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LEGISLATION ON MANAGER COMPENSATION LIKELY

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GERMANY POISED TO INTRODUCE REFORMS TO DIRECTOR COMPENSATION REGULATIONS; LEGISLATION TO AFFECT ONLY STOCK CORPORATIONS

Similar to France, which introduced controls on management remuneration in May 2009, Germany is considering enhanced regulation of management compensation. Proposed amendments¹ to the German Stock Corporations Act (*Aktiengesetz*) and the Commercial Code (*Handelsgesetzbuch*) are presently being discussed in Parliament's Legal Committee.² It is very likely that these amendments will be passed this summer by Parliament with only minor changes, since major compromises have already been reached between the two governing parties in Germany's coalition government.³

If passed, the proposed changes will affect only stock corporations (*Aktiengesellschaften*) and are likely to take effect as of the next fiscal year. The following comments provide an overview of the key proposed changes.

DIRECTOR COMPENSATION. In Germany, director (*Vorstand*) compensation is set by the corporation's supervisory board (*Aufsichtsrat*). In accordance with § 87 of the Stock Corporations Act, the supervisory board is obliged to ensure that director

compensation (including bonuses and ancillary benefits) is reasonable in relation to the responsibility of the individual director and the business situation of the corporation. The supervisory board is *empowered* to reduce director compensation where there has been a fundamental worsening of the corporation's business position and where this worsening would render the payment of the director's compensation seriously unreasonable. It is under no obligation to do so.

The proposed amendments provide the supervisory board with an *obligation* to reduce compensation paid to directors where either (a) the business situation of the corporation has worsened, or (b) where - looking backward - the compensation paid to directors appears unreasonable (*unbillig*). Note that the original threshold of 'seriously' unreasonable has been reduced. The definition of director compensation would now also explicitly include stock options.

In addition, when approving director compensation, the supervisory board would further be required to

ensure that such compensation is not only reasonable with respect to the director's responsibilities and the business situation of the corporation, but also in relation to 'typical compensation'.

If passed, these amendments will constitute major changes to the responsibilities of the supervisory board in determining director compensation. Both the objective standard 'typical compensation' and the obligation of the supervisory board to – retroactively – reduce compensation in light of only a general 'worsening' of the corporation's business situation are not defined at law.

The proposed amendment does not incorporate a cap on management compensation, as has been sought in other contexts in Germany, particularly for businesses which are receiving government aid.

SUPERVISORY BOARD RESPONSIBILITY. Supervisory board approval of unreasonable compensation may be challenged by shareholders on behalf of the corporation.⁴ Under the proposed amendments, if such a challenge is successful, board members would be personally liable to pay damages in the amount of the excessive compensation.

EXTENSION OF STOCK OPTION HOLD PERIODS. The proposed amendments also provide for an extension of mandatory 'hold periods' for stock options granted from two to four years.⁵ This amendment – as currently proposed – would apply to stock options granted to both management personnel and regular employees of a stock corporation. The aim here is to more closely align management incentives with the long-term stability and health of the corporation.

ADDITIONAL PROPOSALS. There are ongoing political discussions on a series of additional proposals which may eventually be included within the government's legislative initiative.⁶ These include:

- obligatory fixed deductibles payable by directors personally in the event that a claim is filed under a D&O insurance policy;
- 'cooling-off periods' of two years in which a director may not assume a board membership in the corporation's supervisory board
- prohibitions on bonuses being paid on the basis of short-term (i.e. annual) results. Instead, such compensation would be payable at the end of a director's tenure.

COMMENT

This legislative proposal has been watered down from original reforms sought by the SPD coalition party. These would have included limits on a corporation's ability to deduct directors' compensation as a business expense, a cap on the number of board memberships held by an individual, and a general limitation on the number of members of a corporation's supervisory board.

The proposed amendments affect all stock corporations. This is unfortunate: stock corporations in Germany are not necessarily capital market-oriented, and many businesses select this legal form for the flexibility it offers in transferring shares *outside* of publicly-traded markets. The desire for reform prompting the amendments to the Stock Corporations Act, however, stems almost entirely from disapproval of manager compensation in prominent publicly-traded companies. For example, shareholders have recently commenced an action⁷ with respect to the reported EUR 77 million in compensation paid to Porsche's CEO. These amendments would necessarily affect the hundreds of stock corporations which serve as either holding vehicles or essentially privately-held entities.

If passed, it is likely that many stock corporations will move quickly to revise compensation packages for their directors (if they are interested in keeping them). German businesses have traditionally favoured high fixed-salary compensation models; it is only in the recent past that proportionately high

performance-based compensation has become popular and commonplace. As a result of these reforms, it is possible that we will see a return to a old German remuneration system of proportionately high fixed-salary compensation for directors. In addition, as one member of the Parliamentary Legal Committee noted, the objective term ‘typical compensation’ could lead corporations as a whole toward an upward spiral of fixed salary increases in order to ensure that numerous examples exist in which similar ‘typical’ compensation has been granted.

Alternatively, performance-based compensation may be modified to account for longer performance-measurement horizons. This would make the structuring of director compensation arrangements more complicated, especially where volatile businesses/industry sectors are involved.

While it is likely that legislation relating to director compensation will be passed this summer in the form described above, especially with respect to the supervisory board’s obligation to reduce director pay in the face of worsening circumstances, the

debates surrounding this issue remain extremely sensitive to Germany’s economic well-being, as well as political positioning in advance of the September federal election.

¹ *Entwurf eines Gesetzes zur Angemessenheit der Vorstandsvergütung*, German Federal Parliamentary Press, No. 16/12278, Draft Legislation prepared by the CDU/CSU and SPD, dated 17 March 2009

² Including numerous prominent professors, representatives of labour and legal practitioners (see Press Service of the Federal Parliament dated 26 May 2009 (G))

³ Debate on such legislation has continued since an original proposal by the SPD party in 2008 during the midst of the financial crisis

⁴ Pursuant to § 116 of the Stock Corporations Act, supervisory board members are subject to the same duty of care as directors with respect to the corporation

⁵ Amendment proposed to § 193 (2) No. 4 of the Stock Corporations Act

⁶ See e.g. *Handelsblatt*, “Manager an der kurzen Leine”, 15 May 2009, www.handelsblatt.com (G)

⁷ *Rheinische Post* (www.rp-online.de) and *Spiegelonline* (www.spiegelonline.de), 28 May 2009

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