of the special appointment rights would be to provide for employee board representation in tandem with the extent in which they share the company's residual risk.

This would allow a different culture to develop and would enable employees to build capacity as governance actors and expand their financial stakes in the companies they work for. It is also envisaged that trade unions would include demands for employees to be given the opportunity to be paid part of their remuneration in shares on favourable terms within their future collective bargaining strategies. Employee share ownership could be further facilitated by the government by expanding the relevant tax advantages. For instance, the monetary limits that apply for share grants to be exempt

from relevant taxes could be increased. The public interest justifying the extension of the advantageous treatment of employee share ownership schemes by tax law would be the long-term economic benefits to corporate stakeholders and society as a whole arising from improved corporate efficiency and the particular benefits accruing to employees.

The new appointment rights would be incorporated into the articles of association of listed companies and large private companies voluntarily.[140] Once such rights are established, the shares held by employee-shareholders would legally qualify as a distinct class of shares, and the right to appoint certain directors would qualify as a class right.[141] This means that, absent any contrary provision in the articles, the relevant part of the articles could only be altered with the consent of 75% of the relevant class of shares i.e. shares held by employee shareholders.[142] This would allow for some flexibility but at the same time would give employee shareholders a veto over any attempt to remove their board appointment rights. The new rights would be in addition to employee shareholders' normal voting rights.

Whether shares owned by employees under such schemes will be transferable or not will be up to companies to decide. From the perspective of our proposal, it is necessary to clarify that the special appointment rights would apply only in so far as shares are owned by employees, so they would not be attached to the shares as such and, in the case the shares were transferred to a non-employee, they would not pass onto the transferee. As far as listed companies are concerned, the special appointment rights proposed herein would deviate from current UK institutional investor expectations of 'one share one vote' and therefore their adoption would require a change of approach by investors.[143]

The percentage of directors to be appointed by the employee shareholders would reflect the size of their combined equity stake, but in a regressive manner and up to a maximum of a third of the board, as the more shares employees collectively have, the

[140] According to Companies Act 2006, section 21, an alteration to the articles of association requires a special resolution, that is, 75% of the total votes.

[141] It has been established by case law that, when a special right is given to a person in their capacity as member of a company and only insofar as that person remains a member or retains a number or proportion of shares, the shares held by that person constitute a separate class from other shares. See *Cumbrian Newspapers Group v Cumberland* [1986] BCLC 286 and *Bushell v Faith* [1970] AC 1099.

[142] This is the standard procedure to vary or abrogate class rights, prescribed by section 631 of the Companies Act 2006.

[143] For instance, the Investment Association, a trade body that represents UK investment managers managing over £5.7 trillion, 'strongly supports the principle of 'One Share – One Vote". See Investment Association, 'Investors call for Snap not to be included in market indices' (27 March 2017) https://www.theia.org/media/press-releases/investors-call-snap-not-be-included-market-indices.

bigger the practical effect of their normal voting rights. The minimum share ownership threshold for employees to be entitled to appoint one member of the board would be rather low, but still one requiring a more than trivial stake in the company's share capital. The election of the employee-appointed directors would follow the principle of one vote per share, so employee shareholders would vote in accordance with their financial participation in the company.

Each company's workforce advisory panel would be given the power to nominate directors for employee shareholders to consider. TUC argues that nomination should mainly come from recognised trade unions plus representative bodies established through statutory consultation.[144] Nomination by a specified number of workers seems to be another option but not the prevalent one.[145] We argue that advisory panels are a more economically efficient solution in this regard since direct election of employees combined with the educational benefits of such panels will allow for a more pragmatic multiplication of stakeholder voices within companies.

The first step would be to enable the formation of advisory panels comprised of employees, as explained in the previous part. The second step would be for employees to nominate candidates from these panels to become directors. Such directors ought to be required by companies' articles of association to be independent directors,[146] and would have the same duties as other directors. This would minimise the risk that directors appointed by employee shareholders would not act in the interests of the company as a whole. Such risk would in any case be mitigated by the fact that employees would own shares in the company, but not entirely extinguished, as employees owning a relatively small amount of share capital would rationally prioritise their interests as employees over and above their interests as shareholders when the two conflict. The third and long-term step could include the direct appointment by employees of one employee-director amongst the directors to be appointed by the employees, the others remaining independent directors. This gradual approach has the benefit of allowing for a revitalisation of shareholder activism with nomination to the board of directors of persons aiming to represent the different groups in a similar fashion, such as institutional shareholders, employee shareholders and others. Employee-nominated directors thus

[144] See Williamson (n 125 above) 7.
[145] Ibid.
[146] As defined in the UK Corporate Governance Code, Provision B.1.1.

become key players within corporate decision-making mechanisms after having been prepared for this role through their participation in advisory panels.

