Chambers

GLOBAL PRACTICE GUIDE

Definitive global law guides offering comparative analysis from top ranked lawyers

Corporate Governance

Germany
P+P Pöllath + Partners

2019

chambers.com

Law and Practice

Contributed by P+P Pöllath + Partners

Contents

P+P Pöllath + Partners is an internationally operating German law firm, with more than 140 lawyers and tax advisers in Berlin, Frankfurt and Munich providing high-end legal and tax advice. The firm comprehensively advises on all transaction-related areas, such as corporate, M&A, private equity, funds, real estate, private clients, succession planning and all tax-related matters. In particular, P+P's corporate advice covers corporate law and group company law, capital market rules, reorganisations, corporate litigation, and compliance. The team advises publicly listed and private companies on preparing and conducting their general and shareholder meetings on all matters, including mergers, spin-offs and hive-downs, and conversions of legal form; it also advises on all corporate advisory matters related to management and supervising bodies (corporate governance). A further core area is advising on public takeovers with subsequent corporate integration (taking private). Finally, the team represents its clients in litigious corporate law matters.

Authors

Dr Eva Nase is a partner at P+P Pöllath + Partners in Munich. She specialises in advising domestic and foreign institutional and private investors, listed and private corporations and board members on all corporate advisory and capital market matters, public takeovers and private transactions, and all kinds of restructurings, as well as corporate litigation. Her clients include national and international corporations, private equity companies and private clients.

Christoph-Alexander May is an associate at P+P Pöllath + Partners in Munich. He specialises in corporate law, including the corporate governance of listed and private corporations, restructuring measures, public takeovers, capital markets advice and corporate litigation.

1. Introduction

1.1 Forms of Corporate/Business Organisations

German law differentiates between capital companies and partnerships.

Capital companies are legal entities, where the liability is limited to the assets of the company – ie, the shareholders' liability is limited to what they have invested in the company. The most common legal forms of capital companies are the limited liability company (*Gesellschaft mit beschränkter Haftung* – GmbH) and the stock corporation (*Aktiengesellschaft* – AG). Other forms of capital companies are the European stock company (*Societas Europaea* – SE) and the partnership limited by shares (*Kommanditgesellschaft auf Aktien* – KGaA). The KGaA is a capital company, but also has some elements of a partnership.

Partnerships are characterised by the personal liability of the partners. The most popular legal form of a partnership is the limited partnership (*Kommanditgesellschaft* – KG), consisting of limited partners whose liability is limited to a certain amount agreed and disclosed in the commercial register, and general partners with unlimited liability. However, the general partner may have the legal form of a capital company, thereby limiting its liability. German law also acknowledges the partnership under civil law (*Gesellschaft bürgerlichen Rechts* – GbR) and the general partnership (*Offene Handelsgesellschaft* – OHG), with unlimited liability of their partners.

The following article will focus on capital companies, as these are the most important and regulated forms of companies in Germany.

1.2 Sources of Corporate Governance Requirements

The primary sources for corporate governance requirements for capital companies in Germany (GmbH, AG, KGaA, SE) are the German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* – GmbHG), the German Stock Corporation Act (*Aktiengesetz* – AktG), the European and German acts on SEs (in particular the European SEVO and the German SEAG), the German Commercial Code (*Handelsgesetzbuch* – HGB), the Reorganisation of Companies Act (*Umwandlungsgesetz* – UmwG), the German Securities Acquisition and Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz* – WpÜG) and the Securities Trade Act (*Wertpapierhandelsgesetz* – WpHG).

Beyond this, for listed companies the German Corporate Governance Code (*Deutscher Corporate Governance Kodex*

– DCGK) sets further corporate governance rules, which differentiate between recommendations and suggestions.

Moreover, non-governmental regulations such as applicable listing rules enacted by the stock exchanges also establish corporate governance requirements.

Certain industry sectors (eg, banks) are subject to further regulation with respect to, inter alia, their corporate governance.

1.3 Corporate Governance Requirements for Publicly Traded Companies

Shares of an AG, SE and, less common, a KGaA may be listed on a stock exchange. The primary source for corporate governance requirements concerning listed AGs and KGaAs as well as, to a lesser degree, SEs is the AktG, as it differentiates between rules for listed and non-listed companies. Its requirements are mandatory. The HGB, WpHG, WpÜG, the European and German Securities Prospectus rules (the European WPVO and the German WpPG), the Stock Exchange Act (*Börsengesetz* – BörsG) and the Market Abuse Regulation (MAR) provide for further mandatory regulation, inter alia, in relation to listed companies' corporate governance.

To promote a high corporate governance standard, the DCGK contains corporate governance standards in the form of recommendations and suggestions for listed companies with a two-tier corporate governance system; however, the rules of the DCGK shall also be applied correspondingly by listed companies with a one-tier corporate governance system (see **3.1 Bodies or Functions Involved in Governance and Management**, below). The DCGK is not enacted by the legislator, but by the German Corporate Governance Commission and is therefore not a statute or an ordinance, but rather "soft law", so the standards set in the DCGK are principally voluntary. Recommendations shall be complied with and, if not, deviations have to be explained and disclosed (principle of "comply or explain") in the corporate governance declaration (*Entsprechenserklärung*), to be resolved upon annually by the responsible corporate governance bodies of the listed company. The issuance of the corporate governance declaration is obligatory. Deviations from suggestions are allowed without disclosure. In practice, listed companies seek to comply with the standards set out in the DCGK, in particular the recommendations.

