

Towards a new regulatory framework for the German managing board via the *Appropriate Remuneration Act 2009*

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Introduction*

By virtue of the *Appropriate Remuneration Act 2009* (*Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG*), the German legislator has considerably amended the principles governing the managing board's remuneration, contained in § 87 of the *Stock Corporation Act 1965* (*Aktiengesetz, AktG*). The *Appropriate Remuneration Act* aims at enforcing the corporation's sustainable development as the major benchmark for structuring the managing board's remuneration. Thereby, the board's remuneration will prospectively emerge as the key instrument in piloting the board's course of action. Such change of tendency may, however, touch upon the most basic principles of German Stock Corporation Law. In particular, it manifestly opposes the traditional balance of rights and duties allocated to, on the one hand, the company's supervisory board and to, on the other hand, its managing board. In this article, we will analyze the new legal framework's impacts on remuneration standards and its implications for the legal practitioner advising corporations, as well as its scholarly interest.

I. The German legislator's intentions in introducing the *Appropriate Remuneration Act*

By adopting the *Appropriate Remuneration Act 2009* (*VorstAG*) and thus considerably restricting the permissible managing board's remuneration, the German legislator has, against the background of the financial crisis, responded to the remuneration practices of DAX corporations allegedly being carried into extremes.¹ The new framework instantly triggered

legal scholars and practitioners to comment on its prospective application, proving the latter to loom far more difficult than the legislator assumed it to.² Intense discussions have not only concentrated on mere doctrinal details – which one may well expect to be solved by traditional legal reasoning³ – but also on the fundamental principles of German Stock Corporation Law: These may be affected by shifting the allocation of power from the company's managing to its supervisory board.

The new framework's policy intention clearly makes a point of controlling the board's behaviour, as well by admitting remuneration incentives as by imposing sanctions, namely loss sharing and personal liability. This policy is in line with those theorists assuming remuneration and liability as key instruments in order to direct the managing board's activity towards good and successful corporate governance. Such concepts are predicated on diverse variations of the agency doctrine and on shareholder value based models.⁴ This view is thus ascribing substantial responsibility for the current crisis to the hitherto prevailing managing board's remuneration standards.⁵ Accordingly, it is supposed that companies will be

NZG 2009, p. 538; for a profound treatise on the new regulatory framework, see *Mertens/Cahn*, in: *Kölner Kommentar zum Aktiengesetz*, 3rd ed. 2009, § 87; of the diverse doctrinal views published in law journals, see especially *Annuß/Theusinger*, BB 2009, p. 2434; *Bauer/Arnold*, AG 2009, p. 717; *Bosse*, BB 2009, p. 1650; *Cannivé/Seebach*, *Der Konzern* 2009, p. 593; *Dauner-Lieb*, *Der Konzern* 2009, p. 583; *Deilmann/Otte*, GWR 2009, p. 261; *Fleischer*, NZG 2009, p. 801; *Fleischer*, BB 2010, p. 67; *Gaul/Janz*, NZA 2009, p. 809; *Hoffmann-Becking/Krieger*, NZG supplement No. 26/2009, p. 1; *Hohaus/Weber*, DB 2009, p. 1515; *Hohenstatt*, ZIP 2009, p. 1349; *Hohenstatt/Kuhnke*, ZIP 2009, p. 1981; *Jahn*, GWR 2009, p. 135; *von Kann/Keiloweit*, DStR 2009, p. 1587; *Lembke*, NJW 2010, p. 257; *Leuner*, AG 2009, p. 622; *Lingemann*, BB 2009, p. 1918; *Martens*, in: *Festschrift Hüffer* 2009, p. 647; *Nicolay*, NJW 2009, p. 2640; *Peltzer*, NZG 2009, p. 1041; *Seibert*, WM 2009, 1489; *Seibert*, in: *Festschrift Hüffer* 2009, p. 956; *Spindler*, NJOZ 2009, p. 3282; *Thüsing*, AG 2009, p. 517; *Wagner/Wittgens*, BB 2009, p. 906; *Weber-Rey*, WM 2009, p. 2255; *Weller*, NZG 2010, p. 7; *Wilsing*, DB 2009, p. 1391; *Wittuhn/Hamann*, ZGR 2009, p. 847; for discussions on the law before the adoption of the *Appropriate Remuneration Act 2009*, see especially *Thüsing*, ZGR 2003, 457; *Fonk*, in: *Semler/von Schenck* (eds), *Arbeitshandbuch für Aufsichtsratsmitglieder*, 3rd ed. 2009, § 9 nos. 105 ss.

2 See *Seibert*, WM 2009, p. 1489; for the scope of doctrinal opinions on the *Appropriate Remuneration Act's* policy intentions, cf., on the one hand, *Thüsing*, AG 2009, p. 517, and, on the other hand, *Peltzer*, NZG 2009, p. 1041.

3 *Dauner-Lieb*, *Der Konzern* 2009, p. 583, is discussing how commentators treat legal uncertainties methodologically.

