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Perspectives in Company Law and Financial Regulation

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The Commission Recommendations of 14 December 2004[1] and of 15 February 2005[2] and their implementation in Germany

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I. Introduction

By virtue of their law-making powers European Union institutions may enact Regulations and Directives. During the past forty years, the Commission has made extensive use of both these powers particularly concerning company law.[3] Over the course of this time the Commission's actions were accompanied by remarkable changes in its general policy on a number of occasions. Starting off with the idea of a widespread harmonization of the law,[4] this policy was virtually abandoned by the Commission in 1990. However, under the impact of the capital markets and under the banner of Corporate Governance, the Commission discovered its own original policy at the turn of the millennium. One of the key role players in this realignment of the Commission's policy was the so-called High Level Group and

[1] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies 2004/913/EC [2004] OJ L 264/32.

[2] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) boards 2005/162/EC [2005] OJ L 52/51

[3] Cf. detail list in M. Lutter, *Europäisches Unternehmensrecht*, (Berlin: de Gruyter, 1996, 4th Edn). Since then, the Directive of the European Parliament and of the Council of 21 April 2004 on takeover bids 2004/25/EC [2004] OJ L 142 and the Directive of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies 2005/56/EC [2005] OJ L 310/1 have been issued in addition.

[4] The famous Structure Directive (reform proposal of 20 November 1991, [1991] OJ C 321) has altogether undergone three reform changes since its original presentation on 9 October 1972 but has never been issued formally. The same is true of a directive modelled on the German group law regime ('Konzernrechts-Richtlinie'), which has never been taken further on from the stage of its preliminary drafts in 1974 and 1984.

their report dated from 4 November 2002.[5] The Commission warmly welcomed this report by the High Level Group, which had in fact been set up by the Commission itself, and implemented a corresponding EU Action Plan.[6] At the same time, the Commission began reviewing further options as to how the proposals made by the High Level Group might be implemented as law in a form other than a Directive. It was during this reviewing process that the Commission came to regard the Recommendation as a viable alternative for the Directive, since they, too, are listed as in Art. 249 (5) of the EC Treaty as an option for action by the Commission. Yet Recommendations are not binding (Art. 249 (5) EC Treaty) and therefore do not constitute law, at least in the German sense of the word. Nevertheless, the Recommendation can be of quite some interest to the Commission when it comes to using it as a strategic device in order to influence Member States towards its own ends. This is particularly true if the Commission combines a Recommendation with a threat to the effect that a legally binding Directive with an equivalent content shall be enacted should Member States not observe the Recommendation in the first place. In fact, this is exactly what happened with respect to both of the aforementioned Recommendations. Alas for the Commission, combining a Recommendation with a threat of enacting identical rules in the form of a Directive in case of the former's non-observance is easier said than done. The option of acting by way of Recommendation has such great appeal for the Commission because the Commission may enact the Recommendation on its own without having to consult either the European Parliament or the European Council of Ministers. By comparison, with respect to the Directive, the Commission only reserves the power of initiative, the power of enactment itself remaining with the Parliament and the Council. The difficulties which thus lie behind this balance of power have only been too visible for observers of the recent enactment of the Directive on Takeover Bids.[7]

With regard to the transformation into national law of its two Recommendations, the Commission has not ruled out from the start the possibility for member states to bring about harmonization by other

[5] The report may be downloaded from http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf; an abstract in German language may be found here: Maul, *Der Betrieb* (DB) 2003, 27.

[6] Communication from the Commission to the Council and the European Parliament of 21 May 2003, COM (2003), 284 final.

[7] Directive 2003/25/EC, (*supra* note 3).

means than legislation, but instead has talked of 'appropriate actions' which the Member State must undertake. Accordingly, harmonization may also be resolved through the respective national Corporate Governance Codes.

The Commission therefore attaches most importance to the effective implementation of the Recommendations as such, insofar as this can be reasonably expected. The implementation of both Commission Recommendations in Germany is going to be the topic of this contribution.

