



Fundamental Changes to German Stock Corporations by the New German Reasonableness of Management Remuneration Act (Gesetz Zur Angemessenheit Der Vorstandsvergütung – VorstAG)

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On August 5, 2009, the new German Reasonableness of Management Remuneration Act (in German: *Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG*) entered into force. The VorstAG is a response to the financial crisis, which the Federal Government of Germany considers a result of, *inter alia*, misguided incentive-based management remuneration particularly in the case of financial institutions. An example would be remuneration policies that incorporate the earnings and share price of the company and thereby, in the opinion of the German legislator, tempt managers into carrying out irresponsible risks. Consequently, at the essence of the VorstAG is the principle of sustainability. Instead of striving for short-term goals, the managers of German stock corporations are to act in the best interests of the long-term welfare of the company. In addition, the new legislation intends to strengthen the responsibility of the supervisory board in determining management remuneration, as well as improve transparency to both the shareholders and the public.

Sec. 87 para 1 of the German Stock Corporation Act (in German: *Aktiengesetz – AktG*) has been amended to the effect that manager remuneration must not only be at an appropriate rate to that of a comparable business but also to managers' performance. Furthermore, total compensation, including incentive-based remuneration components such as share subscription rights may no longer exceed the conventional remuneration without good reason. Particularly for listed stock corporations, the principle of sustainability is now stated in sec. 87 para 1 sentences 2 and 3 AktG. In addition to the general requirement for aligning the remuneration structure of listed stock corporations with sustainable company development, it is also determined that variable elements of remuneration are supposed to have a multi-annual assessment base, and furthermore, that an option to limit remuneration in the event of extraordinary developments should be granted. The supervisory board is supposed to create incentives for managers to act with the long-term development of the business in mind and not to establish bonuses and gratuities with a short-term view without caring about any long-term effects.

Under sec. 87 para 2 AktG, the preconditions for reducing remuneration to a reasonable level if the company's situation deteriorates have been substantially simplified. Before the VorstAG, the requirement was that continuing to grant the same remuneration would have to be unfair if the company's situation was in decline. Now,

any inequity is sufficient reason to reduce remuneration. Furthermore, the supervisory board no longer merely has the right to reduce remuneration, but rather, is obliged to do so. This means it must exercise discretion in compliance with the legislative provisions (in contrast to having absolute discretion). An example of such decline provided by the guidance to the VorstAG is where the company has to dismiss employees and can no longer pay out dividends; bankruptcy of the company is not a condition precedent. Retirement pensions and bereavement payments can also be reduced under sec. 87 para 2 AktG, but not longer than three years after the manager's retirement.

The legislative regulations are to be enforced by the new sec. 116 para 3 AktG, whereby members of the supervisory board may be held personally liable for damages if they determine an inappropriate remuneration. This personal liability is meant to emphasise the exceptionally important duty of the supervisory board in determining reasonable management remuneration. Determining such remuneration may no longer be delegated to an executive committee (sec. 107 para 3 sentence 3 AktG) and as a result, transparency should be increased.

Under the new sec. 93 sentence 3 AktG, in the event of taking out so-called "D&O" (director and officer) insurance to cover a manager against business risks, the company must ensure that there is a self-retention quota for the insured executive board member of at least 10 percent of the loss up to at least 150 per cent of the annual fixed remuneration. From July 10, 2010, these requirements will also apply to D&O insurance taken out before the VorstAG entered into force. However, if the service contract entered into with company dates before August 5, 2009 and does not provide for any D&O self-retention quota, the stock corporation shall comply with this agreement until it expires.

The VorstAG also has a bearing on the composition of the supervisory board. In order to avoid conflicts of interest, a two-year cooling off period is required during which former managers who have retired may not become members of the supervisory board. Exemptions are only made if shareholders with more than 25 per cent of voting rights elect such managers onto the supervisory board. Recently, the statutory regulations regarding the composition of the supervisory board were tightened by the Act to Modernise Accounting Law (in German: *Bilanzrechtsmodernisierungsgesetz – BilMoG*), which entered into force on May 29, 2009. In accordance with the BilMoG, capital market-oriented enterprises must now have an independent member on the supervisory board who has specific knowledge of accounting or audits.

The VorstAG also extends the minimum waiting period for the first-time exercise of stock options from two to four years after granting of the

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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subscription right. This should give the manager incentive to act in accordance with the sustainable development and welfare of the company.

Other new provisions introduced by the VorstAG are the authorisation of the shareholders' meeting to pronounce a vote regarding the management remuneration system as a suitable controlling instrument, which although not legally binding, provides the shareholders with the means to articulate their approval or non-approval of the remuneration system. Furthermore, the VorstAG tightens the disclosure requirements in connection with the annual and consolidated accounts: They must also now contain information about remuneration and ancillary benefits that are paid to the managers in the event of early or regular retirement. The revised sec. 285, 286 of the German Commercial Code (in German: *Handelsgesetzbuch* – HGB) apply to annual and consolidated accounts of stock corporations for fiscal years past December 31, 2009.

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