4 For an extensive and crucial analysis in this context, see *Arnold*, *Die Steuerung des Vorstandshandelns*, 2007, especially at p. 115; for a crucial practitioner's view on the overestimation of "unfortunate incentives", see *Fonk*, I.c. (fn. 1), § 9 nos. 107, 133 ss.; for early scepticism, see *Thüsing*, ZGR 2003, p. 457 at 473. In the same conservative line, *Mertens/Cahn*, I.c. (fn. 1), § 87 no. 23.

5 Bundestag printed paper no. 16/12278 A/B at p. 1, as well as General Reasons (*Begründung Allgemeiner Teil*) at p. 5; Bundestag printed paper 16/13433 A at pp. 1 s.; cf. also: FSB Principles for Sound Compensation Practices, 2 April 2009, p. 1 (http://www.fsforum.org/publications/r_0904b.pdf); CEBS High-level Principles for Remuneration Policies, 20 April 2009, p. 1 (<http://www.c-ebis.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/high-level-principles-for-remuneration-policies.aspx>); Recommendation 2009/384/EC, **Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, OJ L 120 of 15 May 2009, p. 22 Recital 2.**

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1 Bundesrat printed paper no. 592/09; Bundestag printed papers no. 16/13433 and no. 16/12278; for comments on the legislative procedure, see the opinions of *Hirte*, *Thüsing*, *Goette*, as well as that of the German Bar Association's (Deutscher Anwaltverein, DAV) Committee on Commercial Law, NZG 2009, p. 612, and that of the German Chambers of Industry and Commerce (Deutscher Industrie- und Handelskammertag, DIHK),

redirected to implement sustainable corporate strategies by means of adjusting remuneration standards.⁶ Not only the scholarly but also the public debate concentrating on the appropriateness of management remuneration has built on these premises, declaring that corporate development can be controlled. Though no-one seems to challenge the underlying assumptions so far, however, these turn out to be problematic and debatable.⁷

In particular, we observe that the debate tends to discriminate neither between different management levels nor between distinct industry sectors. But does it make sense to refer indiscriminately to diverse phenomena, such as allegedly misguiding bonus systems benefitting investment bankers, such as the salary promised to *Arcandor*'s CEO by a major shareholder, or such as remuneration plans designed for managing board members by MDAX companies in traditional sectors? We wish to stress that, in principle, the remuneration of managing board members and that of management staff do raise very distinct problems: While the latter for the most part do implement objectives imposed on them, the managing board, according to § 76 *AktG*, has to *conduct the corporation on its own authority* and therefore needs to map out the *corporate strategy* and the *corporate planning*.⁸ However, the problems currently evoked by bonuses awarded in the financial sector are solely located on the subordinate management level.⁹

In this article, we will only consider the remuneration of managing board members. This issue has figured on the policy agenda in Germany for quite a while, being regarded as possible legal instrument in gaining control over the managing board's course of action. For a long time, commentators on the German Stock Corporation Law have, with good reasons, queried the feasibility and the rationality of more narrowly defining the term "appropriate", formerly prescribing in § 87(1) *AktG* the sole limit imposed on the board's remuneration, with great scepticism.¹⁰ Notwithstanding, the "carrot" philosophy attracted ever more supporters and was, for the first time, applied by the German Federal Court of Justice (*Bundesgerichtshof, BGH*) in its well-known decision in the *Mannesmann* case of December 21st, 2005. Briefly summarised, the Federal High Court held that any remuneration not even potentially qualifying as incentive may, in principle, constitute an abuse of trust, liable to prosecution according to § 266 of the German Criminal Code (*Strafgesetzbuch, StGB*).¹¹ The public debate triggered by the decision in the *Mannesmann* case prompted the legislator to – merely – tightening the disclosure rules with regard to remuneration of managing board members by virtue of the *Board Members*

Remuneration Public Disclosure Act 2005 (Gesetz über die Offenlegung von Vorstandsvergütung, VorstOG).¹² In the same line, the *Appropriate Remuneration Act* is hence imposing legally binding – and therefore in principle litigable – rules defining the extent and the composition of the board's remuneration. In particular, the new framework delicately stipulates that the board's remuneration system be sustainable and perennial (see, § 87(1) *AktG*).

II. Utilizing remuneration systems as instruments in piloting the managing board

1. The objective: Sustainable corporate design and development

The economical, juridical, and political debate is almost entirely based on the premise that the board's entrepreneurial activity can, in the company's best interest, sensibly be piloted by the kind and composition of the remuneration awarded. The policy intention animating the *Appropriate Remuneration Act* embraces this premise as its philosophical foundation, as if, in a way, it was to constitute an implicit precondition to the law.¹³ Historically, this presupposition's contents are inherently linked to the agency doctrine, the shareholder value theory, and both their diverse variations. In roughly summarising these concepts, one might dare to formulate one main idea as follows: The managing board, acting as the shareholders' agent, shall, albeit not originally sharing his principal's interests, be conditioned to interiorize these by means of remuneration incentives. The agent is hence supposed to pursue his master's cause, that is to say, the cause of enhancing shareholder value. In the beginning, *remuneration systems incorporating stock allotments* or, subsequently, stock options were expected to pilot the managing board as desired.¹⁴ Today, the lessons taught by the global crisis seem to be learnt, and, as a matter of fact, remuneration systems based on stock allocations have proven to potentially incite partial, short-term, and sometimes even manipulative managing board decisions. Through the backdoor, a completely new and noteworthy point of view has been introduced, yet so far without having been subject to theoretic analysis: Incentive systems are no longer concentrating on the *risk-averse*, but on the *not sufficiently risk-aware* manager.¹⁵ According to this new objective, § 87(1)(2) *AktG* stipulates the corporation's sustainable development. This development may be considered to go hand in hand with emphasizing afresh the need for stakeholder interests as opposed to pure shareholder value concepts.¹⁶ Mutatis mutandis, the objectives and parameters affecting the variable remuneration components can be