2. Corporate Governance Framework

2.1 Key Rules and Requirements

Over and above the corporate governance rules this article will focus on, German law provides for the following particularity changing the (allocation of seats of the) supervising body of certain companies.

Under German law, there are two different kinds of employee representation in supervisory boards of an AG, KGaA and GmbH – the so-called co-determination ("*Mitbestimmung*"). If an AG or a KGaA exceeds the threshold of generally 500 German employees, one third of the supervisory board members of the company must be employee representatives – ie, the one third participation (*Drittelbeteiligungsgesetz* – DrittelbG). If an AG, KGaA or GmbH and its controlled companies exceed 2,000 German employees in total, the supervisory board must consist of 50% employee representatives – ie, the parity co-determination (*Mitbestimmungsgesetz* – MitbestG).

With respect to a GmbH, the establishment of a supervisory board is only required if co-determination rules become applicable. Thus, a GmbH with more than 500 German employees must establish a supervisory board with one third of the supervisory board members being employee representatives. Also, a GmbH with more than 2,000 German employees within it and its controlled group must establish a parity co-determined supervisory board with a minimum of six shareholder and six employee representatives.

Shareholder representatives on the supervisory board are generally appointed by the general meeting, while employee representatives in cases of co-determination are generally appointed by employee elections.

German co-determination rules do not apply to the SE. When incorporating an SE by way of the 'numerus clausus' of incorporation, an agreement on the participation of employees in the SE (the so-called employee participation agreement) has to be negotiated with the special negotiating body, which is established particularly for such negotiation, representing employees from the German company, its subsidiaries and branches that are in EU and EEA member states other than Germany. The rules on co-determination are part of the agreement, with the general principle that the level of co-determination of the German company used to incorporate the SE shall be maintained (freeze of co-determination/prior to and after principle) – eg, if no co-determination exists and needed to exist prior to the incorporation of the SE, then no co-determination would need to be agreed upon in the employee participation agreement for the SE, etc.

2.2 Current Issues and Developments

A key forthcoming development in the area of corporate governance will be the upcoming national implementation of the amended EU-Shareholders' Rights Directive, as well as the amended DCGK, which is not yet in force.

The amended EU-Shareholders' Rights Directive addresses several ongoing "hot topics" of corporate governance. With regard to the remuneration of members of the management of an AG, of the general partner of a KGaA, if any, and of an SE, the general meeting of a listed AG, SE and KGaA

currently has an advisory vote on the remuneration of the members of the management board ("say on pay"). This does not affect the remuneration of senior management. The management board and the supervisory board resolve upon the resolution proposal to be proposed to the general meeting; they are currently free to decide whether and how often the general meeting shall vote. This will change due to the implementation of the amended EU-Shareholders' Rights Directive, which is currently in the legislative procedure and was supposed to become effective on 10th June, 2019 at the latest; however, the implementation act has not yet been passed by parliament. According to the current draft implementation act, the annual general meeting must vote on any material change to the remuneration policy, but at least every four years. The draft implementation act also sets out minimum requirements for the remuneration policy. If the general meeting dismisses the resolution proposal upon the remuneration, the next annual general meeting has to resolve upon an amended remuneration policy again. The resolution has to be published on the website of the company for the period of the application of the remuneration system, for at least ten years. The annual general meeting also has to resolve upon the approval of the remuneration report for the previous financial year, with the exception of small and mid-sized corporations, if the remuneration report is presented as a separate item on the agenda of the annual general meeting. Neither the vote/resolution on the remuneration policy nor the vote/resolution on the remuneration report can be objected to by means of a contesting action or an action for annulment by a shareholder. The remuneration report also has to be published on the website of the company for at least ten years.

The draft act implementing the amended EU-Shareholders' Rights Directive also provides for approval requirements and further disclosure requirements for related party transactions, including transactions of the company with its various members of corporate bodies and introduces new rules with respect to intermediaries, institutional investors, asset managers and proxy advisers.

Furthermore, the commission overseeing the draft and amendment of the DCGK adopted an amended version of the DCGK. The amended DCGK will not be handed in for publication at the Federal Ministry of Justice and Consumer Protection until the act implementing the amended EU-Shareholders' Rights Directive enters into force. The amended DCGK will enter into force upon its publication. While a lot of provisions of the DCGK shall be deleted following the amended DCGK because they repeat applicable law rather than set additional standards, the draft introduces the concept of principles preceding the individual recommendations and outlining the essence of the most important legal rules and concepts. The commission introduced new recommendations regarding the remuneration of the management board, seeking, among other goals, greater transparency, social acceptance of the compensation of the management board and to incentivise certain behaviours of the management board. The third aspect which has been heavily modified is the rules concerning the supervisory board, especially the indicators on when a member of the supervisory board is to be considered "independent". Some other recommendations have also been added – for example, a maximum of five supervisory board mandates per individual is recommended, and, where an individual is a member of the management board of another listed company, a maximum of two supervisory board mandates is recommended. Also, in the latter case, none of those mandates shall be as the chair of the supervisory board. The amended DCGK eliminates the need for a separate corporate governance report and instead calls for information on the corporate governance to be included in the declaration on corporate governance in the management report.

