

REDUCTION OF COMPENSATION AND POST-RETIREMENT BENEFITS OF CORPORATE OFFICERS PURSUANT TO THE ACT ON THE APPROPRIATENESS OF MANAGEMENT BOARD REMUNERATION (GENERALLY KNOWN AS THE VORSTAG) AND THE EFFECT THEREOF IN THE CASE OF MANAGING DIRECTORS OF LIMITED COMPANIES

BACKGROUND AND IMPORTANCE The Act on the Appropriateness of Management Board Remuneration came into force on 5 August 2009. This Act is Parliament's response to – ostensible – abuses in the area of executive compensation that have come to light in connection with the financial and economic crisis. Its purpose was to create incentives at the level of compensation to achieve sustainable corporate performance. To that end, the Stock Corporation Act (Aktengesetz – AktG) as amended by the VorstAG provides, among other things, that the entire supervisory board is responsible for decisions regarding executive compensation, that D&O insurance must make provision for a minimum deductible, and that a two-year waiting period must elapse before an executive officer may become a member of the supervisory board. What is important here is the change in the main provision of section 87 of the Stock Corporation Act that governs the appropriateness of executive compensation. The VorstAG not only sets more stringent standards for determination of the appropriateness of executive compensation in section 87(1) of the Stock Corporation Act, but also significantly lowers the threshold for a subsequent reduction of compensation in section 87(2) of the Stock Corporation Act. In addition, the new standard also applies to post-retirement benefits. Section 87(2) of the old version of the Stock Corporation Act did indeed allow for the subsequent reduction of executive compensation prior to the enactment of the VorstAG, but for all practical purposes, this was never done. The reform seems to have changed that. Only a few weeks after the VorstAG went into effect, the press announced a reduction in the severance and post-retirement benefits of Wolfgang Ziebart, an executive officer who had recently departed from Infineon AG, in light of the background of the changed legal situation, and this attracted considerable attention. This provides an occasion for taking a closer look at the new possibilities, which include significant changes and indeed for the first time postulate subsequent adjustment in executive compensation as an actual duty.

1. CONTENT OF THE REVISED LEGISLATION According to section 87(2) of the old version of the Stock Corporation Act, supervisory boards had the “right” to effect an “appropriate reduction” in the future compensation of corporate officers in cases in which the situation of a company has undergone such “significant deterioration” after compensation had been set that further payment would represent a “severe inequity” for the company.

By comparison, section 87(2) of the new version of the Stock Corporation Act is in several ways significantly more stringent: According to the revised legislation, a supervisory board should “reduce the future compensation of corporate officers “to the appropriate amount” if the situation of the company has “deteriorated” to the extent that continued payment would be “inequitable” for the company.

1.1 CONSTITUENT ELEMENTS As far as the constituent elements requiring a reduction in compensation are concerned, elimination of the requirement of “significant” deterioration in the situation of the company and “severe inequity” for the company has significantly lowered the threshold for reducing the compensation of corporate officers. At the practical level, it remains to be seen how the undefined legal terms “deterioration of the situation of the company” and “inequity of further payment of compensation” will be fleshed out.

Deterioration of the situation of the company

How is this to be understood? According to the explanatory memorandum to the new legislation, a “deterioration in the situation of the company” can be ascertained, for example, if the company must dismiss personnel or reduce wages or can no longer distribute profits. According to the explanatory memorandum, insolvency or an immediate crisis is consistently to be considered to represent a deterioration in the situation of the company, but not to be a prerequisite for the existence of such deterioration. The examples cited in the legislative materials do not help in every case. Dismissals or wage cuts may well be indicative of such deterioration; on the other hand, they can also improve the earnings performance of a company.

It is in any case advisable to thoroughly assess and weigh the company's financial ratios.

It remains to be clarified whether a deterioration in the situation of a company that is already foreseeable, i.e., included in the company's business plans at the time when the compensation of corporate officers is set and which then subsequently materializes as expected, can constitute ground for a reduction in the compensation of a corporate officer. The wording of the legislation would seem to confirm that this is possible and that such cases would have to be judged on the basis of the second constituent element, i.e., the "inequity" of further payment of the compensation as agreed upon. The same is likely to apply in the case of the deterioration in the situation of the company "at the upper level."

Inequity of further payment of compensation

When does further payment of compensation of corporate officers become "inequitable" for a company in view of a deterioration in its situation? According to the explanatory memorandum, further payment is to be considered inequitable if management has acted in breach of its duties, but also in the absence of any such breach if the deterioration in the situation of the company occurs during the executive's term of office and can be attributed to him. A causal contribution of the executive officer to the deterioration of the situation is therefore required. An executive is not likely to be able to mount a defense based on the circumstance that the deterioration cannot be attributed to his area of responsibility, since this will, as a rule, be precluded by the joint responsibility of management for corporate performance.