6 See *Seibert*, WM 2009, p. 1489.

7 Cf. *Arnold*, l.c. (fn. 4), especially at p. 115; *Fonk*, l.c. (fn. 1), § 9 no. 105 ss.; *Mertens/Cahn*, l.c. (fn. 1), § 87 no. 23.

8 See *Fleischer*, in: *Fleischer*, Handbuch des Vorstandsrechts, 2006, § 1 no. 13; *Mertens/Cahn*, l.c. (fn. 1), § 76 no. 4, citing further references; *Oltmanns*, in: *Heidel*, Aktienrecht, 2nd ed. 2007, § 76 no. 5.

9 For a recent discussion, see the Bill of the Federal Government of 9 February 2010 (*Regierungsentwurf des Gesetzes über die aufsichtsrechtlichen Anforderungen an die Vergütungssysteme von Instituten und Versicherungsunternehmen*).

10 *Hüffer*, Aktiengesetz, 8th ed. 2008, § 87 no. 3; for a profound analysis including related issues, see *Thüsing*, ZGR 2003, p. 457.

11 Federal High Court (*Bundesgerichtshof, BGH*), Judgement of 21 December 2005 – 3 StR 470/04, imprinted: DB 2006, p. 323 = NJW 2006, p. 522; for discussions on the underlying principles, see *Hüffer*, BB 2003, supplement No. 7; *Brauer*, NZG 2004, 502; *Martens*, ZHR 169 (2005), p. 124.

12 Federal Law Gazette (*Bundesgesetzblatt, BGBl.*), Series I, 10 August 2005, pp. 2267 s.

13 For a divergent – crucial – view, see: *Arnold*, l.c. (fn. 4), p. 115.

14 Cf. *Fedderson*, ZHR 161 (1997), p. 269; *Hüffer*, ZHR 161 (1997), p. 214; *Jäger*, DSr 199, p. 28; *Kohler*, ZHR 161 (1997), 246; *Schneider*, ZIP 1996, p. 1769; for a comprehensive analysis of the most current doctrinal contributions, see *Mertens/Cahn*, l.c. (fn. 1), § 87 nos. 37 ss.

15 For an extensive and crucial discussion on those models denoting problems in the relationship between business and manager to be caused by opportunistic, easy-going, and most notably all too risk-averse management, see *Arnold*, l.c. (fn. 4), p. 131; for an early comment on the shortcomings of the agency model, see *Thüsing*, ZGR 2003, p. 457 at 475.

16 See no. 4.1.1 of the German Corporate Governance Code (*Deutscher*

observed to rely increasingly on ratios which are not related to company value or operating results, such as staff satisfaction, carbon dioxide emission, or corporate social responsibility.¹⁷

The *paradigm shift* caused by the *Appropriate Remuneration Act* inevitably entails far-reaching changes in formulating success indicators and parameters determining the variable remuneration components. The hitherto dominating shareholder value approach had focussed on indicators such as stock price and total shareholder return, or on economic value added (EVA)¹⁸; less often, further accounting and financial ratios, such as EBT, EBIT, or ROCE have been taken into account.¹⁹ However, commentators have precisely been criticising the usage of accounting ratios as success indicators for their susceptibility to looking backwards, to being manipulated, and to operating short term.²⁰ As board remuneration has been aligned with the aspired sustainable corporate policy, the scope of success indicators has been extended and diversified. Financial ratios need to content themselves with merely figuring among a big variety of parameters and objectives intended to pilot the managing board's activity; moreover, they often, possibly even regularly, are only taken into account on an average base. This new practice is predicated on the assumption that the perennial assessing of variable remuneration components (as prescribed in § 87(1)(3) *AktG*) will necessarily produce a more sustainable corporate governance (see, § 87(1)(2) *AktG*). This assumption arguably raises doubt as to its plausibility. To assess success indicators based on perennial average figures means to undermine their influencing role. The evaluation predicated on average figures causes positive and negative developments to mutually outweigh one another in terms of the financial ratios subject to analysis. Accordingly, the intended influence of incentives is subject to analogous attenuation.

The significance of the fact that, along with pursuing "sustainability", further success indicators gain weight in measuring variable remuneration components may not be underestimated. We will call these parameters *performance and sustainability indicators*. They include, inter alia, individual and/or collective management performance, integration achievements, improvements in management culture and in corpo-

rate development, as well as parameters with regard to R&D, corporate social responsibility, innovation, pollutant emission, energy efficiency, customer loyalty, staff satisfaction, average wage level, and, ever more importantly, compliance.

