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PERFORMANCE AND REMUNERATION OF COMPANY DIRECTORS

- Legal approaches in Germany, the EU, and the U.S. -

Abstract

Fundamental changes in the global economy have led to pronounced changes in executive remuneration practices worldwide. Remuneration for company directors has increased dramatically and has become a stumbling block. Various legal approaches have been developed to prevent excesses with regard to executive compensation. While in the past a material assessment of what is reasonable compensation was deemed to be viable and appropriate, recent developments – especially high profile law proceedings – hint at the opposite. Thus, the regulatory focus has increasingly shifted to the pay-setting process. Moreover, recent developments in legislation demonstrate the preference of the law-makers for disclosure obligations. While all of these approaches have their advantages and disadvantages, establishing procedural requirements for the pay-setting process and introducing sophisticated disclosure rules are the "globalized" answer addressing the pronounced changes in executive remuneration practices.

Key words: remuneration of directors; informations; Germany; EU; USA

US-$ 68,5 million in salary, bonus and stock awards have been paid to the chief executive officer (CEO) of Goldman Sachs as remuneration for last year,[2] and around 60 million Euros were paid to the CEO of Porsche.[3]

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2 See *White*, Goldman co-presidents' pay outstrips peers' remuneration, Financial Times, March 8, 2008, online at http://www.ft.com/cms/s/0/4555e6aa-ecb3-11dc-86be-0000779fd2ac.html?nclick_check=1.

3 See for example *Schwab*, Alles gut in Wiedekings Welt, Focus Money Online, 28.11.07, online at http://www.focus.de/finanzen/boerse/aktien/porsche_aid_214869.html.

These cases might be special; however, they illustrate well the overall trend in directors' compensation: The pay for CEO's in large stock companies has increased dramatically over the past decades. The average total remuneration for CEO's in S&P 500 firms in the U.S. increased from about US-$ 850,000 in 1970 to over US-$ 14 million in 2000.[4] While extremely high compensation seemed to be a unique phenomenon of U.S. companies during the last century, fundamental changes in the global economy have led to pronounced changes in executive remuneration practices also in other parts of the world, especially in Europe. Here, the considerable increase in executive compensation has become a stumbling block and has led to a heated debate.[5] With the average worker receiving only modest increases, the enormous payments to company directors seem to be somewhat out of proportion.

Hence, it was only a matter of time before a public prosecutor would take the issue to the court and indict directors for violating their duties. This happened in the Mannesmann case in Germany[6] which attracted

4 *Jensen/Murphy/Wruck*, Remuneration, ECGI Finance Working Paper No. 44/2004, July 2004, p. 24.

5 For example in Germany *Adams*, ZIP 2002, 1325; *Brauer*, NZG 2004, 502; *Baums*, Aktienoptionen für Vorstandsmitglieder, in Martens, FS Claussen, 1997, p. 3; *Fleischer*, DStR 2005, 1279 and 1318; *Fonk*, in Semler/v. Schenk, Arbhdb. AR-Mitglieder, 2nd ed., 2004, § 9 Rn. 109 et seq.; *Fonk*, NZG 2005, 248; *Harbarth/Kienle*, European Company Law 2006, 90; *Peltzer*, Wider den „greed" – Betrachtungen zu §§ 86 und 87 AktG, in Uwe H. Schneider et al., FS Lutter, 2000, p. 571; *Rönnau/Hohn*, NStZ 2004, 113; *Schwark*, Die Angemessenheit der Vorstandsvergütung, in Damm et al., FS Raiser, 2005, p. 377; *Spindler*, DStR 2004, 36; *Thüsing*, ZGR 2003, 457; *Vetter*, ZIP 2008, 1; *Wagner*, NZG 1998, 127. With a European Perspective *Ferrarini/Moloney*, ECGI Law Working Paper No. 32/2005, April 2005. In the USA *Batter/Martella*, European Company Law 2006, 86; *Bebchuk/Fried*, Pay without Performance, 2004; *Bebchuck/Fried*, 1 Berkeley Bus. L.J. 291 (2004); *Bebchuck/Fried/Walker*, 69 U Chicago L. Rev. 751 (2002); *Brown*, 82 N.Y.U.L.Rev. 1102 (2007); *Dorff*, 28 Cardozo L. Rev. 2025 (2007); *Ellis*, 35 Hous. L. Rev. 399 (1998); *Gordon*, 30 J. Corp. L. 675 (2005); *Johnson*, 26 J. Corp. L. 145 (2000); *Loewenstein*, 35 Wake Forest L. Rev. 1 (2000); *Polsky*, 64 Wash & Lee L. Rev. 877 (2007); *Thomas/Martin*, 79 Wash. U.L.Q. 569 (2001); *Yablon*, 75 Notre Dame L. Rev. 271 (1999-2000). For overviews of other legal systems *De Groot*, European Company Law 3 (2006), 11 (Niederlande); *Dine*, European Company Law 3 (2006), 75 (UK); *Hill*, European Company Law 3 (2006), 64. With an economic perspective *Jensen/Murphy/Wruck*, Remuneration, ECGI Finance Working Paper No. 44/2004, July 2004; *Brick/Palmon/Wald*, J. Corp. Fin. 12 (2006), 403; *Conyon/Murphy*, The Econ. J. 110 (2000), F640.

