



Germany introduces new rules on management board compensation

The Act on the Appropriateness of Management Board Compensation (VorstAG) came into force on 5 August 2009. The VorstAG considerably changes the practice of management board compensation and its determination by the supervisory board. Among other things, the act substantiates the appropriateness of board members' remuneration. Listed stock corporations must implement a compensation structure that promotes sustainable and long-term company development. Existing compensation agreements need not be adjusted, but companies need to act on the extension of existing contracts. In existing directors and officers liability insurance, a deductible complying with the legal regulations must be included before 30 June 2010.

The Act on the Appropriateness of Management Board Compensation (VorstAG) came into force on 5 August 2009. By setting new rules for determining the compensation of management board members and, for listed stock corporations, setting incentives for sustainable and long-term management, the legislation intends to correct undesirable developments. At the same time, the responsibility of the supervisory board for the management board's compensation shall be emphasised and transparency improved for shareholders and the public.

On 18 July 2009, the government commission of the German Corporate Governance Code considered the amendments made by the VorstAG in the revised version of the German Corporate Governance Code (GCGC). Thus, mandatory law was reflected in the GCGC and further regulations were included as recommendations or suggestions.

The recommendations of the EU Commission on the regime for directors' remuneration, published on 29 April 2009, were only partially considered by the legislator and in the GCGC.

New guidelines on the content and determination of management board compensation

Competence for determining management board compensation

Previously, a committee of the supervisory board could determine the management board's compensation. Under the VorstAG, the supervisory board as plenum must decide on the management board's remuneration (salary, profit participation, expense allowances, insurance premiums, commissions or incentive-based remuneration commitments). This entails a serious change to the previous practice, in which the plenum decided only on the management board compensation system and not on its details (see No. 4.2.2 of the old version of the GCGC). The VorstAG assigns only a preparatory function to the supervisory board's personnel committee. The mandatory competence of the supervisory board plenum also applies to a possible reduction in remuneration (section 87 paragraph 2 of the German Stock Corporation Act; AktG).

Criteria for calculating management board compensation

The supervisory board must not only ensure that remuneration is adequate in relation to the performance of the respective management board member and the position of the company, but it must also make sure that the 'customary' remuneration is not exceeded without a particular reason.

According to the legislative material, one must look to the branch, size and country to determine what remuneration would be customary (so-called horizontal comparability). Furthermore, the salaries paid within the company must be considered (so-called vertical comparability). Thus, the supervisory board has to make sure that the remuneration of the management board members remains in proportion to the remuneration system within the company.

The clause indicating that the customary remuneration may not be exceeded without particular reason, which was added by the committee on legal affairs of the German parliament, shall give supervisory boards the necessary flexibility to be able to react to special circumstances.

Incentives for sustainable company development – variable remuneration systems

The supervisory board of a listed company is obliged to implement a remuneration structure that promotes sustainable company development (section 87 paragraph 1 sentence 2 of the AktG).

The long-term effects of the incentive regarding the variable parts of remuneration must thus be kept in mind. According to the legal reasoning, a mixture of short-term and long-term incentives shall be possible if, as a result, a long-term incentive is created. This would mean that common annual royalties or annual bonuses remain permissible in conjunction with other parts of remuneration applied in the mid-term or long-term. Variable parts of remuneration shall be based on the figures from several years. Correspondingly, stock options can in the future be exercised no earlier than four years after they are granted. However, stock option plans that have already been resolved by the shareholders' meeting do not have to be adjusted.

The GCGC also recommends that the remuneration may not incentivise management board members to take unsuitable risks.

On the agreement of the variable remuneration instruments, the supervisory board shall include a cap as a limitation possibility for extraordinary developments. Thus, the management board shall participate in the positive development of relevant parameters, but shall not profit from extraordinary developments (eg takeover offer for the company, sale of assets of the company,

realisation of hidden reserves, external influences). It is up to the supervisory board to determine how such a limitation is to be structured.

Reduction of management board compensation in crisis

If the company's situation deteriorates, the supervisory board shall (but is not forced to) reduce the remuneration to an adequate amount. In principle, this ability to interfere with existing contracts already existed before the VorstAG, but only as a softer 'may-regulation' and not as a 'shall-regulation'. The amendments clearly extend the practical scope of the previously hardly used option of reducing remuneration. In the case of pensions, dependants' pensions and similar payments, a reduction is possible only in the first three years after the management board member has retired.

If the company thus reduces the remuneration, the management board member may in turn terminate his employment contract according to section 87 paragraph 2 sentence 3 of the AktG.

D&O insurance deductible

If the company takes out insurance to cover a member of the management board against risks arising from his professional activities (directors and officers liability (D&O) insurance), then, in accordance with section 93 paragraph 2 of the AktG, the insurance policy must provide for a deductible (threshold) of at least 10 per cent of the individual damage and at least 150 per cent of the fixed annual remuneration of the management board member. This represents the legislator's direct reaction to companies' unwillingness to implement the similar recommendation in No. 3.8 of the old version of the GCGC.

Management board members may take out additional insurance that covers the deductible, as long as the company does not pay the premium for it.

Furthermore, the GCGC recommends the inclusion of a corresponding deductible in D&O insurance for supervisory board members.

Liability of the supervisory board

Under the previous rules, the members of the supervisory board were already personally liable for culpable determination of unsuitably high remuneration.

Now, this liability is expressly emphasised. However, a breach of duty regarding non-reduction of remuneration is not mentioned in the act.

Vote on the remuneration system by the shareholders' meeting

The VorstAG introduces a new concept: following the example of English law, the shareholders' meeting of a listed company may decide on the approval of the remuneration system for the members of the management board in accordance with section 120 of the AktG. However, the resolution does not establish rights and obligations and cannot be contested.

Waiting period for a transfer from management board to supervisory board

The cooling-off period for former management board members means a further deviation from the usual practice. According to the new version of section 100 paragraph 2 of the AktG, a person who was a member of the same listed company's management board within the past two years cannot become a member of its supervisory board, unless his election is made on the suggestion of shareholders who jointly hold more than 25 per cent of the voting rights in the company.

The regulation is limited to listed companies. The exception (no waiting period on shareholders' suggestion with a quorum of 25 per cent of votes) shall make it possible for significant owners (family shareholders, foundations) to continue to secure the knowledge and ability of an esteemed member of the management board.

Furthermore, the GCGC recommends that a member of a listed stock corporation's management board should not occupy more than three positions on supervisory boards in listed companies that are not part of the company group. Previously, it was customary to hold up to 10 positions on supervisory boards.

Extended disclosure obligations

The existing disclosure obligations regarding management board members' remuneration in annual financial statements and group accounts are amplified by the VorstAG, especially for benefits that accrue after the

termination of employment on the management board (eg pension regulations and severance payments). In practice, there will be problems regarding those benefits for which a cash value calculation is not possible or is very difficult.

Need for action

Ongoing management employment contracts do not have to be adjusted to comply with the VorstAG, but there is a need for action on the extension of employment contracts after the act came into force. Existing D&O insurance policies must be adjusted to the new regulations by 30 June 2010. However, this does not apply if the company has bound itself to farther-reaching insurance cover vis-à-vis members of the management board. Adjusting the ongoing employment contracts is thus not necessary.

The waiting period for a transfer from the management board to the supervisory board does not apply to supervisory board members who already held the position on 4 August 2009.

If you have any further questions, feel free to contact your normal contact person at Freshfields Bruckhaus Deringer.