2. Compensation follows strategy

It seems almost trivial to state that effectively piloting anyone's behaviour depends on disposing of precise and specific ideas about what kind of behaviour with regard to *what objectives* is to be stimulated. Incentives without clear objectives may not merely prove futile but possibly even turn out to be dangerous. To state this means to raise the question of how to define the constituent "sustainability" element. Amazingly, this question had been discussed but scarcely during the legislation process.²¹ It seems clear though that sustainability has to be understood as opposed to short-term orientation. The provision in § 87(1)(2) *AktG* is intended to avert that remuneration systems provide incentives deviating from the – well-understood – long-term corporate interests. In particular, the managing board members shall be prevented from increasing their remuneration by way of taking disproportionate risks.²²

Which objectives are sustainable in a favourable way had not been discussed, and even today the question is not brought up directly. It is clear though that assessing an objective's sustainability requires more than a general formula; it needs to respect the particular corporate strategy (e.g., preserving corporate autonomy, increasing market share, developing and launching new products, entering new global markets).²³ Defining all the parameters and objectives affecting variable remuneration components in accordance with § 87 *AktG* requires thus to assess the *individual corporate strategy*. The control objectives, pursued by means of the managing board's remuneration, are expected, or at least desired, to entail compliance with an implementation of the corporate strategy. Consequentially, the principle "*Compensation follows strategy*" compellingly applies. This interrelation is internationally and also nationally recognized. In particular, the recently amended and thus very detailed rules governing the remuneration awarded to the management of banks and insurance companies are based on this connection. These rules stipulate that extent and structure of the remuneration be deduced from the institute's business plan and strategy.²⁴ Moreover, economic theory has never left a doubt that remuneration induced by control objectives is supposed to underpin the corporate strategy. Thus the balanced scorecard system for example builds on "*Translating Strategy into Action*".²⁵ The balanced scorecard system utilizes not only financial ratios but also places emphasis on stakeholder inte-

Corporate Governance Kodex, DCGK) as amended of 18 June 2009; Döll, WM 2010, p. 103 at 107; Gärtner, Der Einfluss von Stakeholder-Gruppen auf den Strategieprozess, 2006, p. 26; Hoffmann-Becking/Krieger, NZG-supplement no. 26/2009, p. 1 at p. 5; Seibert, WM 2009, p. 1489 at p. 1490; Weber-Rey, WM 2009, p. 2255 at p. 2257. As well on the international level, regulative frameworks on sustainable remuneration systems having been published over the last months are emphasizing stakeholder interests: FSB Principles for Sound Compensation Practices, 2 April 2009, pp. 13 ss. (http://www.fsforum.org/publications/r_0904b.pdf); CEBS High-level Principles for Remuneration Policies, 20 April 2009, p. 2 (<http://www.c-eps.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/high-level-principles-for-remuneration-policies.aspx>); Basel Committee on Banking Supervision, Compensation Principles, and Standards Assessment Methodology, p. 24 (<http://www.bis.org/publ/bcbst166.pdf>).

17 On this subject, Förster, RiW 2008, p. 833.

18 Stewart, The Quest for Value: EVA Management Guide, 1991; Stern/Stewart/Chew, Journal of Applied Corporate Finance Vol. 8 no. 2, Summer 1995; Hostettler, Economic Value Added (EVA), 1997.

19 Krieger, in: Festschrift Röhrich 2005, p. 349 at pp. 358 s.; Hoffmann-Becking, ZHR 169 (2005), p. 155 at pp. 176 s.; Marsch-Barnier, in: Festschrift Röhrich 2005, p. 401 at p. 417; Tünzer, BB 2004, p. 2758 at p. 2759.

20 See: Rappaport, Journal of Business Strategies 4 Vol. 2 (1983), pp. 49 s.; Murphy, in: Ashenfelter/Cart (eds), Handbook of Labour Economics, Vol. 3, Part 2 (1999), p. 2485 at p. 2506; Günther, in: Höfner/Pohl, Wertsteigerungsmanagement, 1994, p. 41; Englert/Scholich, BB 1998, p. 684; Stelter/Roos, DStR 1999, p. 1122.

21 For well-founded criticism on the formation of the concept, see Fleischer, NZG 2009, p. 801 at p. 802.

22 Hohenstatt/Kuhnke, ZIP 2009, p. 1981 at p. 1982; Thüsing, AG 2009, p. 517 at p. 520; Fleischer, NZG 2009, p. 801 at p. 803; Bauer/Arnold, AG 2009, p. 717 at p. 721.

23 Dauner-Lieb, Der Konzern 2009, p. 583 at p. 586.

24 See: BaFin Circular (Rundschreiben) 22/2009 (BA) of 21 December 2009, no. 3.1, and Circular 23/2009 (VA) of 21 December 2009, no. 2; Recommendation 2009/384/EC, Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, OJ L 120 of 15 May 2009, p. 25, no. 3.2; CEBS High-level Principles for Remuneration Policies, 20 April 2009, p. 2 (<http://www.c-eps.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/high-level-principles-for-remuneration-policies.aspx>).