II. Remuneration policy and publication of directors' remuneration (Recommendation of 14 December 2004)

This Commission Recommendation deals with the concept of a general remuneration policy for the board directors of listed (stock) companies as well as the publication of each director's respective remuneration, with a special focus on stock-option programmes.

A listed company is therefore required to publish a *report on remuneration* annually, providing information as to the concrete concept according to which remuneration is determined. Further to this, a listed company is required to publish each director's individual annual remuneration. And thirdly, remuneration by way of stock options requires an approving decision of the shareholders' meeting.

In Germany, this Commission Recommendation for the most part was a case of preaching to the converted.

A. Approval of shareholders' meeting in case of remuneration by way of stock-options

Since its introduction in 1937, the German Stock Companies Act ('*Aktiengesetz*') contains provisions on authorized capital ('*bedingtes Kapital*') which serves the hedging of conversion rights ('*Umtauschrechte*'), bonds and debentures ('*Wandelschuldverschreibungen*') and stock-options ('*Bezugsrechte*'). Stock-options such as these may be granted to employees since 1965, and since 1998 to members of the board of directors ('*Mitgliedern der Geschäftsführung*') also.

Pursuant to §§ 192–3 of the German Stock Companies Act, authorized capital as well as the specific terms and conditions of corresponding conversion rights and stock options may only be granted by a decision of the shareholders' meeting. To this extent the Commission

Recommendation had been fulfilled long before its enactment in Germany.

However, according to the wording of Section 2.1 of the Commission Recommendation the term 'members of the board of directors' ('*Mitglieder der Unternehmensleitung*') also refers to members of the supervisory board, which in Germany is called '*Aufsichtsrat*'. In Germany, the legislative[8] and the judicial[9] branch have reached a common view that supervisory directors may not receive remuneration in the form of stock options as a matter of law – contrary to the view regarding management directors. This understanding has been adopted due to fears for their independence, for example concerning enterprise strategy and valuation policy.[10]

B. Publication of directors' individual annual remuneration

In Germany, this particular Commission Recommendation also was a case of teaching the pope Latin. This was largely due to the fact that the debate on such publication requirements had by 2002 developed as follows.

As a consequence of the insolvency of giant construction firm Philipp Holzmann AG, Chancellor Schröder appointed a commission with the following mandate:[11]

> It shall be the commission's task to review the Philipp Holzmann Case, and on the basis of its findings, the commission shall then deal with possible areas of improvement concerning Corporate Governance and Corporate Control. Furthermore, against the backdrop of constant fundamental change in our companies and market structures owing chiefly to globalization and internationalization of the capital markets, the Commission shall make recommendations for a modernization of our present legislation.

[8] Official Reasoning in connection with the Government's Proposal for the Company Control and Transparency Act ('*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*') (KonTraG), Bundestag printing matter ('*Drucksache*') 13/9712, Annex ('*Anlage*') 1, p. 24.

[9] German Federal Court (BGH), 16 February 2004, II ZR 316/02, BGHZ 158, 122.

[10] Opinions from the scientific community show that this issue is still highly controversial; see Bezzenberger, in K. Schmidt and M. Lutter (eds.), *Kommentar zum AktG, 2008*, (Köln: Schmidt, 2007), § 71, NO. 49.

[11] T. Baums (ed.), *Bericht der Regierungskommission Corporate Governance*, (Köln: Schmidt, 2001), 1.