3. Management of the Company

3.1 Bodies or Functions Involved in Governance and Management

The predominant board structure of an AG and an SE follows the two-tier corporate governance system, with a management board (*Vorstand*) managing and representing the company, and a supervisory board (*Aufsichtsrat*) supervising the management board, in each case accompanied by the third corporate body, the general meeting (*Hauptversammlung*). The management board manages the company under its own responsibility and at its own discretion. It is not subject to any instructions from the supervisory board or the general meeting. However, the management board is subject to the prior approval of the supervisory board for certain business transactions and measures, either foreseen in the articles of association of the company or by the supervisory board itself – eg, in the rules of procedure for the management board.

A one-tier corporate governance system primarily known in other jurisdictions with one board is only allowed in Germany within an SE. The board is called the administrative board (*Verwaltungsrat*), and consists of executive and non-executive board members. The administrative board is responsible for the management and supervision of all material company matters (*Oberleitung*) as well as the determination of guidelines for the SE's business, and appoints managing directors (*Geschäftsführende Direktoren*), who are responsible for the day-to-day management of the company. The managing directors may be members of the administrative board if and to the extent that the majority of the members of the administrative board continue to be non-executive. The administrative board is entitled to issue internally binding instructions to the managing directors.

The peculiarity of a KGaA is that the general partner is responsible for the management. The general partner, being

a shareholder of the KGaA, may be one or more natural persons or, more common in practice, a capital company itself – eg, a GmbH, AG or SE. The corporate governance system of such capital company is to be differentiated from the corporate governance of the KGaA. The corporate governance of the general partner company follows its applicable principle. The KGaA has in any case a supervisory board that is responsible for the supervision of the management, but in case of a capital company as general partner it is responsible for neither the appointment, dismissal and service contracts of the management of the general partner nor for the determination of the financial statements.

The general meeting of an AG, SE and KGaA has no corporate governance powers.

A GmbH generally has managing directors (*Geschäftsführer*) and the shareholders' meeting (*Gesellschafterversammlung*), but no statutorily required supervising body. The managing directors are responsible for the management and representation of the company. In principal, they decide autonomously. However, the shareholders' meeting is – in contrast to the situation in the AG – the supreme decision-making body of the GmbH, and has the authority to issue internally binding instructions to the managing directors. In a GmbH, a voluntary supervisory or advisory board may be implemented. Apart from this, a supervisory board is to be installed only in case of co-determination (see **2.1 Key Corporate Governance Rules and Requirements**, above).

3.2 Types of Decisions Made by Governing Bodies

In an AG and a two-tier system SE, the management board responsible for the management of the company decides upon any and all business transactions and measures within and outside the ordinary course of business under its own responsibility and discretion. However, material measures within and measures outside the ordinary course of business are subject to the prior approval of the supervisory board. For this purpose, applicable law provides that a catalogue containing those approval rights has to be established, either by the general meeting in the articles of association or, alternatively and – in practice – more relevant, by the supervisory board itself in the rules of procedure for the management board, which is an important part of supervising the management board.

Besides the supervision of the management board, the supervisory board is responsible for the appointment and dismissal of the members of the management board, for their service contracts, and for the review and determination of the financial statements.

In a one-tier system SE, the administrative board is responsible for fundamental management issues, such as long-term business goals, the organisational structure, and the strategy and general guidelines of the SE, as well as the budgeting, whereas the managing directors are "only" responsible for the day-to-day management. The administrative board has the authority to issue internally binding instructions to the managing directors.

Only selected decisions are reserved by law for the general meeting of an AG and an SE. With respect to the annual ordinary general meeting, such decisions include the appropriation of profits, the appointment of the auditor and the formal approval of action for members of both the management board and supervisory board; with respect to fundamental, extra-ordinary decisions, such decisions include the election and removal of the supervisory board members, amendments to the articles of association, and resolutions on restructuring measures and the sale of substantially all of the corporation's assets, as well as on corporate agreements (profit and loss pooling agreements).

Managing directors of a GmbH can principally make day-to-day management decisions without consulting the shareholders. However, as the shareholders' meeting is the supreme body, a broader catalogue of decisions is reserved by law for the shareholders' meeting of a GmbH than a general meeting of an AG: all decisions that the ordinary general meeting of an AG has to take plus the review and determination of the financial statements and all fundamental, extraordinary decisions of the general meeting of an AG, as well as the right to instruct the managing directors.