25 On this subject, see: Kaplan/Norton, Harvard Business Review 1992, p. 71;

rests (clients, staff, environment, etc.) and their conversion into remuneration parameters. In this respect, it demands entrepreneurial activity aimed at implementing the targets retained in the corporate strategy.

In order to apply § 87 *AktG* effectively, the corporate strategy therefore needs to be formulated and settled on, before remuneration objectives and parameters can be deduced from it. The same holds true for different time frames contemplated in the corporate strategy; remuneration objectives and parameters operating in the short, medium, and long term can only be determined based on short-, medium-, and long-term strategies. Piloting the managing board's activity with regard to sustainability by means of remuneration depends on previously settling on such a sophisticated corporate strategy.

3. The necessity of continuously adjusting the corporate strategy

The almost trivial finding that remuneration systems aiming at sustainable corporate development depend on the particular corporate strategy allows perceiving another important problem in applying the new statutory law: Companies operate in ever changing contexts. External macro- and micro-economic data as well as legal, social, and political surroundings are never permanent. Entrepreneurial activity thus forces those in charge to readily anticipate such changes and to infer from these how to react accordingly. Against this backdrop, short-, medium-, and long-term corporate strategies may neither persist but need to be continuously refined and to be adapted to the ever-changing market environment.

As the objectives and parameters implemented in the remuneration system need to be deduced from the corporate strategy, they must also be subject to revision and adjustment in regard to their being consistent and compatible with changing corporate strategies. Ignoring this, the German Corporate Governance Code (*Deutscher Corporate Governance Kodex, DCGK*) recommends in No. 4.2.3 that subsequently amending reference targets and parameters shall be debarred. Then again, the rules on remuneration bank management formulated by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) conflict with the aforementioned *DCGK* recommendation; however, they are more appropriate. The *BaFin* rules stipulate not only that remuneration systems be in accordance with the objectives postulated by corporate strategies; they also demand that the changing of corporate strategies be accounted for in framing remuneration systems.²⁶

These findings clearly show important implications on remuneration policies and on the legal situation: Incentives and underlying parameters implemented in remuneration systems must, as far as necessary, be adjusted to changing corporate strategies. However, retrograde or purposeful adaptations of remuneration objectives and parameters – or yet of the corporate strategy itself – in order to increase the managing board's remuneration should evidently be excluded.

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Kaplan/Norton, Harvard Business Review 1993, p. 134; Gleißner, BC 2000, p. 129; Ossadnik, BB 2003, p. 891; Schmeisser/Schindler, DStR 2004, p. 1891.

26 BaFin Circular (Rundschreiben) 22/2009 (BA) of 21 December 2009, no. 3.1, and Circular 23/2009 (VA) of 21 December 2009, no. 2; in the same line: BaFin Circular 15/2009 (BA) – Mindestanforderungen an das Risikomanagement (MaRiskBanken) of 14 August 2009, no. 3 par. 1, and AT 7.1 par. 4.

Thus, the supervisory board may only change or modify the objectives pursued by the remuneration system or the parameters deduced from these, if and as far as the corporate strategy has been changed or modified respectively; otherwise, the supervisory board members must be considered to have disregarded due diligence. On the contrary, adjusting remuneration parameters can also amount to a legal duty, if such proves necessary in order to prevent disparities between corporate and remuneration strategies. However, one problem remains unsolved: Due to certain appealing incentives envisaging sustainability, the managing board might not or not readily perceive changes in the business environment.²⁷

III. The Appropriate Remuneration Act challenges the competence structure in German stock corporations

1. Further regulating the managing board's remuneration

The new legal framework governing the managing board's remuneration, including the remuneration's compulsory assessment by the supervisory board's plenary meeting, will have far-reaching impacts on the functioning of the supervisory board, not only by consuming additional time and energy.²⁸ Previously, § 87(1) *AktG* merely stipulated the remuneration's amount to be appropriate; however, this provision has been regarded as more or less not litigable.²⁹ Henceforward, not only the managing board's remuneration's amount but also its structure is subject to legal regulation. In § 87(1)(1) *AktG*, the new framework establishes that the appropriate remuneration may not exceed the usual standard except for specific reasons. This compulsory connection imposes a completely litigable criterion with respect to the amount of the managing board's remuneration. In particular, assessing the usual remuneration standard by horizontal and vertical comparison is a matter not of law, but of fact.

With regard to listed corporations, §§ 87(1)(2) and (3) *AktG* further regulate the remuneration structure by requiring sustainability to be implemented as objectives into the remuneration system and by demanding the assessment of remuneration parameters to be perennial. As the legislator thereby aligns the remuneration structure with the sustainable corporate development, remuneration becomes a *compulsory instrument in piloting the managing board's activities*. Insofar, the supervisory board does not dispose of licence or discretion; § 87(1)(2) *AktG* stipulates any kind of remuneration system to be purposeful, regardless of whether or to what extent it includes variable remuneration components or not. This paradigm shift caused by aligning remuneration with sustainability may not in the least be underestimated. We consider this paradigm shift in German Stock Corporation Law to be reproducing the economic theory and practice of controlling top executives by means of remuneration policy.³⁰ While hitherto remuneration has been supposed primarily to com-

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27 Dauner-Lieb, Der Konzern 2009, p. 583.

