

Draft Bill on the Adequacy of Management Board Compensation in Germany

Frankfurt
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On March 11, 2009, the German government resolved language for a draft bill¹ (the “Draft Bill”) that would bring about certain modest reforms of the legal regime for the compensation of the members of the management board (*Vorstand*, the “Management Board”) of German stock corporations. The proposal specifies the agreement in principle on such reforms reached by the governing German Grand Coalition of Conservatives and Social Democrats (the “Grand Coalition”) on March 4, 2009.² Contrary to what was suggested in official reports about the Grand Coalition’s agreement, the scope of application of the proposed new rules on the compensation of Management Board members will not generally be limited to German public companies. Rather, the new rules will generally apply to all stock corporations, except for the new rules related to disclosure obligations, which will be limited to public companies.

1. Government Proposal

The Draft Bill will specify the Grand Coalition’s agreement as follows:

- Clarification of the “adequacy” standard regarding the compensation of Management Board members:
 - The total compensation (*i.e.*, the base compensation together with any profit participation, cost reimbursement, insurance premiums, performance- and incentive-based compensation, such as stock options and other ancillary compensation of any kind) of any Management Board member must be “adequate” compared not only to the condition of the company and such member’s tasks but also to such member’s individual performance;

¹ *Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)*; to expedite the legislative procedure, the Draft Bill will be adopted by the parliamentary groups of the Grand Coalition parties, and the legislative procedure will be initiated directly by them.

² For a summary of the Grand Coalition’s agreement in principle and background information on the current legal regime applicable to Management Board compensation in Germany, see our Alert Memorandum “Proposed Amendments to the Regulation of Management Board Compensation in Germany” of March 9, 2009, available on our website www.clearygottlieb.com.

- The compensation of any Management Board member must further be adequate compared to what is “customary”; the standard of what is “customary” is flexible and may take into account the compensation paid in other companies in the same sector, of the same size and in the same geographic area as the company concerned; it may also take into account the overall compensation system and levels within the company concerned;
 - The compensation of any Management Board member must include long-term incentives for the sustainable development of the company (*e.g.*, the criteria for the determination of bonuses should to be structured in a manner that normalizes one-time effects and takes into account the further development of the company); compensation elements are deemed to have a “long-term” perspective if they are geared towards a period of approximately four years or longer.
- Clarification of the rules on a possible reduction of the compensation of Management Board members:
- The proposal for the Draft Bill sets forth an obligation (rather than previously only a right) of the supervisory board (*Aufsichtsrat*, the “Supervisory Board”) to unilaterally reduce the compensation of Management Board members upon occurrence of any deterioration (rather than previously a material deterioration) in the condition of the company if the continued payment of the originally agreed compensation of the Management Board member were to result in an undue burden (rather than previously a grossly undue burden) for the company; in the future, these requirements would not only be met in extreme situations such as the insolvency or imminent crisis of the company, but possibly also when the company experiences less dramatic difficulties involving lay-offs or salary cuts for employees or the cancellation of dividend payments;
 - If the reduction obligation is triggered, the Management Board compensation must be reduced to an “adequate” level (see above); this applies to the compensation of active Management Board members, as well as to pension and similar payments to former Management Board members (including, in the case of a dismissal, payments for the remainder of the contract term) of the Management Board member concerned.
- Extension of the initial holding period for stock options from currently two years to four years going forward.

- Allocation of the responsibility for the compensation of Management Board members to the full body of the Supervisory Board, thus prohibiting delegation to a sub-committee, this measure is intended to increase transparency regarding the determination of the compensation of Management Board members.
- Clarification of the liability of the Supervisory Board:
 - The liability of the Supervisory Board members for the determination of an inadequate Management Board compensation will be explicitly mentioned in the Stock Corporation Act, thus emphasizing the Supervisory Board's duties of care with respect to Management Board compensation issues; the proposal presumably does not substantively increase the Supervisory Board's liability, but is aimed at raising the Supervisory Board members' awareness with respect to their duties of care in the context of Management Board compensation;
 - In the case of a breach of the duty to determine an adequate Management Board compensation, the Supervisory Board members will be liable for damages amounting to at least the difference between the actually agreed compensation and an "adequate" compensation.
- Clarification of the scope of the disclosure obligations regarding individual Management Board member compensation for all business years beginning after December 31, 2009:
 - In addition to the existing disclosure obligations, any agreements regarding payments to be made or other compensation to be granted by the company to Management Board members in the event of an early termination of the office and service agreement of a Management Board member³ and/or regular termination of his or her office⁴ as well as any amendments to such agreements in the current business year must be disclosed separately;

³ The required disclosure includes information as to whether and to what extent compensation must be paid for the remainder of the originally agreed term of the contract, whether the relevant payments are to be discounted, whether substitute income will be credited against the company's payment obligations, as well as on the treatment of missed bonuses etc.

⁴ The required disclosure includes information on the present value of each component of the agreed compensation (including pensions, surviving dependants' pensions and other benefits such as office use, company car etc.) agreed to be paid or granted by the company as well as the amount paid to the relevant Management Board member or provided for by the company in the most recent business year with respect thereto.

- With respect to Management Board members who stepped down from their office during the current business year, any payments or other compensation agreed and/or granted to such member in the current business year in respect of his or her termination must also be individually disclosed.
- Introduction of a waiting period of three years before a retired member of the Management Board can join the audit committee (*Prüfungsausschuss*) of the Supervisory Board:
 - This proposal goes beyond the German Corporate Governance Code which merely suggests (rather than recommends)⁵ that a former Management Board member should not be chairman of the audit committee;
 - The proposal of a general waiting period is aimed at preventing potential conflicts of interest of audit committee members, which may prevent the full investigation and disclosure of past irregularities (this proposal does not appear to have a specific nexus to the regulation of Management Board compensation).

2. *Expected Timing of Legislative Procedure*

Pursuant to a press release of the German Federal Ministry of Justice, it is planned to complete the legislative procedure prior to this year's summer recess.

3. *Assessment of the Proposed New Rules on Management Compensation*

The proposed new rules clarify to some extent the vague standard of "adequate" compensation of Management Board members and link the Management Board members' compensation more closely to the individual member's performance and the specific situation of the company, in particular its long-term development, financial condition, profitability, overall compensation system and levels and its comparative position in the industry. In addition, the proposed new rules stress the responsibility and liability of the Supervisory Board for the determination of the compensation of Management Board members, as well as for the continued monitoring and review of the Management Board members' compensation, in particular with a view to a potential reduction if the situation of the company has deteriorated. In light of this, Supervisory Boards may feel an increased need for advice regarding the adequacy of compensation structures and levels for members of the Management Board. The proposed new rules neither deal with the absolute amount or tax deductibility of the compensation of

⁵ The "comply or explain" rule does not apply to suggestions made in the German Corporate Governance Code.

Management Board members, nor do they address management or executive compensation on any level below the Management Board.

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