3.3 Decision-making Processes

The management board of an AG and a two-tier system SE generally decides in physical or electronically set-up meetings, if a certain quorum of – most of the time – more than half of the members of the management board are present or represented, by way of resolution, generally to be passed by a simple majority. However, qualifying majority requirements can be set – eg, in the rules of procedure for the management board. In practice, it is recognised and common that members of the management board are allocated certain individual responsibilities as part of their department (*Ressort*). Decisions within each department are made by the responsible, single member of the management board, unless such decision is of material nature, in which case a resolution of the management board is necessary. This also applies in case another member of the management board is asking for it. Finally, the management board may form committees for specific tasks, although this is not that common in practice. More or less the same decision-making process applies to managing directors of a one-tier system SE and a GmbH.

The supervisory board of an AG, a two-tier system SE and a KGaA decides by way of resolution, generally with a simple majority. However, the articles of association or the rules of procedure for the supervisory board may foresee qualifying majority requirements. Supervisory board meetings shall be held as physical meetings from the statutory start-

ing point. However, electronically set-up meetings as well as mixture forms are permissible, except for the meeting preparing the annual general meeting, which must be a physical meeting in the presence of the auditor. Supervisory board members not present in a meeting may not be represented by third persons or other supervisory board members, but can only give a written voting declaration (*Stimmbotschaft*). The meeting has a quorum if the majority of members are present – at least three. The supervisory board is entitled to form committees from within itself – eg, an audit committee and a nomination committee. Committees are generally responsible for preparing supervisory board topics and consummating resolutions passed by the supervisory board. Sometimes, committees are also entitled to resolve instead of the supervisory board. However, this is not allowed in statutorily foreseen topics – eg, upon the remuneration and service contracts of members of the management board. Rules applying to the supervisory board in a two-tier system also have to be adhered to by the administrative board in a one-tier system SE.

4. Directors and Officers

4.1 Board Structure

There is no legally predefined structure for the management board of an AG or two-tier system SE, nor for the managing directors of a one-tier system SE or GmbH. The management board can consist of one or more natural persons, unless the articles of association require a minimum number of members; the same applies for the number of the managing directors. The current DCGK recommends that the management boards of listed companies shall consist of several members.

The supervisory board of an AG, KGaA and a two-tier system SE, and the administrative board of a one-tier system SE, has to consist of at least three members or a higher number, up to nine, 15 or 21 members, depending on the registered share capital of the corporation, to be set in the articles of association. The number of members must not be devisable by three (any more), unless in case of co-determination (see **2.1 Key Corporate Governance Rules and Requirements**, above), in which the number of members must be divisible by three. In case of equal co-determination, the total number of supervisory board members is 12 and beyond this depends on the total number of German employees.

4.2 Roles of Board Members

The applicable law does not predefine roles for members of the managing bodies. One member of the management board can be nominated as chairman or spokesperson, as recommended by the current DCGK. Apart from this, it is common for the tasks and duties of the management board and managing directors to be divided between them in several departments, either functional or operational divisions. Thereby, names like CEO, CFO and COO are generally addressed to the members on their business cards, the website, and in the email-footer; however, these are neither statutorily foreseen nor do they trigger any special further rights or obligations.

With respect to the supervisory board of an AG and a two-tier system SE or an administrative board of a one-tier system SE, only the following rules have to be considered. Generally, each member has the same rights and duties, and must be familiar with the relevant business sector of the company. However, according to applicable law and the DCGK, boards of listed companies must have one member with certain skills – for example, financing, reporting and auditing expertise.

4.3 Board Composition Requirements/ Recommendations

Beyond the requirements set out in **4.1 Board Structure** and **4.2 Roles of Board Members** above, there are no other statutory rules governing the composition of the management board of an AG or a two-tier system SE, nor of the managing directors of a one-tier system SE or GmbH. However, if such a company is listed on a stock exchange or co-determined, the supervisory board must determine a target percentage for women on the management board as well as deadlines by when such percentage is to be reached. If at the time of the determination the percentage of women on the management board is below 30%, the target percentage may not be lower than the present percentage. Furthermore, the management board shall make respective determinations with respect to the two management levels below it. These corporations have to include a declaration on corporate governance in their management reports. The current DCGK restates these rules, and recommends that diversity is taken into account.

In AGs, SEs and KGaAs that are parity co-determined and listed on a stock exchange, the supervisory board (or, in the case of a one-tier system SE, the administrative board) shall be composed of at least 30% women and at least 30% men. The minimum percentage shall be complied with by the shareholder and employee representatives on the board in its entirety. Furthermore, corporations that need to fulfil the aforementioned gender criteria must include information on whether the company has complied with the portion requirements for the appointment of women and men as supervisory board members in their declaration on corporate governance.

With respect to the supervisory board of an AG and a two-tier system SE or an administrative board of a one-tier system SE that is listed on a stock exchange or co-determined, the supervisory board must also set a target for women on the supervisory board. The same rules apply with respect to the determination for the management board. The DCGK restates these rules and also recommends, among other matters, that the supervisory board determines concrete

objectives regarding its composition and prepares a profile of skill and expertise for the entire board. According to the recommendations, the composition of the supervisory board should be reflective of, inter alia, the international activities of the company, potential conflicts of interest, the number of independent members, and diversity. It is recommended that both are taken into account for the supervisory board's proposals to the general meeting. The implementation status is to be included in the corporate governance report.