28 On this subject, see Dauner-Lieb, Der Konzern 2009, p. 583 at p. 592.

29 For references, see fn. 10.

30 On this subject, see: *Rappaport*, Journal of Business Strategies 4 Vol. 2

pensate and to reward, economic theory hence prefers it to exert control functions, and the *Appropriate Remuneration Act* finally elevates ‘remuneration acting as incentive’ to a legal rule. This is exactly what the legislator intended, as the government’s explanatory memorandum states: “Additionally, the supervisory board is required to place incentives by means of the chosen remuneration instruments”.³¹ As we could demonstrate, this intention is in accordance with developments on the international level; these developments recognize management remuneration as one decisive cause of the financial and commercial crisis and are thus striving to gain control over the management’s activities and decisions by utilizing remuneration as their key instrument.

However, legally regulating the managing board’s remuneration compellingly turns the focus from remuneration policy and entrepreneurial considerations onto legal questions. Accordingly, the supervisory board will depend more and more on external legal expertise. This need is exemplified by the passionate debates on what makes assessment parameters perennial, as well as on which ratio is required between variable and non-variable remuneration components and how short- and long-term variables can be poised.³² The debate on how to interpret the constituent “sustainability” element in § 87(1)(2) *AktG* is also dominated by legal experts. Most commentators understand sustainability as continuity or durability; remuneration structures are considered sustainable, if variable components are assessed on a perennial basis which is suggested to amount to a period of two to five years.³³ But neither the law nor logic tell us that and why observance of a discretely defined time period should be a necessary precondition for sustainable entrepreneurship. On the contrary, as remuneration parameters compellingly depend on the corporate strategy, the same holds true for the sustainability element: It can only be specified by deduction from the business plan and the corporate strategy.³⁴ Quite evidently, incentives adjusted in compliance with five years’ cycles will almost inevitably mislead when applied in IT or internet companies. However, time will show, whether legal experts should and can structure the managing board members’ remuneration more appropriately than the intrinsically competent organs. Taken into account the remuneration being, on the one hand, dependent on the corporate strategy, and, on the other hand, intended to control entrepreneurial activity, we seriously doubt that legal reasoning should prevail over entrepreneurial considerations.

2. Should the supervisory board pilot the corporation’s top executives in its own right?

The idea of further regulating the managing board’s remuneration, in order to provide a compulsory legal tool for piloting

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(1993), pp. 49 s.; *Murphy*, I.c. (fn. 20), p. 2485 at p. 2506; *Jensen/Murphy/Wruck*, Harvard NOM Working Paper no. 04-28, p. 19.

31 Explanatory Memorandum on the Bill of the Federal Government, Bundestag printed paper no. 16/12278, p. 5.

32 See for example: *Dauner-Lieb*, *Der Konzern* 2009, p. 583 at p. 588; *Hoffmann-Becking/Krieger*, NZG supplement no. 26/2009, p. 1 at p. 2; *Thüsing*, AG 2009, p. 517 at p. 520; *Hohenstatt*, ZIP 2009, p. 1349 at p. 1351.

33 *Hoffmann-Becking/Krieger*, NZG supplement no. 26/2009, p. 1 at p. 3 no. 17 (two years); *Seibert*, WM 2009, p. 1489 at p. 1490; in the same line *Fleischer*, NZG 2009, p. 801 at p. 803; *Gaul/Janz*, NZA 2009, p. 809 at p. 810 (four years); *Thüsing*, AG 2009, p. 517 at p. 521 (five years).

34 *Dauner-Lieb*, *Der Konzern* 2009, p. 583 at pp. 587 s.

the board, poses an even more significant problem with respect to the allocation of competences in stock corporations. Although the supervisory board, the plenary meeting being competent according to § 107(3)(3) *AktG*, still determines the remuneration of managing board, the remuneration objectives and parameters must henceforth be deduced from the corporate strategy. Thus, developing remuneration structures presupposes the corporate strategy to have been decided on beforehand. In German Stock Corporation Law, however, developing and framing the corporate strategy constitutes the managing board’s most distinguished duty.³⁵ According to § 76(1) *AktG*, the managing board conducts the corporation on its own authority; according to § 111(1) *AktG*, the supervisory board has to supervise the corporation’s management. Thus, taken literally, the supervisory board is not called upon to “pilot” or to “control” the managing board. The *Appropriate Remuneration Act* thereby proves capable of disrupting the German Stock Corporation Law: The new framework requires the supervisory board to henceforth align remuneration structures with sustainable corporate development, although such an alignment only makes sense based on the particular corporate strategy – which, according to the traditional allocation of competences in German stock corporations, however needs to be developed by the managing board. Allocation of competences and entrepreneurial authority within the triangle configured by management, supervisory board, and shareholders’ meeting become indistinct. This situation proves even more delicate for the concerned actors, as the legislator, by amending § 116(3) *AktG*, has emphasized the supervisory board members’ liability with respect to the managing board’s remuneration.