The commission dealt with its task within only ten months and produced a volume of more than 130 recommendations, most of which were targeted at reforming or amending the German Stock Company Act. Two of these recommendations were concerned with developing a Corporate Governance Code and to compel German stock companies by law to report annually on the compliance or non-compliance therewith.[12] And so it happened. Two months later, the Minister of Justice appointed a second commission and assigned to it the task of developing a German Corporate Governance Code and amending it at regular intervals (standing commission). Again this assignment took the standing commission only six months to fulfil, and in February 2002 the newly developed Code was published.[13]

Parallel to this development, in June 2002 the Bundestag passed a law introducing a new Section 161 to the German Stock Company Law which compels both the directors of the management board and of the supervisory board to annually publish a declaration concerning their compliance or non-compliance with the Code in the respective past year, as the case may be, and their intention whether or not to comply with it in the future.[14]

The Code differentiates between *recommendations* and *suggestions*, and this difference was taken into account by the legislature when it decided upon the wording of Section 161. The law therefore requires members of both the management and the supervisory board to annually declare themselves on the compliance or non-compliance of *recommendations* only, while the same duty does not exist for *suggestions*.

Much to the astonishment of the general public and executive directors of about 800 listed companies alike, the 2002 first version of the

[12] Baums (ed.), *Bericht der Regierungskommission*, NO. 5–15 (*supra* note 11).

[13] The Rules may be downloaded from www.ecgi.org/codes/code.php?code_id=217.

[14] Section 161 of the German Stock Company Act reads as follows:

> Directors both of the management board and of the supervisory board of a listed company shall declare annually whether or not in the past they complied and in the future intend to further comply with the recommendations as laid down by the Government Commission German Corporate Governance Code ('*Regierungskommission Deutscher Corporate Governance Kodex*') and published by the Ministry of Justice in the Official Journal of the Electronic Federal Gazette ('*Bundesanzeiger*'), or, which of these recommendations were not or will not be applied. This declaration shall be made permanently accessible to the company's shareholders. [NB: English version by author]

For more detail see H.M. Ringleb, T. Kremer, M. Lutter, A. von Werder, *Deutscher Corporate Governance Kodex,* (Munich: Verlag C.H. Beck, 2008, 3rd edn.).

Code under Section 4.2.4 already comprised a *suggestion* for each director to individually publish their annual remuneration. The said section read:

> the individual remuneration of each director of the management board shall be reported in the annex to the consolidated accounts ('*Konzernabschluss*'), divided into the following categories: fixed salary, components according to performance and components based on the concept of long-term incentive. The report shall be personalized.

The reaction of the general public was very welcoming, whereas companies and management directors reacted in a rather reserved or even hostile manner. By some the said suggestion was even viewed as an unlawful interference with the personal integrity and privacy of management directors, and therefore to be regarded as unconstitutional.[15]

The suggestion failed to achieve much success. Because of this modest success, and because of the general public's growing displeasure with high salaries and compensation payments following the termination of manager's contracts, the Code commission reviewed the very same provision only one year later, and after heated debates upgraded it to the level of *recommendation* in June 2003. From then on, companies were compelled by law to *publish* their compliance or non-compliance, as the case may be, and moreover, in case of the latter, to publish their reasons as well.[16]

This measure's success started hesitantly all the same; two years later (by 2005) only two-thirds of the DAX-30 companies and only half of the rest of all listed companies had published their directors' remuneration details. At this point in time politicians had had enough, and the Bundestag passed the Publication of Directors' Remuneration Act ('*Vorstandsvergütungs-Offenlegungsgesetz*') (VorstOG), which came into force on 11 August 2005.[17] The Act compels listed companies to publish each of their directors' remuneration in a personalized and detailed

[15] In favour of this view: W. Porsch, 'Verfassungs- und europarechtliche Grenzen eines GesetzeszurindividualisiertenZwangsoffenlegungderVergütungderVorstandsmitglieder', *Betriebsberater (BB)* (2004), 2533; S. Augsberg, 'Verfassungsrechtliche Aspekte einer gesetzlichen Offenlegungspflicht für orstandsbezüge', *Zeitschrift für Rechtspolitik (ZRP)* (2005), 105; opposed to this view: G. Thüsing, 'Europarechtlicher Gleichbehandlungsgrundsatz als Bindung des Arbeitgebers?', *Zeitschrift für Wirtschaftsrecht (ZIP)* (2005), 1389, 1395.

