

## Proposed Amendments to the Regulation of Management Compensation in Germany

Frankfurt  
March 9, 2009

On March 4, 2009, the governing German Grand Coalition of Conservatives and Social Democrats (the “Grand Coalition”) reached agreement in principle on certain clarifications and modest changes to the legal regime for the compensation of members of the management board (*Vorstand*, the “Management Board”) of German public companies.<sup>1</sup> The agreement is the result of intense negotiations between the Grand Coalition parties, reflecting a political compromise that does not go beyond the lowest common denominator of the two parties’ views, which are hugely different in various respects. No official report or press release regarding the agreement was made available by the Grand Coalition; as a result, at this stage, publicly available information on the agreement is limited to slightly inconsistent press reports and website postings of the Grand Coalition parties. Before laying out some details of the proposal, this memorandum provides a brief summary of the current legal regime applicable to Management Board compensation in Germany.

### **1. *Current Legal Regime Applicable to Management Board Compensation in Germany***

German public companies in the form of a stock corporation (*Aktiengesellschaft*) have a two-tier governance system, comprising the Management Board in charge of the day-to-day management of the company, and the supervisory board (*Aufsichtsrat*, the “Supervisory Board”) in charge of monitoring the Management Board.<sup>2</sup> The Supervisory Board (full body)<sup>3</sup> is also in charge of appointing the members of the Management Board. In addition, the Supervisory Board is responsible for negotiating and concluding the service agreement between the company and the members of the Management Board, which will, in each case, provide for, among other things, details of

<sup>1</sup> “German public companies” are those German companies whose shares are admitted to trading on an organized market in Germany or outside Germany in the European Union or European Economic Area.

<sup>2</sup> German public companies in the form of a so-called European Company (SE) may have a one-tier- or two-tier-board system. In the latter case, the applicable legal regime is very similar to that of a stock corporation. This Memorandum will focus on public companies in the form of a stock corporation.

<sup>3</sup> Depending on the number of employees of a company, one third (between 501 and 2,000 employees) or one half (more than 2,000 employees) of the members of the Supervisory Board will be employee representatives.

the services to be rendered by the member of the Management Board and the compensation to be paid to such member by the company. The Supervisory Board may, and in practice often does, delegate its tasks related to service agreements with members of the Management Board to a sub-committee of the Supervisory Board.

The German Stock Corporation Act sets forth certain principles for the compensation of members of the Management Board. In particular, when agreeing the compensation of a Management Board member, the Supervisory Board must see to it that the aggregate compensation of such member (base compensation, profit participation, cost reimbursement, insurance premiums and any other form of compensation) as well as commitments regarding pension and similar payments are adequate compared to the tasks of such member and the overall condition of the company. In addition, the Supervisory Board has the right to adequately reduce the compensation of a Management Board member upon occurrence of a material deterioration in the condition of the company if the continued payment of the initially agreed compensation were to result in a grossly undue burden for the company.

The German Stock Corporation Act also provides that a conditional capital may be created for purposes of granting stock options to employees and members of the Management Board. The creation of such conditional capital requires approval by the shareholders' meeting.<sup>4</sup> The shareholders' resolution approving the issuance of stock options must include, among other things, the strike price of the underlying shares (or the parameters for its determination), performance goals, as well as issuance, exercise and holding periods. The initial holding period for the stock options must not be less than two years.

Under the German Commercial Code, German public companies are obligated to disclose in the notes to their stand-alone and consolidated financial statements, individually for each member of the Management Board, his or her aggregate compensation for the relevant fiscal year, broken down in non-performance-related components, performance-related components and long-term incentive components. This obligation does not apply if the shareholders' meeting of a public company resolves, with a majority of 75% of the share capital represented at the meeting, to opt out of the disclosure obligation. The opt-out resolution may be adopted for a maximum of five years. Irrespective of an opt-out resolution, the company must disclose for each of the Management Board and the Supervisory Board as a whole in the notes to their stand-alone and consolidated financial statements the aggregate compensation paid in the relevant fiscal year. The number of stock options, if any, granted must be disclosed separately.

In addition to the statutory principles regarding the compensation of Management Board members and the related disclosure obligations set forth in the German Stock

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<sup>4</sup> The required majority is 75 per cent. of the share capital represented at the shareholders' meeting or such **higher** majority as provided in the articles of association of the company.

Corporation Act and the German Commercial Code, the German Corporate Governance Code lays out certain recommendations and suggestions in the area of the compensation of Management Board members. With respect to recommendations laid out in the German Corporate Governance Code, the German Stock Corporation Act sets forth a “comply or explain” rule. More specifically, both the Management Board and the Supervisory Board of a listed German company must issue a declaration on an annual basis that they and the company, as the case may be, have complied and will comply with the recommendations of the German Corporate Governance Code. Any recommendations not complied with must be specifically mentioned in the declaration.

The major recommendations in the area of Management Board compensation are as follows:

- The Supervisory Board (full body) shall, upon proposal of the relevant sub-committee, discuss, and regularly review, the structure of the compensation system for the members of the Management Board.
- The monetary compensation of the Management Board members shall comprise fixed and variable components.
- Stock options and comparable instruments shall be tied to challenging, appropriate performance hurdles.
- A retroactive adjustment of performance goals or hurdles shall not be permitted.
- The service agreement between the company and the Management Board member shall provide for the possibility of a cap in case of extraordinary, unforeseeable developments.
- The chairman of the Supervisory Board shall inform the shareholders’ meeting about the major principles of the compensation of Management Board members and any changes to such principles.
- The required disclosure of the compensation of Management Board members shall be made in the form of a compensation report, which shall be part of the corporate governance report.
- The disclosure of stock option or similar long-term incentive plans shall include the value of the stock options or similar rights.