6 For details see infra III. 5.

substantial media attention. In contrast, in the U.S. courts have usually focused on civil proceedings. On both sides of the Atlantic the law has developed rules with regard to the remuneration of company directors. However, the solutions in Germany, which were and still are influenced by EU law, and in the U.S. are somewhat different. While the courts in the U.S. usually defer to the boards' decisions and accordingly have adopted a "procedural" approach (II), German law focuses mainly on material criteria for assessing executive directors' compensation (see III). However, "procedural" elements have also been introduced in Germany. Moreover, transparency is gaining increasing importance in the EU and in the U.S. as a viable means to aid in monitoring remuneration practices (IV.). To better assess the viability of these rules, it appears helpful to briefly consider some economic aspects regarding the remuneration of directors (I).

I. The Issue of Director's Remuneration – Some Economic Considerations

Currently, the dominant economic approach to the examination of executive remuneration is the principal/agent model.[7] Shareholders who have the residual claims in a company but lack direct control over management decisions[8] are modeled as principals, while managers/directors who make the management decisions but possess relatively small (if any) residual claims are modeled as agents.[9] Because agents are presumed to maximize their personal utility, there is a risk that in situations in which the interests of directors and shareholders deviate from each other directors will favor

7 For the principal/agent model in general see for example *Arrow*, The Economics of Agency: An Overview, in Pratt/Zeckhauser, Principals and Agents: The Structure of Business 37 (1985); *Cooter/Freedman*, 66 N.Y.U. L. Rev. 1045 (1991); *Eisenhardt*, Agency Theory: An Assessment and Review, 14 Acad. Mgmt. Rev. 57 (1989); *Ellis*, 35 Hous. L. Rev. 399, 405 et seq. (1998); *Richter/Furubotn*, Neue Institutionenökonomik, 3rd ed., 2003, p. 173 et seq., 205, 218 et seq.; *Adams*, AG 1990, 63.

8 *Marks*, The Separation of Ownership and Control, in *Bouckaert/De Geest*, Encyclopedia of Law and Economics, no. 5630, p. 692 693, online at http://users.ugent.be/~gdegeest/.

9 On the principal/agent model in Corporate Law *Berle/Means*, The Modern Corporation and Private Property, 1932, 66 et seq.; *Coase*, The Nature of the Firm, 4 Economica 386, 403 et seq. (1937); *Alchian/Demsetz*, 62 A.E.R. 777, 779 et seq. (1972); *Fama*, 88 J. Pol. Econ. 288, 290 et seq. (1980); *Fama/Jensen*, 26 J. Law & Econ. 327 (1983).

their own interests over those of the shareholders.[10] Such a situation can arise for example when a manager has to make a decision that is personally beneficial for him but brings additional costs for shareholders, e.g. buying a new company car for the manager or vice versa. Agency theory suggests that a performance-based pay contract, which links remuneration to shareholder wealth (via performance indicators such as share prices or accounting-based targets), could help to align the interests of managers and shareholders by creating an incentive in directors to pursue the interests of the shareholders.[11]

However, executive pay can also be regarded as an agency cost in itself in that it provides an opaque and potentially fruitful device for self-dealing by conflicted managers.[12] In practice, remuneration is not set by shareholders, but is set on their behalf by the board of directors. A conflicted board may use the pay-setting process to influence pay and extract rents in the form of pay in excess of that which would be optimal for shareholders.[13]

Moreover, the conflicts of interest of executive directors may actually deepen if the remuneration generates perverse management incentives to manipulate financial disclosures, particularly earnings, and distort share prices which can lead to catastrophic corporate failures.[14]. To prevent or at least mitigate the negative effects of such conflicts of interest different legal approaches have been developed.

10 Moreover, directors are presumed to be more risk-averse than the shareholders, because due to their job they depend more on the well-being of the company. See e.g. *Baums*, FS Claussen, 1997, p. 3, 7; *Fama*, 88 J. Pol. Econ. 288, 297 et seq. (1980); *Jensen/Meckling*, 3 J. Fin. Econ. 305, 308 (1976).

11 *Jensen/Murphy/Wruck*, Remuneration, ECGI Finance Working Paper No. 44/2004, July 2004, p. 19; *Schüller*, Vorstandsvergütung, 2002, p. 49.

12 *Bebchuk/Fried*, 1 Berkeley Bus. L.J. 291 (2004); *Bebchuck/Fried/Walker*, 69 U Chicago L. Rev. 751, 784 et seq. (2002); *Yablon/Hill*, 35 Wake Forest L. Rev. 83 (2000); also *Adams*, ZIP 2002, 1325, 1333. Critical about the arguments that slack behavior and self-dealing are issues that have to be dealt with by incentive contracts *Thüsing*, ZGR 2003, 457, 476; *Eisenberg*, The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations, ALI-ABA Course of Study, p. 103, 113 et seq. (Oct. 1999).

13 *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 3. See also *Adams*, ZIP 2002, 1325, 1333.

14 *Yablon/Hill*, 35 Wake Forest L. Rev. 83 (2000); also *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 3.