Of course, a caveat is necessary at this point. Employee share ownership brings the inevitable disadvantage that employees become vulnerable to corporate insolvencies as in such a case they stand to lose part of their personal wealth as well as their jobs.[147] To mitigate this risk, it is necessary for companies to provide sufficient information to employees before they join share ownership schemes regarding the level of risk they are taking. This is an area where uniform mandatory rules may be required to ensure that employee-investors are fully protected. In addition, companies could explore the possibility of making available to employees a form of insolvency insurance that would be offered by an insurance firm and paid for by the employees with a possible company subsidy. The aim of the insurance would be to compensate employees for at least part of the price that they originally paid for their shares in case of insolvency of the company.

PRAGMATISM AND TOKENISM IN EMPLOYEE PARTICIPATION IN CORPORATE GOVERNANCE

Our proposal on permanent employee advisory panels and gradual transition towards employee representation on boards overcomes the conceptual friction between shareholder and hybrid governance since it enables employees to gradually form part of the shareholder governance model, without disrupting the established UK approach on this matter. The novelty of our normative proposal contributes to the formation of a potentially much more efficient mechanism which aims to reap the benefits of both governance models while contributing to innovation; in line with our proposed share ownership schemes and associated voting rights, employees will align – to a certain extent – their economic interests to the ones pursued by shareholders.

A critical view of the above-mentioned proposals could be that employees' role may be weakened since it will primarily be their shareholder status that will enable them to elect board directors. In other words, our proposals may be seen as shifting the attention to shareholder powers while neglecting the future role that employees can play as a workforce without any additional 'shareholder type' features. We acknowledge the

[147] Shareholders are the last to be paid on winding up, and thus practically they never receive anything through the liquidation process. This is why they are characterised as residual risk-bearers. See E.F. Fama and M.C. Jensen, 'Agency Problems and Residual Claims' (1983) 26 *The Journal of Law and Economics* 327.

fact that the employee empowerment will be even more economically and organisationally efficient if aligned with the institutional features of the UK 'shareholder oriented' capitalist model. By awarding an additional economic feature to employees, there is no risk of assimilation to shareholders on the grounds that their residual risk in the company enables them to appoint directors via an 'entry fee' process. The mixture of shareholder and stakeholder features is not uncommon in today's markets. Several high-profile NGOs have become shareholders to exert pressure on companies at various levels.[148] In parallel, particular in the US, it is common for public sector pension funds, universities and religious organisations to use their voting power to promote environmental and social agendas.[149] Attributing the same dual function to employees can only reinforce their presence within companies without diverging from their stakeholder status.

The question of enforcement of the engagement agenda with the workforce is also a challenging issue whose implications will undoubtedly arise in the public debate. More recently, bold proposals have come to light arguing that employee (without share ownership) derivative claims would be preferable to ensure compliance with their interests, following Section 172 (1) of the Companies Act 2006, and the three options given to companies to demonstrate relationships with the workforce.[150] While we acknowledge the 'tokenism' concerns related to adopting flexible and malleable regulatory approaches in this context, we also accept the perfectible character of derivative actions in terms of enforceability and their overall operational context.[151]

Aiming to ensure the success of the workforce engagement compliance agenda upon litigation mechanisms may shift attention away from the real challenges and opportunities that lie ahead. Indeed, employee derivative claims would compromise the current plans for meaningful engagement with the workforce and drive employees

[148] For an early study on this topic, see T. Guay, J.P. Doh and G. Sinclair, 'Non-Governmental Organisations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications' (2004) 52(1) *Journal of Business Ethics* 125.

[149] On this, see G. L. Clark, J. Salo and T. Hebb, 'Social and Environmental Shareholder Activism in the Public Spotlight: US Corporate Annual Meetings, Campaign Strategies, and Environmental Performance, 2001-04' (2008) 40 *Environment and Planning A: Economy and Space* 1370; C. Flammer, 'Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors' (2013) 56 *Academy of Management Journal* 758; and L. Schopohl, 'The Materiality of Environmental and Social Shareholder Activism – Who cares?!' (2017) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991544.

[150] N. Safari and M. Gelter, 'British Home Stores Collapse: The Case for an Employee Derivative Claim' (2018) 6 *Journal of Corporate Law Studies* 1, 11.

[151] A.R. Keay, 'The Public Enforcement of Directors' Duties: a Normative Inquiry' (2014) 43 *Common Law World Review* 89.

towards litigation for a drastic – yet short-term – solution, instead of allowing them to potentially reap the benefits of a longer-term engagement process with the board. Employees would therefore expect courts to secure compliance with matters that regard them and would not make the necessary effort to advance their own agenda within the company. This would also legitimise company boards' decision not to pursue meaningful engagement with the workforce since their attention would be shifted to avoiding potential liability instead of communicating with the workforce.