4.4 Appointment and Removal of Directors/ Officers

In an AG and an SE, the respective supervisory or administrative board is responsible for appointing and generally dismissing the members of the management board or the managing directors. The maximum term of office is five years in an AG and six years in an SE; a reappointment or extension is principally permitted.

The members of the supervisory and administrative board are appointed by the general meeting, for a maximum term of office of approximately five years in an AG and six years in an SE. Reappointment is permitted. Dismissal could happen by resolution of the general meeting with a majority of at least three quarters of the votes cast, unless the articles of association provide otherwise.

The appointment and dismissal of the managing directors of a GmbH is, in principle, the responsibility of the shareholders' meeting. The term of office may be indefinite.

4.5 Independence of Directors and Conflicts of Interest

The members of the management board of an AG are subject to a duty of loyalty to the company, have to observe the best interests of the company and are bound by a non-compete obligation for the duration of office. They shall disclose conflicts of interest to the supervisory board without undue delay. The DCGK also makes statements to that effect. In certain situations, members of the management board should thus either abstain from casting votes or not even participate in the meeting or the relevant topic.

The members of the supervisory board of an AG and a two-tier system SE and of the administrative board of a one-tier system SE are also bound by a duty of loyalty, but there are no mandatory statutory provisions that require and define independence. However, a few restrictions aiming at independence prohibit an individual from becoming a member of the supervisory or administrative board – eg, where the individual is part of the management of a subsidiary of the company. Nevertheless, the DCGK requires a certain degree of independence to avoid conflicts of interest. In this respect, the supervisory board shall determine an appropriate number of independent members – ie, that do not have any personal or business relations with the company, its corporate bodies, a controlling shareholder and affiliated companies that may cause a substantial or not merely temporary conflict of interest.

4.6 Legal Duties of Directors/Officers

Members of management bodies shall conduct the company's affairs with the due care of a prudent and diligent businessman, in particular in accordance with the applicable laws and the articles of association (duty of legality, including and of ever-increasing importance the duty to establish and maintain an effective compliance management system). In case of entrepreneurial decisions, the so-called business judgement rule applies in order to eliminate hindsight bias when legally evaluating the management bodies' past conduct. This means that members of the management board may be exempt from liability if they reasonably had assumed that they were acting on the basis of adequate information and in the best interests of the company.

The same applies to the members of the supervisory and administrative board. However, their differing tasks and roles in the corporate governance of the respective company lead to a different emphasis of duties.

4.7 Responsibility/Accountability of Directors

In principle, members of management and supervising bodies owe their duties primarily to the company; they always have to act in the best interests of the company. However, the interests of the company include, to a certain extent, the interests of all stakeholders (like creditors and employees) of the company (German 'stakeholder model' in contrast to the Anglo-Saxon 'shareholder model').

4.8 Breach of Directors' Duties

In an AG and SE (with a few exceptions of special statutory rules – eg, in the event of an insolvency, and in the context of wilful misconduct), creditors and shareholders cannot enforce a breach of duties of members of management and supervising bodies. The members of the bodies are rather jointly and severally liable in the internal relationship towards the company due to their joint responsibility. Thus, individual members of a management and supervising body may not alleviate themselves from liability because a certain task or responsibility was delegated to a different member internally. Furthermore, such breach may lead to a dismissal and, with respect to the management members, a termination of their service contract.

In principle, the supervisory board is responsible and – according to case law – even has a duty to assert damage claims to the management board members. The company may waive its damage claims or enter into settlement arrangements on these claims only if three years have lapsed since the claim arose and the general meeting resolved thereupon without a minority of the shareholders (at least 10% of the share capital) raising an objection.

In the event that members of the supervisory board culpably breach their duties, the management board is responsible to pursue possible damage claims against the supervisory board members jointly and severally.

The rights and obligations on asserting claims against members of corporate governance bodies in an AG, SE and KGaA are independent of whether or not the members of these respective bodies have been discharged. Another particular consequence of a breach of duty in a listed company is that the company may be obliged to disclose it to the capital market by way of ad hoc notification.

In case of a GmbH, the consequences of a breach of the duties of managing directors are, to a great extent, comparable to an AG. In general, the managing directors, like the management board members, are not directly liable to the creditors of the company. The shareholders' meeting has the right to pursue damage claims and to decide about the dismissal of managing directors and the termination of the service contract. In contrast to the situation in the AG, if the shareholders' meeting has discharged the managing director knowing the facts underlying such breach, such discharge leads to an exclusion of liability.

4.9 Other Bases for Claims/Enforcement Against Directors/Officers

Certain special law remedies and, in case of wilful misconduct, general civil law remedies exist. From the company's point of view, these do not generally extend claims any further than those under corporate law. However, since shareholders do not have a direct claim against the members of management and supervising bodies under corporate law, in certain situations (eg, capital market fraud) general civil law remedies may give opportunity for claims of shareholders. However, the courts have traditionally been cautious to recognise such claims.