II. A Procedural Approach: Structuring the Pay-Setting Process

1. The Approach in the U.S.

A kind of procedural approach has been developed in the U.S. but has also become more prominent in the EU as of late. The courts in the U.S. have developed a tradition of deferring to the remuneration decisions of the boards and limiting their scrutiny of such decisions to egregious cases. Generally, the courts apply the so-called business judgment rule.[15] According to the business judgment rule the "directors of a corporation … are clothed with [the] presumption, which the law accords to them, of being [motivated] in their conduct by a bona fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge".[16] It is thus presumed that "in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest."[17] Hence, the requirements for an appropriate remuneration setting process, the result of which will not be questioned by the courts, are that the directors are (1) not self-interested in the decision they make, (2) act on an informed basis and (3) act in the honest belief that their actions are in the corporation's best interest.[18]

However, even if directors are self-interested, company law statutes such as the Delaware Code contain safe-harbor clauses that ensure that a transaction or vote is not void or voidable if certain other conditions are met. In Delaware, these are that (1 a) the material facts as to the transaction and the interest of a director are either disclosed or known to the board/committee or to the shareholders if they are entitled to vote and (1 b) the board/committee authorizes or the shareholders approve the transaction in good faith or (2) if the contract is (objectively) fair as to the corporation as of the time it is authorized or approved.[19] Similar to the later, the courts

15 *Cox/Hazen/O'Neal*, Corporations, § 11.5.

16 *Gimbel v. Signal Cos.*, 316 A.2d 599, 608 (Del. Ch. 1974).

17 *Garner* (ed.), Black's Law Dictionary, 8th ed, 2004, p. 212; *Hopt*, in GroßkommAktG, 4th ed., 1999, § 93 Rn. 83.

18 For an overview of the organisational reforms of the board and the pay-setting process see *Tegtmeier*, Die Vergütung von Vorstandsmitgliedern in Publikumsaktiengesellschaften, 1998, p. 86 et seq.

19 § 144 (a) (1)-(3) Del. Code. For further details *Eisenberg*, The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations, ALI-ABA

have held that a director can defend himself by proving that the decision was objectively in the interest of the company.[20]

As a backstop to a failed process, the courts resort to the so called entire fairness test.[21] According to that test, the utmost good faith and the most scrupulous inherent fairness of the bargain is required.[22] The test has two prongs:[23] fair dealing and fair price. Fair dealing addresses the questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The fair price component of entire fairness review assures the transaction was substantively fair by examining the economic and financial considerations.

2. The Approach in the EU

With its recommendation on the role of non-executive or supervisory directors from February 2005, the EU Commission has also focused on procedural elements for the remuneration setting process.[24] For example, it recommended installing a remuneration committee.[25] Its primary purpose is to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration and to help organize its work with a view to ensuring that the decisions it takes are free of material conflicts of interest.[26] Hence, the remuneration committee should be composed exclusively of non-executive or supervisory directors of whom at least a majority should be independent.[27] The task of the remuneration committee is to make proposals on the remuneration policy for executive directors, the

Course of Study, p. 103, 121 et seq. and 125 et seq. (Oct. 1999).

20 Treadway Companies, Inc. v. Care Corporation, 638 F.2d 357, 382 (U.S. Court of Appeals, Second Cir., 1980).

21 *Gordon*, 30 J. Corp. L. 675, 689 (2005).

22 Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); recently Valeant Pharmaceuticals Int'l v. Jerney, 921 A.2d 732, 746 (Del .Ch. 2007).

23 Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); recently Valeant Pharmaceuticals Int'l v. Jerney, 921 A.2d 732, 746 (Del .Ch. 2007).

24 EU Commission, Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, O.J.EU. 2005 L 52/51 of 25.2.2005.

25 Art. 5 s. 2 and Annex I no. 3.1 of the recommendation of 15.02.2005. See *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 23 f.

26 Art. 6.1 s. 2 of the recommendation of 15.2.2005.

27 Annex I No. 3.1 digit 2 of the recommendation of 15.2.2005.

individual remuneration to be allocated to executive directors, and suitable contracts for executive directors, and also to assist the (supervisory) board in overseeing the disclosure of remuneration-related items.[28] While a remuneration committee which is structured as recommended reduces the probability of influence by interested directors and thus the risk of conflicts of interest, it does not solve the problem that the members of the remuneration committee and the board are also only agents who who make decisions as to other people's money decide about other people's money.[29] This might be resolved by an affirmation adopted at the annual general meeting.[30]

This approach has been embraced by the EU Commission in its recommendation of 14.12.2004 fostering an appropriate regime for the remuneration of directors. It suggested that the remuneration policy should be an explicit item on the agenda of the annual general meeting.[31] Moreover, all schemes under which directors are remunerated in shares, share options or any other right to acquire shares or are to be remunerated on the basis of share price movements should be subject to the prior approval of shareholders by way of a resolution at the annual general meeting prior to their adoption.[32] This is also suggested for the setting of deadlines within which these types of compensation to individual directors may be awarded and for substantial changes in the terms and conditions of such schemes.[33] However, these recommendations have only been implemented in national law by a minority of the EU member states.[34] Already the High Level Group

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28 Annex I No. 3.2 digit 1 of the recommendation of 15.2.2005. Digit 2 concerns the duties of the committee with regard to the executives of a company.

29 *Thüsing*, ZGR 2003, 457, 482.