Engagement norms and duties thus sit uncomfortably with legal enforcement mechanisms (derivative claims in this context). Market and social enforcement tools (reputational sanctions, market reaction) should be preferable despite their perfectible nature.[152] We therefore argue that awarding employees (who do not own shares) the right to bring a derivative claim risks creating instrumentalisation and disruption trends within the company. Employee shareholders would, of course, remain free to bring a derivative claim for ordinary claims related to directors' duties, but the right to initiate litigation should not be conceived as a pressure tool for securing the directors' compliance in relation to their interests since this instrumentalisation might have counter-productive and economically inefficient effects.[153]

Driven by an understanding of corporate law as a means to maximise economic efficiency, our proposals aim to inculcate a different enforcement mind-set deriving from the workforce that unfolds in a market and social enforcement spectrum. This type of enforcement comes from within the company via the gradual empowerment of employees and from outside the company via the reaction of third parties or potential investors who are concerned about risks related to inequality or lack of engagement.[154] Under our proposal, the formation of a continuous 'dialectic' between different market actors, including but not limited to investors who integrate ESG criteria in their investment strategies, and social enforcers who will continue to nudge the adoption of sustainable practices, becomes realistically achievable. Such 'dialectic' will also have a

[152] For an overview of the dichotomy between legal and social enforcement in relation to engagement duties, see K. Sergakis, 'Legal Versus Social Enforcement' in H. Birkmose and K. Sergakis (ed), *Enforcing Shareholder Duties* (Cheltenham: Edward Elgar, 2019) 128. More generally, on the limitations of public enforcement by regulatory authorities, see also Andreas Kokkinis, *Corporate Law and Financial Instability* (Abington: Routledge, 2017) 180 – 182.

[153] Employees increasingly interested in initiating litigation against directors, instead of attempting to engage and voice their agenda within the company, would force boards to dedicate time and resources to face litigation. Attempting to resolve internal company affairs of that nature in court would therefore lead to costly and damaging outcomes in the long term.

[154] See TIIP (n 109 above).

long-lasting impact on companies since the exerted pressure towards a long-term agenda will be multi-faceted and will be stemming from actors who will gradually gain more prominence and visibility (employees, investors, NGOs, consumers and others).[155]

Aiming to draw a bigger picture of the potential impact of our proposals on the UK corporate governance framework, we argue that our flexible approach, based on advisory panels and subsequent employee board representation under employee share ownership schemes, is also well suited to the current need to avoid stricter and unduly burdensome legal reforms that would actually risk reducing employees' economic utility within companies. Indeed, concerns may be raised in relation to an interventionist approach that would dictate employee board representation without any preparatory or educational processes. Employees would indeed be appointed but would not necessarily benefit to the same extent compared to the benefits that they can derive from our flexible approach.

Our proposal could also stand as a viable alternative to the disruption of the flow of information that could occur by the mere appointment of employee directors[156] who would be conflicted between their employee and director status, refraining from sharing all the information with the workforce.[157] Indeed, such information flow problems could be aggravated within the UK context, in light of the unitary board structure that will include employee directors without any separation between the supervisory and management boards, as is the case in Germany.[158] Employee directors would therefore find it difficult to ensure a regular flow of information to the workforce.[159]

Following our approach, by introducing advisory panels out of which candidates to the board would emerge in the long run, this obstacle can be avoided at least in the beginning when the most crucial phase of transforming corporate culture would unfold.

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[155] See, for example, the high profile shaming campaign launched by Amazon employees in relation to climate change: 'Hundreds of Amazon Employees Publicly Attack its Climate Record' Financial Times, 27 January 2020, https://www.ft.com/content/33dce38e-4128-11ea-bdb5-169ba7be433d. Consumers also start showing increased levels of awareness and demonstrate their preference for companies that respond to climate and social change: Salesforce Research, 'Ethical Leadership and Business' (2020) https://c1.sfdcstatic.com/content/dam/web/en_us/www/documents/research/salesforce-research-ethical-leadership-and-business.pdf.

[156] As has been observed in the German context: M. Roe, 'German Codetermination and German Securities Markets' (1998) 98 *Columbia Business Law Review* 167, 171.

[157] For a critical approach, see Safari and Gelter (n 150 above) 16.

[158] Streeck (n 123 above).

[159] On the concept of codetermination as an information channel between employees and directors, see G. Hertig, 'Codetermination as a (Partial) Substitute for Mandatory Disclosure?' (2006) 7 *European Business Organisation Law Review* 123, 130.