In addition to the recommendations summarized above, the German Corporate Governance Code also contains suggestions for good governance in the area of compensation of Management Board members. No disclosure has to be made regarding compliance or non-compliance with these suggestions.

## 2. *Proposal of the Grand Coalition*

Pursuant to the limited publicly available information, the Grand Coalition's compromise proposes the following clarifications and amendments to the legal regime currently applicable to the compensation of Management Board members of German public companies:

- Clarification of the “adequacy” standard regarding the compensation of Management Board members compared to their tasks and performance on the one hand and the condition of the company on the other hand.
- Clarification of the rules on a possible reduction of the compensation of Management Board members; in particular, introduction of an obligation (rather than only a right) of the Supervisory Board to reduce the compensation of Management Board members upon occurrence of 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 a grossly undue burden for the company.
- 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 no longer permitting the current practice of delegating Management Board compensation to a sub-committee of the supervisory board (on which the chair of the works council typically was the only employee representative).
- Tightening of the liability of the Supervisory Board by introducing stricter duties of care (presumably in the area of Management Board compensation).
- Clarification of the disclosure obligations regarding individual Management Board member compensation.
- 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. It is unclear what nexus this proposal has to the regulation of Management Board compensation, since the agreement of the Grand Coalition does not include the proposal that a retired member of the Management Board can generally only join the Supervisory Board after a certain waiting period.

The Grand Coalition has not reached agreement on various other Management Board compensation-related proposals introduced into the political debate by the Conservatives on the one hand and the Social Democrats on the other hand, such as an introduction of an absolute limit on Management Board compensation, limitation of the

tax-deductibility of Management Board compensation exceeding a certain threshold, limitation of the number of Supervisory Board mandates that can be assumed by one individual, limitation of the maximum size of Supervisory Boards, transfer of the responsibility for Management Board compensation to the shareholders' meeting. The Grand Coalition agreed to establish a working group that will look into a further potential tightening of the regulation of Management Board compensation of German public companies beyond the proposals currently on the table.

Also, the proposal does not address the compensation of executives of a public company other than members of the Management Board. In particular, the proposal does not reflect a concept similar to the U.S. concept of limiting – in certain situations – the compensation of “senior executive officers”, which, in addition to the CEO and CFO also include three of the most highly paid managers who are not board members.

### **3. *Expected Timing of Legislative Procedure***

The German government is expected to adopt the draft bill regarding the proposed amendments to the regulation of Management Board compensation summarized above in the course of this week. The draft bill should become available immediately thereafter. Unless any unforeseen difficulties come up, the legislative procedure may be completed, and the amendments be enacted, early this summer.

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We will keep you posted on how the proposals summarized under 2. above will be implemented in the draft government bill. If you have any questions in connection with this Memorandum, please contact Gabriele Apfelbacher ([gapfelbacher@cgsh.com](mailto:gapfelbacher@cgsh.com)) or Daniel Weyde ([jweyde@cgsh.com](mailto:jweyde@cgsh.com)) in our Frankfurt office.

CLEARY GOTTlieb STEEN & HAMILTON LLP

**FRANKFURT**

Main Tower  
Neue Mainzer Strasse 52  
60311 Frankfurt am Main, Germany  
49 69 97103 0  
49 69 97103 199 Fax

**NEW YORK**

One Liberty Plaza  
New York, NY 10006-1470  
1 212 225 2000  
1 212 225 3999 Fax

**WASHINGTON**

2000 Pennsylvania Avenue, NW  
Washington, DC 20006-1801  
1 202 974 1500  
1 202 974 1999 Fax

**PARIS**

12, rue de Tilsitt  
75008 Paris, France  
33 1 40 74 68 00  
33 1 40 74 68 88 Fax

**BRUSSELS**

Rue de la Loi 57  
1040 Brussels, Belgium  
32 2 287 2000  
32 2 231 1661 Fax

**LONDON**

City Place House  
55 Basinghall Street  
London EC2V 5EH, England  
44 20 7614 2200  
44 20 7600 1698 Fax

**MOSCOW**

Cleary Gottlieb Steen & Hamilton LLP  
CGS&H Limited Liability Company  
Paveletskaya Square 2/3  
Moscow, Russia 115054  
7 495 660 8500  
7 495 660 8505 Fax

**COLOGNE**

Theodor-Heuss-Ring 9  
50668 Cologne, Germany  
49 221 80040 0  
49 221 80040 199 Fax

**ROME**

Piazza di Spagna 15  
00187 Rome, Italy  
39 06 69 52 21  
39 06 69 20 06 65 Fax

**MILAN**

Via San Paolo 7  
20121 Milan, Italy  
39 02 72 60 81  
39 02 86 98 44 40 Fax

**HONG KONG**

Bank of China Tower  
One Garden Road  
Hong Kong  
852 2521 4122  
852 2845 9026 Fax

**BEIJING**

Twin Towers – West  
12 B Jianguomen Wai Da Jie  
Chaoyang District  
Beijing 100022, China  
86 10 5920 1000  
86 10 5879 3902 Fax