30 See the references in *Cheffins*, Company Law, 1997, p. 677, fn. 167. For the U.S. see *Gordon*, 30 J. Corp. L. 675, 698 et seq. (2005). For positive experiences with (even if only non-binding) votes of shareholders *Hill*, European Company Law 3 (2006), 64, 70, who mentions shareholder votes by GlaxoSmithKline. Critical *Thüsing*, ZGR 2003, 457, 482, who points out that the experiences with shareholder votes on option plans in Germany point to the contrary. So far they have always been successful – no matter what they cost.

31 Art. 4.1 and 4.2 of the recommendation of 29.12.2004. The vote can be mandatory or only advisory, Art. 4.2 s. 2 of the recommendation of 29.12.2004. About these recommendations *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 24 et seq.

32 Art. 6.1 s. 1 of the recommendation of 29.12.2004.

33 Art. 6.3 and 6.4 of the recommendation of 29.12.2004.

34 Commission of the European Commission, Commission Staff Working Docu-

of Company Law Experts had recommended against the introduction of shareholder votes, because the effects of such votes could vary between member states.[35]

All in all, recommendations of the EU Commission with regard to directors and their remuneration are markedly flexible: Not only need merely a majority of the members of the remuneration committee be independent, but it is also left to the companies how they want to determine independence.[36] That holds the risk that companies that have directors who are already prone to slack behavior can creatively work around the recommendation of the Commission. However, with the different corporate systems in the EU, a more harmonized approach might have been impossible to achieve. Nonetheless, the Commission recommendation fuels a convergence of the different corporate board systems in the EU. In Germany, the influence of the EU has shifted the focus to a strengthening of the procedural approach for resolving conflicts of interest.

III. A Material Approach: The Reasonableness of Compensation

A material approach as can be found in Germany focuses on the remuneration itself and whether it is appropriate or not. Section 87 para. 1 s. 1 of the Stock Corporation Act (AktG) states: "*The supervisory board shall, in determining the aggregate compensation of any member of the management board (...) ensure that such aggregate compensations bears a reasonable relationship to the duties of such member and the condition of the corporation.*" This provision is meant to ensure that managers do not overly enrich themselves at the expense of the corporation – and thus indirectly the shareholders.[37]

In this provision, compensation is understood very broadly and comprises salary, profit participation, reimbursement of expenses, insurance premiums,

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ment, Report on the application by Member States of the EU of the Commission Recommendation on directors' remuneration, SEC(2007) 1022, Brussels, 13.07.2007, p. 6.

35 About further criticisms *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 25.

36 Art.13.2 and recital 18 of the recommendation of 15.2.2005.

37 *Hüffer*, AktG, 7th ed., 2006, § 87 Rn. 1; *Mertens*, in KölnKomm z AktG, 2. Aufl., 1996, § 87, Rn. 2; *Wulff*, Aktienoptionen für das Management, 2000, p. 19; *Spindler*, DStR 2004, 36, 37. For an overview of the history of this provision see *Schüller*, Vorstandsvergütung, 2002, p. 114 et seq.

commissions and additional benefits of any kind.[38] The premium for D&O-Insurance is compensation only if it is an individual policy, rather than group insurance which also covers officers who are not members of the management board.[39] With "duties" the provision refers to the business area that has been assigned to the manager.[40] This encompasses the complexity and nature of his work but also the degree of responsibility that a manager has to be for the corporation's business.[41] The "condition" of the corporation relates to the overall economic situation of the company.[42] This includes the current wealth and earnings[43] but also the prospects of the company.[44] The same focus can be found in provision 4.2.2 of the German Corporate Governance Code which explicitly refers to the outlook of the company.[45] Other criteria that can be considered are, for example, qualification, expert knowledge or experience.[46]

More complicated is the determination of what is a "reasonable" relationship.[47] Various ideas have been advanced, but almost none of them are without flaws.

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38 See Section 87 para. 1 s. 1 of the Stock Corporation Act (AktG).

39 *Harbarth/Kienle*, European Company Law 3 (2006), 90, 91.

40 LG Düss., NJW 2004, 3275, 3277; *Fleischer*, DStR 2005, 1279, 1280.

41 *Hefermehl/Spindler*, MüKoAktG, 2. Aufl., 2004, § 87 Rn. 13; *Tegtmeier*, Die Vergütung von Vorstandsmitgliedern in Publikumsaktiengesellschaften, 1998, p. 279; *Adams*, ZIP 2002, 1325, 1338; *Fleischer*, DStR 2005, 1279, 1280; *Rönnau/Höhn*, NStZ 2004, 113, 116; *Schwark*, FS Raiser, 2005, p. 377, 383.

42 LG Düss., NJW 2004, 3275, 3278; *Adams*, ZIP 2002, 1325, 1338; *Fleischer*, DStR 2005, 1279, 1280; *Schüller*, Vorstandsvergütung, 2002, p. 124; *Schwark*, FS Raiser, 2005, p. 377, 384; also *Rönnau/Höhn*, NStZ 2004, 113, 117.

43 *Schwark*, FS Raiser, 2005, p. 377, 384.

44 *Fleischer*, DStR 2005, 1279, 1280; *Schüller*, Vorstandsvergütung, 2002, p. 124; *Schwark*, FS Raiser, 2005, p. 377, 384 with reference to § 289 Abs. 2 HGB.