Post-retirement benefits

Although the old version of section 87(2) of the Stock Corporation Act pertained exclusively to the compensation of active corporate officers, the revision also applies to post-retirement benefits, survivors' benefits and benefits of a similar nature, including non-lapsable earned benefits as well as current benefits. According to the revised section 87(2) sentence 2 of the Stock Corporation Act, these post-retirement

benefits may, however, be curtailed only in the first three years immediately following the officer's departure from the company, but with effect for the entire remaining duration of the benefits. The possibility of the reduction of post-retirement benefits that an executive has earned through past performance has been severely criticized in the scholarly literature and even considered by some to constitute a violation of the Basic Law. In particular, the fact that a former executive officer cannot in such cases, as would be possible in the event of a reduction in current compensation during his term of office, respond to such a reduction by resigning pursuant to section 87(2) sentence 4 of the Stock Corporation Act constitutes grounds for concern.

1.2 LEGAL CONSEQUENCES

Mandatory action

Whereas the old version of section 87(2) of the Stock Corporation Act gave supervisory boards only the "right" to reduce executive compensation in the presence of circumstances warranting such action and the decision therefore lay in its discretion, section 87(2) of the revised version of the Stock Corporation Act calls for mandatory action. In the presence of circumstances warranting such action, supervisory boards have a duty to reduce executive compensation and may refrain from doing so only in the case of extenuating circumstances.

Appropriate reduction

The legal situation was previously such that the law made provision for an "appropriate reduction." For the most part, only a reduction in executive compensation to an amount that no longer represented severe inequity for the company was considered permissible. However, the revised section 87(2) of the Stock Corporation Act now requires reduction "to the appropriate amount." On the basis of the explanatory memorandum, this must be taken to mean that a supervisory board must reduce the compensation of corporate officers to the level that would be considered appropriate pursuant to the amended version of section 87(1) of the Stock Corporation Act. As a result, in making a decision concerning reduction of compensation pursuant to the new version of section 87(2) of the Stock Corporation Act, a supervisory board must comply with the new, more stringent requirements of the amended version of section 87(1) of the Stock Corporation Act in respect of the appropriate level of executive compensation.

Termination for cause

In such situations, the right of an executive officer to respond to a reduction in his compensation by terminating the respective employment agreement with effect as of the end of the next quarter with a period of notice of six weeks remains unchanged. The possibility of resignation will become important in terms of how it affects the duty to reduce compensation. After all, according to widespread opinion, a supervisory board may refrain from effecting a reduction in compensation that is actually justified if the executive officer in question is indispensable to the company and threatens to resign in the event of any reduction in his compensation.

2. IMPLICATIONS IN PRACTICE FOR THE ENTIRE SUPERVISORY BOARD

As was shown above, the revision of section 87(2) of the Stock Corporation Acts presents supervisory boards with a series of complex issues that must be assessed and weighed in connection with any decision to reduce executive compensation. In view of the personal liability of the members of supervisory boards pursuant to section 116 in conjunction with section 93(1) of the Stock Corporation Act, it would therefore seem advisable in the future to ensure in the event of the presence of any indication of a deterioration of the situation of a company that the supervisory board is consistently on the watch for conditions that would warrant a reduction in executive compensation pursuant to section 87(2) of the Stock Corporation Act, form an opinion and, if appropriate, take action accordingly. In this context, it is necessary to carefully document that the factual basis underlying the supervisory board's actions in the matter was accurate and complete and that the assessment and decision-making process were carried out on the basis of the respective constituent elements contained in section 87(2) of the Stock Corporation Act. Since any decision in respect of executive compensation, including a

reduction, may no longer be delegated to a committee pursuant to the amended version of section 107(3) sentence 3 of the Stock Corporation Act, this review must be undertaken by the board as a whole and recorded in its memoranda.

3. IMPLICATIONS FOR MANAGING DIRECTORS OF LIMITED COMPANIES

The VorstAG contains no explicit provision that governs the reduction of the salaries of managing directors of limited companies. Managing directors of limited companies were in the past already obligated to accept a reduction in compensation in the event of significant deterioration in the situation of their companies, which, according to some voices in the scholarly literature, required a threat to the existence of the company in question. The prevailing opinion found in the literature and that of the Federal Court of Justice infer this obligation from the general duty of loyalty of managing directors pursuant to section 242 of the German Civil Code, which, according to the Federal Court of Justice, is manifested in the legal principle underlying section 87(2) of the old version of the Stock Corporation Act. Whether the more stringent standard introduced by the VorstAG will affect the nature of the duty of loyalty of managing directors of limited companies is the subject of dispute. Much would speak against this. However, future case law will bring clarity.

4. CHRONOLOGICAL APPLICATION

The VorstAG makes no provision for a transition in respect of the application of section 87(2) of the Stock Corporation Act, i.e., the new provision has been in effect since the VorstAG came into force on 5 August 2009 and also applies to existing executive employment contracts.

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