The liability of a member of a management and supervising body in an AG, SE and KGaA cannot be limited, as this would in particular qualify as an impermissible waiver by the company upfront – ie, prior to the expiry of the three-year period (see **4.8 Consequences and Enforcement of Breach of Directors' Duties**, above). However, D&O insurance for the members of the management and supervising body is permissible and common in practice in order to protect them against risks arising from their professional activities for the company. Premiums are generally paid by the company, although members of the management board of an AG, SE and KGaA are obliged to bear a deduction of at least 10% of the damage to at most one and a half times their annual fixed salary. With respect to supervisory and administrative board members, a respective deduction is recommended by the DCGK.

4.10 Approvals and Restrictions Concerning Payments to Directors/Officers

The remuneration of the management board members of an AG and a two-tier system SE is resolved upon by the supervisory board and contractually agreed upon in the service contract. However, the general meeting of a listed company has an advisory vote on the remuneration system ("say on pay") and certain further rights following the implementation of the amended EU-Shareholders' Rights Directive (see **2.2 Current Corporate Governance Issues and Developments**, above). Besides the fixed salary, the monetary remuneration shall consist of variable short and long-term bonuses and incentives, including profit-sharing and stock options. When determining the overall remuneration of individual management board members, the supervisory board has to ensure that they are appropriate in relation to their tasks and performance as well as the economic situation of the company. In addition, the supervisory board shall make sure that the customary remuneration is not exceeded. In case of a listed company, the long-term incentives shall be oriented towards the promotion of the sustainable development of the company. The remuneration system has to be regularly reviewed and may, in grave circumstances, be reduced by the supervisory board. Furthermore, according to the DCGK, appropriate remuneration of the management board should take the remuneration of senior management and all staff into account. In particular, payments made to management board members due to the early termination of their service contracts shall not exceed twice the annual remuneration (severance cap), and shall not constitute remuneration for more than the remaining term of the employment contract.

The remuneration of the supervisory board members may be specified in the articles of association or granted by the general meeting. It should be appropriate in relation to the tasks of the members of the supervisory board and the company's economic situation. The DCGK further recommends taking the status as chair or deputy chair of the supervisory board or committee into consideration in this context. If the remuneration is performance-based, it is recommended that it is linked to the sustainable growth of the company. Another recommendation is that the individual remuneration of each member is disclosed.

In a GmbH, the remuneration of managing directors is the responsibility of the shareholders' meeting, which must not adhere to any restricting rules.

In a KGaA, the general partners generally receive no remuneration for their activities, but are entitled to receive a fee for taking over the liability of the KGaA vis-à-vis third parties. In case of a capital company as general partner, the remuneration of its management members is to be set according to the rules applying to the respective legal form of such capital company.

4.11 Disclosure of Payments to Directors/Officers

All capital companies are required to disclose the total remuneration of the management board in the annual financial statements. An exception is made only for capital companies that fulfil at least two of the following criteria (small capital companies):

- the balance sheet total does not exceed EUR6 million;
- the sales revenues within the last 12 months amount to less than EUR120 million; and
- the company employs, on an annual average, fewer than 50 employees.

In a listed company, the payments of every individual management board member and the principal features of the management remuneration system have to be disclosed, in particular in implementing the amended EU-Shareholders' Rights Directive (see **2.2 Current Corporate Governance Issues and Developments**, above). In addition, the DCGK recommends certain contents for the so-called management board remuneration report, such as information on the nature of the fringe benefits provided by the company. In addition, the service cost incurred in the reporting period for pension benefits and other commitments shall be disclosed. The DCGK provides sample tables that can be used for the disclosure of information on the remuneration of the management. As regards the amended version of the DCGK, disclosure requirements aim at being harmonised with the prerequisites of the implemented Shareholders' Rights Directive (see **2.2 Current Corporate Governance Issues and Developments**, above).

5. Shareholders

5.1 Relationship Between Companies and Shareholders

The purpose of the company is determined by its shareholders in the articles of association. The shareholders can only exert influence on the decision-making process by way of resolutions. The general meeting of an AG, SE and KGaA has fewer rights and powers than the shareholders' meeting of a GmbH, in particular due to their ability to instruct the managing directors (see **3.2 Decisions Made by Particular Bodies**, above). Furthermore, the shareholders have fiduciary duties towards the company and the other shareholders, and so have to promote the purpose of the company and may not act to its detriment.

5.2 Role of Shareholders in Company Management

The involvement of the shareholders in the management of a company differentiates according to the legal form of the company.

In an AG, SE and KGaA, the general meeting is entitled to appoint the members of the supervisory and administrative board, generally by simple majority, and to dismiss them by 75% of the share capital represented. However, the members of the management board and the managing directors in a one-tier system SE are appointed by the supervisory board, respectively the administrative board. The general meeting cannot instruct the supervisory or administrative board or the management board. However, if the management board so requires, the general meeting is entitled to resolve upon management affairs. In practice, such requests do not happen. Apart from this, the general meeting does not have any influence on the management.