45 *Peltzer*, Deutscher Corporate Governance Kodex, 2. Aufl. 2004, Rn. 99; *Ringleb* in Ringleb/Kremer/Lutter/v.Werder, Deutscher Corporate Governance Kodex, 3. Aufl. 2008, Rn. 710.

46 *Hüffer*, Aktiengesetz, 7th ed., 2006, § 87 Rn. 2; *Hefermehl/Spindler*, MüKoAktG, § 87 Rn. 13; *Adams*, ZIP 2002, 1325, 1338; *Fleischer*, DStR 2005, 1279, 1280. Accordingly, no. 4.2.2 para. 2 s. 2 of the German Corporate Governance Codex states that criteria for the appropriateness of compensation are, in particular, the tasks of the respective member of the management board, his personal performance, the performance of the management board as well as the economic situation, the performance and outlook of the enterprise taking into account its peer companies.

47 This has already been discussed by *Thüsing*, ZGR 2003, 457 et seq.

1. Reasonable Defined as *What is Common*

A first approach could be to determine “reasonable” by the standards of what is common in the market.[48] If all or at least a viable majority of the companies pay their executives a certain amount then the mechanism of supply and demand has determined that amount to be appropriate and thus a reasonable remuneration for the services rendered. Such a “market”-approach is only viable if the market in question is efficient, meaning that all necessary information can flow into the price setting process and this process itself is free from any failures. However, with regard to executive remuneration it has been asserted that market failures exist.[49]

The difference in the absolute amounts paid as remuneration in the U.S. and Europe is not a sign of market inefficiency, though. This might just be a sign of two distinct markets and thus where a high compensation might be “common” in the U.S. the same amount might not be justified in Europe. While a few years ago, it was easy to dismiss the idea of a worldwide single market for managers,[50] the situation is changing today – at least with regard to the U.S. and Europe. But still, even if more and more managers work or have worked abroad, it appears to be a bit overstated to talk about a worldwide single market for managers: The remuneration levels in the U.S. and Europe are still very disparate, and European companies still perform well compared to U.S. companies. It does not appear as if they only get the second best managers. Therefore, the differences in executive remuneration between Europe and the U.S. are not a sign of a market failure, but a sign of two separate markets – which might actually be converging.

However, the process of negotiating and setting the remuneration in corporations seems to be prone to inefficiencies. First, in large corporations directors decide about other people’s money – the impact, if any, on their own investment is usually very small due to their small share of the company’s stock –, so their interest in fierce negotiations with the

48 *Mertens*, in KölnKomm z AktG, Bd. 2, 2. Aufl. 1996, § 87 Rn. 5; *Tegtmeier*, Die Vergütung von Vorstandsmitgliedern in Publikumsaktiengesellschaften, 1998, p. 278; *Wulff*, Aktienoptionen für das Management, 2000, p. 19 et seq.; *Baums*, FS Claussen, 1997, p. 3, 30; *Peltzer*, in FS Lutter, 2000, p. 571, 575.

49 *Bebchuk/Fried*, Pay without Performance, p. 23 et seq., 61 et seq. For Germany *Adams*, ZIP 2002, 1325, 1338; *Fleischer*, DStR 2005, 1279, 1282. That appropriateness is possible even if there are market inefficiencies *Rönnau/Höhn*, NStZ 2004, 113, 118.

50 *Adams*, ZIP 2002, 1325, 1339; for a common job market of the US and the UK *Baums*, FS Claussen, 1997, p. 3, 23.

managing directors appear to be small. Moreover, where – as in one-tier systems[51] – directors are responsible for determining and negotiating the payment of their fellow directors inefficiencies cannot be ruled out.[52] In that case, remuneration committees consisting of independent directors will help. However, the members of the remuneration committee often lack knowledge and experience with regard to remuneration negotiations. At a minimum, they are often in an inferior bargaining position if the executive officer on the other side of the table has engaged a professional consultant who knows the market and assists in the negotiations. The same can be said about the directors in the supervisory boards in two-tier systems. Additionally, the directors of the supervisory board are often executive officers in other companies and vice versa. Thus, if executive officers supervise their supervising directors in another company (interlocking directorates) the potential for mutual back-scratching is high.[53] Hence, the risk of an inefficient market is rather high and therefore referring to the common "market price" to determine the reasonable remuneration does not help.

2. Average employee wages as comparison

Another approach could be to determine the reasonable remuneration as a multiple of the salary of an average employee of the company.[54] With regard to Section 87 para 1 AktG there are some historical references that could support such an approach. The earlier AktG of 1937 which first introduced that provision also contained a Section 77 para 3 s. 1 which stated that there should be a reasonable relationship between the royalties of the executive directors and the expenses for the employees or

51 In Germany with its two-tier board system the introduction of the European Company (Societas Europaea, SE) has opened the floor for monistic boards, as well. See Section 20 et seq. of the Gesetz zur Ausführung der Verordnung (EG) Nr. 2157/2001 des Rates vom 8. Oktober 2001 über das Statut der Europäischen Gesellschaft (SE).

52 See the details provided by *Adams*, ZIP 2002, 1325, 1333; *Bebchuck/Fried/Walker*, 69 U Chicago L. Rev. 751, 785 (2002).

53 About these and other problems of the traditional pay-setting process see *Adams*, ZIP 2002, 1325, 1333; *Bebchuk/Fried*, Pay without Performance, p. 24 et seq.; *Tegtmeier*, Die Vergütung von Vorstandsmitgliedern in Publikumsaktiengesellschaften, 1998, p. 90 et seq.