[16] Code Sec. 3.10.

[17] Publication of Directors' Remuneration Act ('*Gesetz über die Offenlegung von Vorstandsvergütungen*') of 3 August 2005, Federal Law Gazette ('*Bundesgesetzblatt*') (BGBl.) I, S. 2267.

manner in either the annex to the balance sheets ('*Anhang zur Bilanz*') or in the management report ('*Lagebericht*') and the group management report ('*Konzern-Lagebericht*') following *due examination by the annual auditor*.

In short, at the time when the Commission issued its Recommendation concerning the remuneration of management directors on 14 December 2005, the German Corporate Governance Code already comprised an equivalent provision. A few months later, this Code provision was elevated to the status of Act of law, as can be seen in Section 285 Sentence 1 No. 9 of the German Commercial Code (HGB).

III. The composition and independence of supervisory board directors as well as the formation of committees according to the Recommendation of 15 February 2005

A. The election of supervisory board members

Section 11.1 of the Recommendation reads:

> It is recommended that the supervisory board define, and review at regular intervals, its own ideal composition in light of the company's structure and field of activity in order to guarantee well-balanced diverse professional competence among its ranks. It is further recommended that the supervisory board ascertains that its members as a team can command the necessary professional competence, soundness in decision making and expertise.

In Germany, this topic has a story of its own.

The supervisory board as formed by German law ('*Aufsichtsrat*') has always, from its very inception, been assigned the task of supervising the management, and – with hindsight – has never shied away from this task. However, its self-image had widely been quite different all the same: the average supervisory board was part of a nationwide entrepreneurial network: management directors of one company often acted as supervisory directors of many other companies. In this respect, the integration of banks as helpers in need into supervisory boards and the establishment of links with suppliers and recipients was of crucial importance. Supervision ranked only second to networking, and was of a merely reactive nature. In cases of economic disaster, more than one company's supervisory board was unable to accomplish anything more than to simply grin and bear.

This attitude has changed drastically since the mid-1990s, i.e. since the international capital markets conquered the hitherto sealed-off German system. The idea of Corporate Governance was being put at the top of the agenda then, and the German legislature gradually awarded the *Aufsichtsrat* its fair share of entrepreneurial responsibility. As if overnight, the *Aufsichtsrat* was given co-responsibility for general planning and strategy, and it also became its task to give advice to the management board and even to make joint managerial decisions. In short, the active, co-entrepreneurial *Aufsichtsrat* today is a matter of law. Network relations were replaced by personal competence. More than one company's *Aufsichtrat* was not prepared for this change, and many more have not caught up with the development even now. Cases where there is a lack of personal competence to a degree as to render the *Aufsichtsrat* deficient in terms of personal competence when compared to the management board have been and continue to be numerous.[18]

Since that time, scientific writers have zoomed in on this issue,[19] and have postulated the exact same recommendations as are the Commission's, that is:

(i) an abstractly termed outline of a composition scheme as to how shareholders' representation on the supervisory board ought ideally be organized, for example:

- one financial expert
- one accounting and controlling expert
- one expert with technical knowledge
- one marketing expert
- one law and tax expert
- one expert for overseas business activity;

(ii) a hunt for the most qualified candidates to meet the requirements of this composition scheme.

[18] M. Lutter, 'Der Aufsichtsrat im Wandel der Zeit – von seinen Anfängen bis heute', in W. Bayer and M. Habersack (eds.), *Aktienrecht im Wandel*, (Tübingen: Mohr Siebeck, 2007), 389.

