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New rules in the statutes regarding the Appropriateness of the Management Board's Remuneration call for supervisory board members to follow their duties more closely than before.

The Act regarding the Appropriateness of the Management Board's Remuneration

The Act regarding the Appropriateness of the Management Board's Remuneration (*Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG*) came into force on August 5, 2009. It falls into line with a number of legislative reactions regarding the current financial and economic crises. As opposed to other measures, it is not aimed at the crises' effects but rather at their causes. Amongst others, these are seen in the shortcomings regarding management boards' remunerations.

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The Act regarding the Appropriateness of Management Boards' Remuneration (*Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG*) is a combined act, amending different provisions in the German Stock Companies Act (*Aktiengesetz, AktG*), in the German Commercial Code (*Handelsgesetzbuch, HGB*) and in the German Limited Liability Companies Act (*Gesellschaft mit beschränkter Haftung-Gesetz, GmbHG*). The Act's purpose is to promote sustainability within a company's management. The Act imposes stricter responsibilities on the supervisory board (*Aufsichtsrat*) to assess appropriate remuneration for the management board (*Vorstand*) and thus grant more transparency. The changes are directly applicable to all stock companies. However, three special rules (sustainability of the remuneration structure, non-binding opinion issued by the general assembly (*Hauptversammlung*), and cooling-off period) only apply to listed companies. Beyond that the new rules largely apply to all legal forms of German corporations under a regime of labor co-determination.

Public Corporate Governance Codex

Companies which are majority-owned by the German government must also abide by these new rules. Therefore, on July 1, 2009 the German Federal Government (*Bundesregierung*) passed the Public Corporate Governance Codex (PCGC); the individual German states will pass similar rules for their respective interests. The codex captures the VorstAG's rules and determines the applicability to public interest companies, irrespective of legal form.

The PCGC establishes mandatory rules in case of wholly or majority government owned companies. The application of PCGC rules is recommended in case of minority public interest. Government controlled companies, which – due to a listing – already observe the German Corporate Governance Codex (e.g. Telekom AG or Deutsche Post AG) do not fall within the scope of the PCGC.

Assessment of the Management Board's Remuneration, Section 87 Subsection 1 AktG

In the past the supervisory boards made market oriented and case-by-case decisions when it came to determining the management boards' remuneration. They had a large margin of discretion. Under the VorstAG the discretion is more restrictive. According to the new provisions the management board's remuneration must relate more closely to performance and customary and arm's length principles and may not exceed these limits without good reason (Section 87 Subsection 1 AktG). The statutory reference to performance and arm's length conditions already increases the supervisory board's obligation

to carefully study market and comparable cases and to obtain fairness opinions from qualified experts for executive compensation. The reference to the usual remuneration should increase the supervisory boards' obligation to examine comparable environments. Among these are, for example, industry, company size, state's customs but also wages and remuneration matrices within the companies.

Maintaining the Remuneration Structure, Section 87 Subsection 1, Section 193 Subsection 2 No. 4 AktG

A further topic covered by the new provisions is the remuneration matrices of listed companies: they should now be adjusted in line with the company's development and based on several years' assessment data. The supervisory board should agree upon a possibility of limiting the remuneration if extreme developments arise, as these could lead to extreme demands by the management board (Section 87 Subsection 1 AktG). The management boards' possibility to exercise their stock options should be limited for four years, as opposed to the two years which were applicable so far (Section 193 Subsection 2 No. 4 AktG). The general assembly can approve their remuneration by issuing non-binding, declaratory opinions. Therefore, the supervisory board's responsibility and liability are not limited.

Retroactive Decrease of the Management Board's Remuneration, Section 87 Subsection 2 Clause 1 AktG

If there was a substantial decline in a stock corporation in the past the supervisory board was able to decrease an active management board member's remuneration. This, however, was only the case if continuing to pay the remuneration would have meant a substantial unfairness for the company. Most experts believe that this option was rarely exercised because the company's economic difficulties were not sufficient in justifying such a reduction. There was no blanket-justification, rather, it was necessary to assess each instance on a case-by-case basis.

The VorstAG now gives the supervisory board more possibilities to retroactively reduce the remuneration if the company is distressed (Section 87 Subsection 2 Clause 1 AktG). In the future a reduction will neither necessitate a substantial decline of the stock corporation's situation nor that the continued payment of the remuneration is grossly unfair. It will be sufficient that the company's situation has declined so substantially that to continue granting the remuneration in the same amount would be unfair. Indicators for a company's decline could be reduction in wages and terminations but also the fact that the company can no longer distribute profits; crisis and insolvency will always fulfill these requirements. It would also certainly be unfair to continue to grant the remuneration if the company's decline was caused by the management board or falls within the time of the management board's responsibility.

If the above-mentioned requirements are fulfilled, the supervisory board "should" decrease the remunerations to an appropriate amount. This wording constitutes a legal duty as a rule for the supervisory board to decrease remuneration. It can only be departed from in justified exceptional cases. Pensions and payments to former management boards members' dependants can also be decreased, however, only within a period of three years after retirement from the company.