54 De lege ferenda *Adams* ZIP 2002, 1325, 1343; cautious *Schwark*, FS Raiser, 2005, p. 377, 389; *Thüsing*, ZGR 2003, 457, 472; crit. *Fleischer*, DStR 2005, 1279, 1281.

the public at large.[55] However, due to the subsequent historical and legal developments in Germany the importance of these (historical) references has faded.[56] Currently, the legal literature and the courts seem to be very reluctant as concerns such ideas. The reason is probably that it merely shifts the focus to the question of which multiple is the right one. That would imply that it is possible to determine the difference in the degree of complexity between the work of an average employee and an executive director. This is doubtful.

3. The size of a company as point of reference

Instead of focusing on the salary of an average employee, the reasonable remuneration could be derived from the size of the company.[57] The idea is that companies will be divided in certain classes depending on their turnover, number of employees or other factors[58] and for each class the law would determine an amount up to which a rebuttable presumption would exist that this amount was reasonable. Any higher remuneration would need a special justification.

However, focusing on the size of a company is a dubious approach as well. It would reward inefficient empire-building (amalgamation of different branches) – as the developments in the 1970's in the U.S. show.[59] The bigger a corporation becomes, the higher the possible remuneration of the executives will be. From a certain point, however, a company can only grow if it enters new business fields and diversifies its operations. Too much diversification, however, leads to inefficiencies and an inefficient company is not in the interest of the shareholders.

55 For details see *Schlegelberger/Quassowski*, AktG, 3. Aufl. 1939, § 77 AktG 1937, Rn. 22; for the continuing applicability of these principles today *Mertens*, in KölnKomm z AktG, 2. Aufl., 1996, § 86 Rn. 1; *Schwark*, FS Raiser, 2005, p. 377, 389.

56 *Fleischer*, DStR 2005, 1279, 1281.

57 See *Lücke* in Lücke, Vorstand der AG, 2004, § 2 Rn. 130. Summarizing and supporting this approach *Fleischer*, DStR 2005, 1279, 1282; also in favor *Fonk*, in Semler/v. Schenk, Arbhdb. AR-Mitglieder, 2nd ed., 2004, § 9 Rn. 113; *Fonk*, NZG 2005, 248 with fn. 4; crit. *Hüffer*, Aktiengesetz, 7th ed., 2006, § 87 Rn. 3.

58 It has been suggested to take the classes of Section 267 HGB as point of reference.

59 *Jensen/Murphy/Wruck*, Remuneration, ECGI Finance Working Paper No. 44/2004, July 2004, p. 26 et seq.

4. Functional criteria

Taking into account economic arguments it appears to be more appropriate to focus on functional criteria. In Germany, this approach finds its justification in the German Corporate Governance Code. Provision 4.2.3 para. 2 s. 2 of this Code recommends that variable parts of the remuneration should contain components that are linked to the commercial success of the company and components that include long term incentives. Thus, a reasonable remuneration is one that is necessary and appropriate to induce a certain behavior from the executive directors that is in the interest of the company.[60] Especially in regard of variable parts of the remuneration such an approach seems viable. If these variable payments have no incentive effect they are of no use and thus are not "reasonable". In that context, it has to be noted that incentive effects grow only on a diminishing scale:[61] The declining marginal utility of each additional payment necessitates larger remuneration increases in order to achieve an (additional) incentive effect. After a certain point, achieving additional incentive effects becomes very expensive and thus justifications for additional payments more and more difficult.

5. The Mannesmann Proceeding

The viability of the material approach was tested in the Mannesmann Proceeding in Germany.[62] The core issue of that proceeding was whether gratitude bonuses that had been awarded to the CEO were in line with section 87 AktG. In 1999 the CEO of Mannesmann AG tried to avert a hostile takeover by its competitor Vodafone Airtouch plc. until a friendly takeover could be reached, ultimately occurring in 2000. The final agreement provided much better conditions for the Mannesmann shareholders and by the end of the acceptance period almost 99 per cent of the Mannesmann shareholders had accepted the offer. After the understanding on a friendly takeover was reached in February 2000, the supervisory board committee agreed on the award of extra-contractual "appreciation bonuses" to the CEO in the amount of EUR 16 million in addition to his contractually stipulated bonus of approximately EUR 15 million to honor his services and performance in the course of the takeover battle.

60 *Thüsing*, ZGR 2003, 457, 473. This is especially of importance for the variable parts of directors' remuneration.

61 *Thüsing*, ZGR 2003, 457, 474.