Listed companies also do not engage with their shareholders, in particular not outside the general meetings. In preparing such meetings, the CEO has calls with shareholder representatives and potential proxy voters, but abstains from providing them with any information that has not already been disclosed in the invitation or that the CEO does not intend to disclose in the general meeting to all other shareholders. However, the current DCGK provides that the chairman of the supervisory board should, to an appropriate extent, be in regular conversation with investors on supervisory board-related issues.

Vice versa, non-listed companies typically do engage with their shareholders.

In a GmbH, the involvement of the shareholders in the management is also statutorily more extensive. In contrast to the AG, the shareholders' meeting resolves upon the appointment and dismissal of the managing directors and on the conclusion of their service agreements. Also, the shareholders of the GmbH are able to direct the managing directors to take or refrain from taking certain actions in the business by way of internally binding instruction.

5.3 Shareholder Meetings

An annual general meeting is mandatory in an AG and KGaA within the first eight months of a financial year, and in an SE within the first six months of a financial year. The annual meeting has to resolve upon the ordinary topics (see **3.2 Decisions Made by Particular Bodies**, above) and upon the remuneration policy (see **2.2 Current Corporate Governance Issues and Developments**, above). Further extraordinary topics on fundamental decision can also be put on the agenda of the annual general meeting, or can be passed in an extraordinary general meeting. Apart from this, general meetings are to be convened if necessary for the welfare and going concern of the company. The general meeting has to be convened no later than 30 days prior to the date of the general meeting, or no later than 36 days prior to the meeting if shareholders are required to register for the general meeting. In an AG and a two-tier system SE, the convening is generally the obligation of the management board, or exceptionally the supervisory board. Within a one-tier system SE, the administrative board is responsible for the

convening. However, shareholders whose share is equivalent to at least 5% of the registered share capital may also demand the convening of a general meeting. Shareholders whose share in the share capital is that high or corresponds to a nominal stake of EUR500,000 may demand that certain additional items are put on the agenda. The demand has to be received by the company at the latest 24 days prior to the general meeting, or no later than 30 days prior to the general meeting for listed companies.

The invitation has to fulfil a lot of formalities, like setting out the business name and seat of the company, the time and place of the general meeting, and the agenda. For listed companies, the invitation has to provide further information – eg, about the rights of the shareholders in respect to the general meeting.

Unless stipulated otherwise in the articles of association, the general meeting should be held at the seat of the company. Resolutions may not be taken by written consent, but the articles may provide that shareholders may cast votes in written form. Shareholders may be represented by a proxy/proxy voter at the general meeting, or may exercise their rights via electronic communication; the latter option is only available if the articles of association allow this form of attendance and voting.

In listed companies, each resolution adopted by the general meeting is to be recorded in the minutes of the meeting prepared by a notary public. For non-listed companies, it is sufficient to have the minutes signed by the chairman of the supervisory board as long as no resolutions are adopted for which applicable law requires a majority of 75% of the votes cast or a greater majority.

In a GmbH, the regulations in respect to the shareholders' meeting are not as strict as in the AktG for AGs, SEs and KGaAs. Resolutions generally have to be passed in a meeting of the shareholders, but can also be made in writing. The shareholders' meeting generally has to be convened by the managing directors by registered letter. In case of a meeting, the invitation has to be sent at least one week before the meeting, and the agenda of the shareholders' meeting has to be announced in the invitation. However, these formalities on the invitation can be waived or amended in the articles of association.

There are no special requirements for the holding and conduct of shareholders' meetings. Shareholders may submit their vote in writing or may grant proxy. It is also permissible to hold meetings via electronic communication.

5.4 Shareholder Claims

Shareholders generally do not have any direct claims against members of corporate governance bodies (see **4.8 Consequences and Enforcement of Breach of Directors' Duties** and **4.9 Other Bases for Claims/Enforcement Against Directors/Officers**, above).

Any shareholder who holds only "one" share may appeal resolutions (*Anfechtungs- und Nichtigkeitsklage*) of the general or shareholders' meeting for breach of law or the company's articles of association. Another objection shareholders can try to bring forward in such lawsuits is the violation of the (majority) shareholder's duty of good faith. As these duties are not statutorily defined, the chances of success are based on case law. The defendant is the company, not the other shareholder(s) who has (have) voted in favour.

By filing such objection and voidance claims in court, minority shareholders can block the completion (ie, entry into the commercial register) of, for example, corporate and integration measures. Registration will take place when the minority shareholders' court challenges are overcome by a so-called release proceeding, which the company must file (*Freigabeverfahren*). The company will in particular prevail in the release proceeding and thereby achieve registration in the commercial register if minority shareholders cannot prove that they hold more than a nominal value of EUR1,000 of the registered share capital of the company since the announcement of the convocation of the general meeting.

If in the context of a resolution the company or a majority shareholder has to offer to acquire shares of minority shareholders at fair value based on an IDW S1-valuation, those resolutions cannot be objected (any more) to with the argument that the valuation is too low. However, minority shareholders are entitled to challenge the adequacy of the price at court in a special shareholder compensation proceeding (*Spruchverfahren*).