The new legal framework governing the managing board’s remuneration therefore turns out to be alien to the system of competences in German stock corporations. As a matter of fact, commentators yet have hardly taken note thereof. This fact could be explained by considering that behaviour control via remuneration, as developed and discussed on the international level, is structurally proportioned for legal forms possessing a general board system. Those legal forms do not distinguish between management and management control. Legal forms following the monist approach require the board to decide on the corporate strategy as well as on the executive directors’ remuneration. Insofar, conflicting assessments and indistinct allocation of competences with regard to management and controlling are thus barred in the monist board system. The implications for German stock corporations are considerable: Through implementing compulsory controlling by means of remuneration, entrepreneurial authority over the corporate strategy could be shifted from the managing to the supervisory board. The *Appropriate Remuneration Act* could thus – without having attracted a great deal of attention thereon – slowly approximate the German stock corporation’s structure to the monist board system. Such a development would raise diverse problems. In particular, it would conflict with basic rules on employee co-determination in German Stock Corporation Law. The law has reason to provide for employee co-determination only in the supervisory, but not in the managing board: The supervisory board (merely) has to supervise the managing board and is precisely neither competent nor responsible for conducting the business.

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35 See: *Fleischer*, I.c. (fn. 8), § 1 no. 13; *Mertens/Cahn*, I.c. (fn. 1), § 76 no. 4, citing further references; *Oltmanns*, I.c. (fn. 8), § 76 no. 5.

3. The shareholders' meeting's facultative competence (Say on Pay)

The situation becomes even further complicated because the amended § 120(4) *AktG* vests the shareholders' meeting with the competence to resolve on the structure of the managing board's remuneration. As the sustainability requirement is supposed to serve the corporate strategy's implementation, the shareholders' meeting needs to discuss the corporate strategy in order to reasonably decide on the managing board's remuneration structure; however, the shareholders' meeting cannot authoritatively resolve on the corporate strategy. The traditional rights and duties of the managing board, the supervisory board, and the shareholders' meeting are described in § 76(1), § 111, and § 119 *AktG* respectively. The *Appropriate Remuneration Act* substantially disrupts this allocation of competences with regard to the essential domains of both the managing board's remuneration and, in particular, the corporate strategy, yet without the legislator consciously having intended such a paradigm shift. Commentators are likewise largely ignoring the resulting disruptions threatening the German stock corporation's traditional structures, that is to say, the authority, responsibility, and liability of the supervisory board members, including particularly the employee representatives.

IV. Pleading to interpret afresh the new legal framework

1. Point of departure

Most commentators so far suppose the term “*assessing* the managing board's remuneration” employed in § 87(1) *AktG* to imply that the supervisory board members in person are competent and responsible for developing a remuneration system meeting the new requirements, especially the sustainability target. The consequential problems and disruptions capable of turning the German stock corporation towards the monist board system have been outlined before. However, such policy has neither been intended nor desired by the legislator. The legislator conceived of the *Appropriate Remuneration Act* as a moderate policy intervention intending the managing board's activity to focus on sustainable corporate development.³⁶ The interpretation of § 87(1) *AktG* as amended thus requires new ideas to be explored: Incorporating the new legal framework's policy intentions into the traditional German Stock Corporation Law without causing too many tensions consequentially demands to interpret afresh the supervisory board's function in assessing the managing board's remuneration. As a starting point, we must consider that the managing board's members invariably determine the business strategy and objectives on behalf of the corporation, thereby assuming entrepreneurial responsibility vis-à-vis the supervisory board and the shareholders. The *Appropriate Remuneration Act* may not accidentally allow the managing board, under reference to the remuneration's control function, to clandestinely shift this responsibility to the supervisory board.³⁷ On the contrary, the managing board members must additionally assume responsibility for their proper

remuneration; their entrepreneurial accountability therefore must be sustained. The regulatory framework within which any entrepreneur may act must be taken into account in appraising the procedure of assessing the board's remuneration, while the supervisory board's function as controlling body must be consolidated.

The application of the *Appropriate Remuneration Act* manifestly creates tensions between the managing board's duty of conducting the corporation in its own authority, on the one hand, and the supervisory board's new duty of providing for sustainable controlling by means of assessing the managing board's remuneration structure, on the other hand. In practice, the supervisory board, usually acting through its chairman (mostly chairing the competent committee as well), enters into the question of whether and to what extent the managing board's remuneration has to be adjusted according to the new regulatory framework introduced by the *Appropriate Remuneration Act*. However, the chairman generally entrusts the managing board members informally with elaborating proposals on the remuneration structure; usually, by cooperating with the HR department competent for top executives, and, if necessary, supported by external experts. This kind of proceeding is justified by referring to the managing board's competence of framing the corporate strategy. The managing board's proposals for remuneration objectives and parameters are frequently and to a large extent adopted in the supervisory board's assessment.