[19] M. Lutter, 'Auswahlpflichten und Auswahlverschulden bei der Wahl von Aufsichtsratsmitglieder, *Zeitschrift für Wirtschaftsrecht (ZIP)* (2003), 417; M. Lutter, 'Legal Success', *Handelsblatt,* 27 March 2008, No. 60, 9; S. Maul,' Gesellschaftsrechtliche Entwicklungen in Europa – Bruch mit deutschen Traditionen?', *Betriebsberater (BB)* (2005), special issue, 19, 2; D. Bihr and W. Blättchen, 'Aufsichtsräte in der Kritik: Ziele und Grenzen einer ordnungsgemäßen Aufsichtsratstätigkeit – Ein Plädoyer für den 'Profi-Aufsichtsrat', *Betriebsberater (BB)* (2007), 1285.

Yet, Germany is still light years away from arriving at the utopia of a seamless operationalization of these recommendations by listed companies. At least, the first version Code under Section 5.4.1 already showed a similar tendency:

> Upon the proposal of candidates for the election as member of the supervisory board, special attention shall be paid to ensuring that board members as a team command the knowledge, the abilities and the expertise necessary for the sound execution of the board's lawful tasks at all times.

Here, the Code clearly tackles the issue of an ideal composition of the supervisory board from the perspective of the required personal competence; even so, the recommended solution is of an ad hoc nature, not a systematic approach.

A step forward, the Code as amended by 2007 under Section 5.3.3 now recommends the formation of a *nomination committee* (see below).

B. The formation of committees

According to Section 5 the commission recommends the formation of three committees to the supervisory board:

- a nomination committee
- a remuneration committee
- an audit committee.

Section 107 paragraph 3 of the German Stock Company Act provides that a company may, at its discretion, form advisory and co-deciding committees. In practice, the so-called *President Committee* has been prevalent up till now, the task of it being to make recommendations to the plenum with regard to the appointment of new management directors, and upon appointment, to conclude, on its own responsibility, the corresponding manager's contract including remuneration details.

Since its early beginnings, the Code has always recommended the formation of an *audit committee* under Section 5.3.2. This recommendation has widely been put into practice; these days, almost every listed company has an audit committee.[20]

[20] The formation of an audit committee was made mandatory by the EU's 8th directive, Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, [2006] OJ L 15.

In June 2007, the Code commission amended its said recommendation by adding to it the nomination committee (Sect. 5.3.3), to which it assigned the task of making recommendations to the plenum regarding the composition of the supervisory board. On the one hand, according to Section 101 Paragraph 1 of the German Stock Company Act, the election of supervisory directors from among the group of shareholders is reserved to the shareholders' meeting. On the other hand, according to Section 124 Paragraph 3 of the German Stock Company Act, it is the acting supervisory board's task to make candidate proposals to the shareholders' meeting. In practice, the shareholders' meeting almost always follows these proposals, to the effect that a de facto co-optation is established.

Since the nomination committee is compelled to give reasons for its recommendations in a plenary session, hopefully the system of due selection as discussed above will more and more become standard practice.

C. The independence of the supervisory board

In dealing with this topic, the Commission puts a decided emphasis on it by not only drawing up a principle under Section 4, but also a number of detailed recommendations, as in:

- Section 13.1 a definition
- Section 13.2 the establishment of criteria on Member State level
- Section 13.3 publication of these criteria.

Additionally, the Commission set up nine criteria in Annex II to the said Recommendation, which, if fulfilled, are assumed to have a detrimental effect on the independence of supervisory directors, one of them reading: 'd) The person in question may in no case be a controlling stockholder, or its representative.'

The fate of this recommendation in Germany has been markedly different from those already discussed above. This is due to the fact that controlling stockholders are a less rare phenomenon in Germany than elsewhere (BMW, Porsche, VW, Dresdener Bank, METRO etc.), and it comes as no surprise that they usually strive for and in fact do exert influence on 'their own' company. Furthermore, it is common practice in Germany for professionally successful and personally esteemed management directors to take up a seat on the supervisory board at the time of their age-related withdrawal from management functions.

There are virtually no legal rules on independence in Germany, apart from the law stating that no person may be a member of the management board and the supervisory board at the same time. It thus comes as a bit of a surprise that even the first version Code (2002) comprised a provision on this very matter. The very first version of Section 5.4.1 reads:

> Upon the proposal of candidates for the election of members of the supervisory board, special attention shall be paid to…ensuring candidates' sufficient independence.