Also, shareholders can request (by demanding either an invitation of an extraordinary general meeting or the adding of a topic on the agenda – see **5.2 Role of Shareholders in Company Management**, above) that the general meeting shall – with a simple majority of the votes cast – appoint a special auditor (*Sonderprüfer*) to analyse statutorily specified decisions of the executive and supervisory board. If the general meeting rejects the motion to appoint a special auditor, and if facts and circumstances justify severe breaches of tasks and duties by the management, minority shareholders who together hold 1% of the registered share capital or a nominal value of at least EUR100,000 can file for the appointment of the special auditor in court.

Also, minority shareholders may influence the assertion of damage claims against management and supervisory board members following breaches of tasks and duties if, in a first instance, the general meeting resolves with a simple majority to assert such claims. Minority shareholders who together hold 10% of the registered capital or a nominal value of at least EUR1 million can then judicially file for the appoint-

ment of a special representative (*besonderer Vertreter*) to assert these claims. Minority shareholders who together hold 1% of the registered share capital or a nominal value of EUR100,000 or more can also apply in court for admission to assert these claims of the company in their own name.

5.5 Disclosure by Shareholders in Publicly Traded Companies

Shareholders of listed companies have to notify the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) and the issuer if their direct and/or indirect holdings exceed or fall below certain thresholds (3%, 5%, 10%, 15%, 20%, 25%, 30%, 50%, 75%) and if their positions in financial instruments relating to shares exceed or fall below the aforementioned thresholds (except for the 3% threshold). The notification is to be published by the issuer and can be viewed on its website at any time.

6. Corporate Reporting and Other Disclosures

6.1 Financial Reporting

Except for small partnerships, companies have to prepare an annual financial statement. Capital companies additionally have to prepare a management report, unless the company is a small company (based on the criteria set out in **4.11 Disclosure of Payments to Directors/Officers**, above). The annual financial statements and the management report differ in that the annual financial statements are primarily for presentation purposes, whereas the management report is more of an analysis and commentary. The management report includes information on the risk profile of the company and its risk management system. For large listed companies, the HGB requires a declaration on corporate governance and a non-financial declaration including statements on environmental, social and labour-related concerns, among other matters.

In addition to preparing the annual financial statements and the management report, listed companies are also required to prepare and publish a half-year report. Some stock exchanges may require further reporting with respect to a certain market segment.

Certain industry sectors – for example, banks and other financial institutions – are subject to further reporting requirements.

6.2 Disclosure of Corporate Governance Arrangements

The declaration on corporate governance includes information on how the management board and the supervisory board conducted their duties, and also has to address other issues, such as whether quotas for female members of the management and supervisory board have been met, and whether or not the company has a diversity concept (see **4.3 Board Composition Requirements/Recommendations**, above). Furthermore, listed companies have to publicly declare each year whether they comply with the DCGK (see **1.3 Corporate Governance Requirements for Companies with Publicly Traded Shares**, above). The declaration is part of the declaration on corporate governance.

As described, the principal features of the management remuneration system and the remuneration of the management board and the supervisory board have to be disclosed in the annual financial statement, and in the management report thereto.

The annual financial statement also has to include information on related party transactions that were not at arm's length. The draft act implementing the EU-Shareholders' Rights Directive seeks to extend the disclosure requirements with respect to certain related party transactions beyond disclosure in the annual financial statement to a requirement to disclose such transactions as they occur.

6.3 Companies Registry Filings

A company has to file the following with the commercial register (*Handelsregister*):

- the articles of association, including the company's business name and legal form, registered seat, purpose of the enterprise and registered share capital;
- the names of the legal representatives, their place of residence and dates of birth;
- if existent, the name and place of residence of authorised officers ("*Prokurist*");
- in an AG and SE, a list of supervisory and administrative board members;
- in a GmbH, a list of shareholders; and
- subsequent amendments to the above-mentioned points.

Those filings are publicly available at www.handelsregister.de, which contains all entries in the commercial register filed since 2007.

7. Audit, Risk and Internal Controls

7.1 External Auditors

A company has to appoint an external auditor unless it is a small company (based on the criteria set out in **4.11 Disclosure of Payments to Directors/Officers**, above). The key requirements governing the relationship between the company and the auditor are set out in the HGB. The auditor is appointed by the general or shareholders' meeting. In an AG and two-tier system SE, the supervisory board is responsible for issuing the actual audit mandate, while in a one-tier system SE it is the administrative board and in a GmbH it is the managing directors.

7.2 Management Risk and Internal Controls

In an AG, SE and a KGaA, the management board must install a system to detect and monitor risks to the continued existence of the company. However, it is best practice to maintain several systems and refined rules (for example, through reporting lines and codes of conduct) to ensure internal compliance and effective risk management. The supervisory board will review the existence and effectiveness of such measures. According to German case law, effective compliance management systems are also required in order to fulfil the duty of care owed to the company.

P+P Pöllath + Partners

Rechtsanwälte und Steuerberater mbB
Hofstatt 1
80331 München

P+P Pöllath + Partners
Attorneys-at-Law | Tax Advisors

Tel: +49 89 24240 0
Fax: +49 89 24240 999
Email: eva.nase@pplaw.com
Web: www.pplaw.com