In other words, during the initial period of advisory panels, the company's focus would be on enabling employees to engage with the board while gaining familiarity with a series of issues and contributing to the gradual escalation towards a more holistic decision-making model that would be coupled, at a later stage, with the nomination of employees to the board. Even if at that second stage employee directors find it difficult to maintain the informational flow, the overall participative governance model will have been enriched within each company in the meantime. Therefore, although some problems may persist, the benefits of appointing employees to the board (long-term accrued value generated by their presence) will outweigh the costs (potential conflicts of interest and informational flow problems).

The perils arising from the adoption of a formalistic compliance approach in relation to employee participation and representation standards cannot be underestimated. For example, the codetermination system in Germany shows some other perfectible elements in relation to its overall approach since it dictates employee board participation without the intermediate step of preparedness for assuming such roles. Without claiming that the lack of this intermediate step is behind the imperfections of the codetermination system, which has been shaped in different institutional and historical circumstances, we aim to advance a new employee participation and representation model going beyond well-known systems and conceiving employees' role in a novel, efficiency-driven spectrum.

Interventionist approaches [160] may, of course, be more useful to increase regulatory visibility and the utility of legal reforms for public consumption purposes, as they will be successful in conveying the message that balance amongst shareholders and employees, or income inequality, can be achieved via such reforms. The latter trend is becoming increasingly popular in both the UK [161] and the US, [162] by focusing on the redistribution of wealth maximisation and on the reduction of income inequality for the benefit of employees. Notwithstanding the laudable aims of such agendas, we argue that

[160] Safari and Gelter (n 150 above).

[161] See, for example, the Brexit-driven discussion on the reform of UK corporate governance at the Department for Business, Energy and Industrial Strategy (n 114 above). In this policy paper, Theresa May referred to the need to 'build an economy that works for everyone, not just the privileged few' and mentioned that 'For many ordinary working people – who work hard and have paid into the system all their lives - it's not always clear that business is playing by the same rules as they are.' The policy paper was issued some months after the Brexit referendum that was perceived, *inter alia*, as an expression of frustration by low- and middle-income workers.

[162] See Warren (n 3 above).

they are not economically efficient in the long term. Nevertheless, the long-term recalibration of corporate governance structures and corporate culture can only be realistically achieved by flexible and adaptable solutions that focus on the long-term economic efficiency of the reforms and not on short-term political gains deriving from drastic legal changes.

That being said, in the longer-term, if our approach is followed successfully by a critical mass of large UK companies, the available evidence may come to justify legal intervention to nudge companies towards employee participation. One way to achieve this, while preserving an element of flexibility would be via the introduction of strong default rules, i.e. rules that require a costly process to be disapplied and hence aim to discourage contractual mutation.[163]

CONCLUSIONS

In this article, we demonstrated that there is no a priori reason for employee participation in corporate governance to be inefficient and that there are sound grounds for UK companies to explore it as a viable option. We formulated a new flexible approach, suitable to the specificities of the UK institutional framework, which can offer pragmatic and long-term solutions to the challenges of employee participation and board representation. Engagement with the workforce should become meaningful and realistically achievable in both listed and large private companies, as our analysis has aimed to show, given the commonly shared challenges and the impact of all types of companies' strategies upon employees.

Our approach constructs a new paradigm for employee participation in two distinct phases: the introduction of formal advisory panels, and the subsequent appointment of employees to boards via employee share ownership schemes. Addressing concerns of tokenism, we argue that such structure can offer a series of benefits to

[163] The economic function of strong default rules cannot be explained simply by reference to the Easterbrook and Fischel thesis that default rules ought to deliver what the parties would have wanted. See e.g. F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991). An alternative economic theory of default rules has been proposed by Ayres and Gertner. According to this theory, it is often efficient to impose default rules that no party would have wanted (penalty default rules) to incentivise parties to disclose information to the other party in order to contract around the penalty rule, or strong default rules that can act as a substitute for mandatory rules when there is a mild case of market failure. See I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87; and I. Ayres, 'Making a Difference: The Contractual Contributions of Easterbrook and Fischel' (1992) 59 *University of Chicago Law Review* 1391.

employees, most notably in the area of education, preparedness for appointment to the board and ongoing dialogue within the company. Disregarding the need to participate in a gradual cultural transformation in a holistic way that involves all company constituencies, and opting instead for drastic short-term solutions that would be both costly and disruptive, would ultimately fail to prepare companies and their employees to adequately face the challenges lying ahead. Conversely, our approach fosters long-term value creation by facilitating closer engagement of companies with employees and investors and the inculcation of a culture of trust between capital, labour and management. This new paradigm aims to accord a new *raison d'être* to shareholder-based governance with wider ramifications for the re-conceptualisation of corporate law as a hybrid governance mechanism enabling long-term engagement of investors, employees and other stakeholders.