62 See BGHSt 50, 331 (2005).

According to the Federal High Court, the members of a special compensation committee[63] – the same would apply to the supervisory board as a whole – owe a special duty to administer and protect the interests of the corporation and therefore to act for the benefit of, and prevent loss or detriment to, the corporation.[64] As far as retroactive payments for contractually-owed performances are concerned, the Court highlighted that such payments may be made pursuant to a good-faith discretion only under one of the following conditions:[65] either such payments are foreseen by the Executive Service Agreement and are subject to the parameters of reasonableness and proportionality set out by Section 87 AktG and provision 4.2.3 of the Corporate Governance Code, if applicable, or, absent a contractual basis, such payments are for the benefit of the corporation and are proportionate within the meaning of section 87 para. 1 AktG. Providing an incentive for other or future executives can constitute a benefit to the corporation provided that the payment signals that extraordinary performances of an executive are welcomed.[66] If an extra-contractual payment is exclusively in the nature of a reward for past performance and provides no incentive with regard to the future governance of the corporation – as in the Mannesmann case – such payment constitutes a waste of corporate assets and is therefore *per* se illegal, irrespective of its amount.[67]

If directors do not observe their duty to grant only reasonable compensation they can be liable for damages according to sections 116 s. 1, 93 para 2 s. 1 AktG. Moreover, as the Federal High Court ruled in the Mannesmann case, such behavior would also be considered criminal according to section 266 of the German Penal Code.

However, the difficulty of applying these rules in practice became apparent on retrial of the issue after the Federal High Court had reversed the trial court's judgment and remanded the matter for further proceedings. Due to the difficulty of assessing the reasonableness of a compensation payment such as the one in question, the retrial ended with a plea bargain and the abandonment of prosecution whereby the defendants agreed to pay several million euros in exchange for all criminal charges being dropped. Thus the question of the reasonableness of the payment was left unanswered.

63 Sections 84 para. 1, 87 para. 1, 107 para. 3, 112 AktG.
64 BGHSt 50, 331, 335 et seq. (2005).
65 BGHSt 50, 331, 336 et seq. (2005).
66 BGHSt 50, 331, 337 (2005).
67 BGHSt 50, 331, 337 (2005).

6. In the U.S.

In the U.S., the principle that the remuneration of directors may not be inappropriate or unreasonable with regard to their duties and the condition of the company is known as well.[68] However, in 1979 the Delaware Supreme Court actually relaxed the standard of review, shifting from "reasonableness" to "waste" in the vetting of stock option plans that had been ratified by shareholders.[69] Thus, the standard of waste became the general substantive test regarding remuneration decisions of boards.[70] The test asks whether a board could have made a good faith judgment that compensation was justified, even if upon examination the arrangement appears one-sided and excessive.[71] To prove waste it is necessary to prove that "an exchange is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration".[72] In other words, waste is a rare, "unconscionable case[ ] where directors irrationally squander or give away corporate assets."[73]

The probability that a disinterested director makes a decision that can not be regarded as fraud but as waste of corporate assets is so small that thus far U.S. courts have generally been unwilling to scrutinize remuneration decisions too closely.[74]

68 Glenmore Distilleries Co. v. Seidman, 267 F.Supp. 915 (E.D.N.Y. 1967); Black v. Parker Mfg. Co., 106 N.E.2d 544, 545 (Mass. 1952); Berman v. Meth, 258 A.2d 521 (Pa. 1969).

69 Compare Michelson v. Duncan, 407 A.2d 211, 212 (Del. 1979) (waste) with Beard v. Elster, 160 A.2d 731, 737 (Del. 1960) (reasonableness) and Kerbs et al. v. California Eastern Airways, Inc., 90 A.2d 652, 653 (Del. 1952) (reasonableness). See also Lewis v. Vogelstein, 699 A.2d 327, 336 et seq. (Del. Ch. 1997) (tracing the history of the standard of review); *Johnson*, 26 J. Corp. L. 145, 155 et seq. (2000).

70 Recently In re Walt Disney Co. Derivative Litigation, 907 A.2d 693. 748 (Del. Ch. 2005); 731 A.2d 342, 362 (Del. Ch. 1998); Glazer v. Zapata Corp. 658 A.2d 176, 183 (Del.Ch. 1993); Grobow v. Perot, 539 A.2d 180, 189 f. (Del. 1988); Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (Del.Ch. 1962). Already in 1933: Rogers v. Hill, 289 U.S. 582, 591 (1933). See *Baumann/Weiss/Palmiter*, Corporations – Law and Policy, 5th ed., 2003, p. 771 et seq.; *Gordon*, 30 J. Corp. L. 675, 690 (2005).

71 See Lewis v. Vogelstein, 699 A.2d at 336; In re 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999).

72 In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 748 (Del. Ch. 2005). Because of these requirements the control by courts is rather limited, see *Hill*, European Company Law 3 (2006), 64, 67.

73 In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 749 (Del. Ch. 2005).

74 Steiner v. Meyerson, 1995 WL 441999 (Del. Ch. 1995), at 5. Only in rare cases

IV. Transparency: Disclosure of Remuneration

Another strategy to control remuneration decisions is to establish transparency by requiring the board to disclose the compensation of the directors. Disclosure requirements oblige the board to justify its pay choices and the pay-setting process. They can enhance the accountability and visibility of the remuneration committee and facilitate shareholder monitoring.[75] Thus, it is hoped that disclosure obligations will have a restraining effect on boards.