2. Balancing business management and controlling

We have seen that in many cases the managing board members have already been implicated in framing the remuneration components, objectives, and parameters, since they are in charge of the corporate strategy. We firmly argue that this kind of proceeding should overtly and formally be recognized as being best practice, and as such should be further developed. Consequentially, the managing board members would initially have to develop the corporate strategy in accordance with the supervisory board. Based on the corporate strategy, the managing board members would then have to suggest to the supervisory board how to composite and how to assess their proper remuneration. Besides the discrete remuneration components (i.e., the underlying parameters, operating mechanisms, and maximum amounts), these suggestions would in particular have to comprise the targets to be met by the managing board. Thereby, the managing board members would not only be compelled to challenge their properly developed corporate strategy and its feasibility but also would have to argue and to actively defend their view with respect to remuneration and targets vis-à-vis the supervisory board. As the targets to be met in return for the managing board's remuneration within the determined period would be dealt with during the consultation process, the managing board members would insofar fully assume entrepreneurial responsibility for their corporate strategy and for the targets set in order to achieve their strategy. Such a consultation process could provide a down-to-earth framework for the interaction between managing and supervisory board; at the same time, the supervisory board could acquire additional duties in controlling (compliance, risk management). By virtue of imposing such an objective framework, negotiations would probably proceed more orderly; they would focus more keenly on issues, and spare bargaining more easily. To put it simply: The managing board members would comment to the

³⁶ See *Seibert*, WM 2009, p. 1489.

³⁷ Or, to even shift this responsibility (in the policy sense) to the shareholders' meeting by means of a shareholders' meeting decision according to § 120(4) *AktG*.

supervisory board on what they believe to be their value to the company and what business results they intend to achieve in return.

In order to avoid misunderstandings, we wish to clarify that the managing board members should not be vested with the right to assess or to determine their proper remuneration. With regard to assessment and determination, the supervisory board is competent according to § 87(1) *AktG* and accountable according to § 116(3) *AktG*. The supervisory board also will have to ensure independently that the requirements imposed by § 87(1) *AktG* are adhered to; as the case may often be, external experts might be consulted. The managing board members however would become far more implicated in necessarily assuming responsibility for their entrepreneurial targets and the remuneration instruments to be deduced from these; thereby, the managing board's corporate-policy accountability could be further endorsed and thus the basic principle enshrined in § 76 *AktG* would be accounted for. In addressing the shareholders' meeting according to § 120(4) *AktG*, the managing board members again would have to present and to justify their corporate strategy and the remuneration proposals they came about to deduce from the strategy.

3. The managing board's entrepreneurial responsibility as basis for appropriate remuneration

The preceding considerations have demonstrated the possibility of integrating the *Appropriate Remuneration Act's* essential policy intentions into the dualist structure of the German stock corporation. One may also anticipate positive side effects of interpreting afresh the amended § 87(1) *AktG*: If the managing board members had to actively and overtly advocate their targets and their desired remuneration deduced here from vis-à-vis the supervisory board, this proceeding could considerably restrain the remuneration's amount. Managing boards could ill afford to formulate excessively unrealistic targets. On the contrary, they will strive to defend targets they can actually meet. At the same time, these targets will not run the risk of not being sufficiently ambitious: As the managing board has to propose the remuneration's amount and structure as well, the company's success and the remuneration will correlate. The managing board will only dare to formulate ambitious remuneration suggestions, if the targets which have to be met in return will be ambitious, too.

Furthermore, the proposed system might positively influence the coherence of corporate-wide remuneration structures. As the managing board members assume entrepreneurial responsibility not only for the remuneration of staff members, particularly executives, but also for their own remuneration, they can be assimilated in accordance with the corporate-wide system – as already legally prescribed and practised in the case of banks and insurance companies.

V. Synopsis

The *Appropriate Remuneration Act* transforms the managing board's remuneration into a compulsory piloting device, in particular by aligning remuneration with sustainable corporate development. However, reasonable controlling parameters can only be deduced from the individual corporate strategy: 'Compensation follows Strategy'. The corporate

strategy is yet to be developed by the managing board members as their essential occupation. The *Appropriate Remuneration Act* thus creates tensions between the managing board's authority to conduct the corporation and the supervisory board's duty to monitor the corporate management; the German stock corporation thereby runs the risk of slowly turning towards the monist board system. We have suggested a mode of interpretation permitting to resolve potential conflicts. At the same time, we offer to recollect the essentials of entrepreneurship and to increase entrepreneurial responsibility: The managing board members have to formulate corporate targets which are capable of convincing the supervisory board and the shareholders' meeting. From these targets they have to deduce realistic remuneration expectations, and thereby need to adequately tie their revenues – favourably or prejudicially – to the corporation's faith. The supervisory board remains the controlling organ and thus has to assess the managing board's proposals according to § 87 *AktG* with regard to coherence and persuasive power, and finally has to determine the remuneration authoritatively. This proceeding ideally answers the principle 'Pay for Performance': It is capable of maximizing transparency in performance assessment and consistency in strategy implementation; it may as well firmly corroborate credibility with respect both to internal management or controlling processes and to external (equity market) communication.