A unilateral decrease of the management board's remunerations does not affect the employment contract, however, the affected management board member can terminate the employment contract within a set notice period.

Deductible on the D&O-Insurance, Section 93 Subsection 2 Clause 3 AktG

Many companies hold insurance policies for their executive bodies, so called directors' and officers' insurance (D&O-insurance). These policies insure them against risks that might arise in their function and also protects the management board members (at least as a rule) from claims against them for violating their duties. The newly worded Section 93 Subsection 2 Clause 3 AktG states that D&O-insurances should have a mandatory deductible of at least 10 percent of the damages and at least up to the amount of one and a half times the annual remuneration.

This deductible does not apply to supervisory board members as the provisions so far remain in force, which allow for a complete insurance of the liability risks.

The supervisory board's plenum's and the management board's remuneration, Section 107 Subsection 3 Clause 3 AktG

Previously the supervisory board was able to delegate new employment agreements with the respective management member to a committee and, thereby, also the decision regarding structure and amount of the remuneration. Now, however, delegation is no longer permissible and it is one of the supervisory board's plenum's obligations to determine and adjust the management board's remuneration (Section 107 Subsection 3 Clause 3 AktG).

Supervisory Boards' Liability, Sections 116, 93 AktG

According to Sections 116, 93 AktG supervisory boards' members are liable for breaches of obligations. This includes agreeing to an inappropriately high remuneration for management board members. By the inclusion in Section 116 AktG the liability for the inappropriate remuneration is re-emphasized and clearly stated as one of the most important duties; the members are personally liable for breaches of duties (Section 116 Clause 3 AktG).

Two year Cooling-off Period prior to change into the Supervisory Board, Section 100 Subsection 2 Clause 1 No. 4 AktG

Former management board members are not allowed to become members of the supervisory board for the same company during a two year cooling-off period after leaving management; this particularly affects stock listed corporations and is intended to prevent conflicts of interest. There is an exception: if the election into the supervisory board is based upon the shareholders' suggestion, and these hold more than 25 percent of the voting rights, then the cooling-off period can be waived. This exception promotes family companies' interests.

Changes in Commercial Law

The VorstAG should extend the existing disclosure duties for management boards' remuneration in annual and company reports (Sections 285, 314 HGB). In August 2005 the Management Board's Remuneration Disclosure Act (*Vorstandsvergütungs-Offenlegungsgesetz, VorstOG*) already implemented or extended certain requirements for information regarding management boards' remuneration. It was – in certain cases – merely necessary to declare the essential contents of a remuneration commitment.

In future, detailed information is to be disclosed, specifically: payments, which the management board member was promised in case of a regular or premature termination of duties. This also applies if the member departed in the ongoing fiscal year and changes were agreed upon in the previous fiscal year.

These reforms will be applicable for the first time for fiscal years beginning after December 31, 2009.

Application of Amended Provisions Concerning Company Law to the GmbH

The provisions of company law changed by the VorstAG not only apply to stock corporations but rather also – under certain prerequisites – to companies of other legal forms, especially the GmbH.

This particularly affects (German) corporations which employ more than 500, or, as the case may be 2,000 employees and are co-determined. The amended provisions of Section 107 AktG (supervisory board members' obligations, which cannot be transferred), as well as Section 116 AktG (liability for inappropriately high remuneration) are applicable, respectively (Section 1 Subsection 1 No. 3 One-Third Participation Act (*Drittelbeteiligungsgesetz, DrittelbeteiligungsG*); Section 25 Subsection 1 No. 2 Co-Determination Act (*Mitbestimmungsgesetz, MitbestG*)).

On June 15, 1992 the Federal Supreme Court (*Bundesgerichtshof, BGH*) passed a judgment regarding Section 87 AktG (supervisory board's option to decrease management board's remuneration upon decline of company's situation): under certain circumstances this provision is applicable to GmbH managers and can, therefore, also affect the GmbH's management's remuneration.

Practical Implications

Primarily, the described amendments to the provisions for companies' supervisory boards must be re-thought: they must now abide by the new provisions regarding the management board's remuneration, as there is neither a transitional provision nor a right of continuance for existing employment agreements.

The supervisory board must abide by the amended statutory requirements for structure and appropriateness of remuneration in regards to new employment contracts for management boards. Furthermore, now that the VorstAG has come into force a reduction of the remuneration must be continuously assessed. As the supervisory board members are personally liable for wrong decisions they should thoroughly document their examinations and decisions, and particularly so if a possible deduction of remuneration is not implemented.

Numerous vague legal terms are used, especially in the area of board member's remuneration (e.g. appropriateness, customary, unfairness, sustainability), which the supervisory board members must apply correctly. In order to limit the resulting liability risks, an expert (such as a personnel consultancy company accredited for its industry knowledge) should examine the remuneration's and remuneration structure's appropriateness and document these in a "fairness opinion".

The obligation to agree upon the obligatory deductible on the D&O-insurances is both applicable to future as well as current insurance policies. However, there is a transition term for the amendment of the insurance policies through June 30, 2010.

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