Also from the 2002 first version onwards, this was put into rather more concrete terms by Section 5.4.2, which states:

> Independent advice to and supervision of the management board by the supervisory board is facilitated by the stipulation that the supervisory board may comprise no more than two members who have been in a managerial position in the same company at some time or another, and that members of the supervisory board may neither act in a managerial position of nor provide advisory service to another company which is a substantial competitor.

After the publication of the Commission Recommendation of 15 February 2005 on the independence of supervisory board members, the next plenary session of the Code commission dealt with this very issue and decided on amending the Code. The wording 'sufficient independence' under Section 5.4.1 was eliminated, and under Section 5.4.2 the following two sentences were added:

> In order to facilitate independent advice to and supervision of the management board by the supervisory board, the latter shall comprise a sufficient number of independent members, at its own discretion. A member of the supervisory board is to be viewed as independent, if he or she is in no way connected with the company or its management board either business-wise or personally in a way that entails a conflict of interests

whereas the limitation on two members who have been in a managerial position in the same company at some time or another and the non-competition requirement remained unamended.

The Code thereby almost verbally adopted the general wording of the Recommendation (Section 13.1). This is nothing to write home about, though. The general wording of both the Recommendation and the Code more or less states what is self-evident anyway. What was of an explosive nature about the recommendation was not its general wording, but a list contained in its Annex, by which the Commission declared who, in its opinion, may *not* be viewed as *independent*. This is where opinions differ. So what is the specific meaning of independence in this context? (Almost) every human being is in some way or another dependent some thing or another. That is not what this is about. What is essential is the *independence from the management board*, be it personal or business-wise. The Code stresses this understanding by its sentence 2 of Section 5.4.2 just cited above.

So is the holder of a controlling stake to be viewed as not independent – as the Commission suggests – or indeed independent? In my opinion, and this is in accordance with the general opinion in Germany, the *management board* is dependent on the controlling stockholder, but not the other way around. Incidentally, this is equally congruent with what the German law states in Sections 17 and 311 of the Stock Company Act. Indeed, the boot is on the other foot: if one can righteously call anybody *independent* from the company and the management board at all, it certainly is the controlling stockholder and its representatives.

This is at least a general rule. There may be exceptions to this rule, i.e. in case business relations are intertwined to such a degree that the controlling stockholder must actually be called dependent – after all, it is the exception which proves the rule.

Consequently, the reception of the Commission Recommendation of 15 February 2005 on the independence of supervisory board members has been ambivalent in Germany. We accept its main principal, and we also accept the principal view that the heart of the whole issue is the independence of supervisory board members from the company and the management board. The German Code has therefore adopted these principles.

Then again we beg to differ, and to differ clearly and decidedly, on a number of sub-issues contained in the list of examples as published in the Annex to the Recommendation. This is why none of these examples have been adopted by the Code: the interpretation of the meanings of *dependence* and *independence* is focused solely on business relations with the company and social and business relations with the management board, but not illustrated with specific examples.

III. The manner of implementation in Germany

When the Recommendation on a regime for the remuneration of directors was published, the German Code already comprised an equivalent recommendation. Shortly afterwards, the Publication of Directors'

Remuneration Act was passed, thereby completing implementation of the Recommendation.

While the legislature did not react to the Recommendation on the role of supervisory directors, the Code did, as described above. There nevertheless remains a difference concerning the interpretation. The Code has almost verbally adopted the general wording of the Recommendation. However, as the examples in the Annex of the Recommendation clearly illustrate, our understanding of the supervisory board directors' independence from the company and the management board is not entirely reconcilable with the Commission's view. In Germany, a general view has developed according to which controlling stockholders and their representatives are to be viewed as independent. That is where we do not find the Commission Recommendation convincing at all, and in this respect we are not going to follow it in the future, either.