1. The situation in the U.S.

In the U.S. the Securities and Exchange Commission (SEC) has issued a number of disclosure obligations for stock corporations. These require a clear, concise and understandable disclosure of the compensation paid to CEO's, CFO's and certain other high-ranking executive officers of public companies. Several documents that a company has to file with the SEC have to include information about the company's executive compensation policies and practices. These are the company's annual proxy statement, the company's annual report on Form 10-K, registration statements filed by the company to register securities for sale to the public and the company's current report on Form 8-K.[76]

The cornerstone of the SEC's required disclosure on executive compensation, however, is the Summary Compensation Table.[77] The Summary Compensation Table provides, in a single location, a comprehensive overview of a company's executive pay practices. As well, it sets out the total compensation paid to the company's chief executive officer, chief financial officer and three other most highly compensated executive officers for the past three fiscal years. The additional tables and disclosures contain more specific information on the components of compensation for the last completed fiscal year. The disclosure includes, among other details, information about grants of stock options and stock

did the courts object to the amount of the remuneration. For a detailed overview *Thomas/Martin*, 79 Wash. U.L.Q. 569 (2001).

75 *Gordon*, 30 J. Corp. L. 675, 695 (2005); *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 12.

76 For more information on these forms see http://www.sec.gov/about/forms/secforms.htm. For a critical analysis *Gordon*, 30 J. Corp. L. 675, 693 et seq. (2005).

77 Item 402(c) of Regulation S-K.

appreciation rights, long-term incentive plan awards, pension plans, and employment contracts and related arrangements. In addition, the Compensation Discussion and Analysis ("CD&A") section explains all material elements of the company's executive compensation programs.

2. The situation in the EU

In the EU, the EU Commission issued a recommendation on the remuneration of directors in 2004 in which it decided to follow a transparency approach as well.[78] The aim is to inform shareholders and give them a clear and comprehensive overview of the remuneration policy of the company.[79] Not only should companies disclose the total remuneration of each director[80] but also their remuneration policy.[81] Moreover, the Commission recommends making the remuneration policy an item of the agenda at the annual general meeting.[82]

The far reaching transparency approach of the EU Commission is not without problems, though. The scope of the information which should be disclosed according to the Commission's recommendation is considerable. Especially, the disclosure of the structure of the relationship between remuneration and performance in the companies' remuneration policy[83] allows valuable insights into the personnel policy. The information can be used by competitors to entice the managers of the disclosing companies. In addition, potential reactions of politicians and the public at large should not be neglected.[84] The disclosure of performance parameters allows competitors to conclude which aims a company targets and how its managers assess the market. Hence, it is not surprising that an evaluation done by the EU-Commission in July 2007 showed that a majority of the EU member states have issued high standards with regard to the disclosure

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78 EU Commission, Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies, O.J.EU 2004 L 385/55 of 29.12.2004. See *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 20 et seq. For an overview of the legal situation in the EU members states see l.c., p. 13 et seq.

79 Recital 5 Satz 1 of the recommendation of 29.12.2004.

80 Art. 5.1 of the recommendation of 29.12.2004. For details see Art. 5.3-5.6.

81 Art. 3.1 of the recommendation of 29.12.2004.

82 Art. 4.1. of the Recommendation of 29.10.2004.

83 For details see Art. 3.3 of the recommendation of 29.12.2004.

84 *Ferrarini/Moloney*, Executive Remuneration in the EU, Law Working Paper No. 32/2005, April 2005, p. 12.

of the remuneration of individual directors, but have abstained from implementing the recommendation on disclosure of and the shareholder votes on the remuneration policy.[85]

3. The situation in Germany

Taking into account the EU Commission's recommendation, the existing disclosure rules in the German Commercial Code (HGB) concerning remuneration have been modified by the Law Concerning the Disclosure of Management Earnings.[86] Accordingly, medium and large corporations[87] have to disclose the total compensation of the management board for the respective fiscal year.[88] Listed companies have to state – additionally – the earnings of each member of the management board, divided into performance-related and -unrelated components and components with long-term incentives.[89] Provision 4.2.4 of the German Corporate Governance Code contains a provision with almost the same wording. Moreover, provision 4.2.5 of the German Corporate Governance Code states that disclosure shall be made in a compensation report which describes the compensation system for management board members in a generally understandable way.[90] Regarding directors' conflicts of interest, payments of third parties are highly relevant. Accordingly, section 285 s. 1 no. 9 lit. a s. 7 HGB states that promised and granted benefits from third parties have to be disclosed as well.[91] This also applies to compensation payments that a director receives from another company within a group of companies.[92] All this information, however, can be kept secret if so decided by a 75%-

85 Commission of the European Commission, Commission Staff Working Document, Report on the application by Member States of the EU of the Commission Recommendation on directors' remuneration, SEC(2007) 1022, Brussels, 13.07.2007, p. 3, for details see l.c., p. 5 et seq.

86 Gesetz über die Offenlegung von Vorstandsvergütungen of 3.8.2005, BGBl. I 2005, 2267 of 10.8.2005. On the disclosure obligation with regard to directors' compensation see *Schüller*, Vorstandsvergütung, 2002, p. 247 et seq.; *Tegtmeier*, Die Vergütung von Vorstandsmitgliedern in Publikumsaktiengesellschaften, 1998, p. 320 et seq.; briefly *Spindler*, DStR 2004, 36,43.

87 Section 288 together with section 267 para. 2 and 3 HGB.

88 Section 285 s. 1 no. 9 lit. a HGB. The elements mentioned in s. 1 can be compared to those in no. 4.2.3 of the German Coporate Governance Code.

89 Section 285 s. 1 no. 9 lit. a s. 4 HGB.

90 No. 4.2.5 of the German Corporate Governance Code.

91 Section 285 s. 1 no. 9 lit. a s. 7 HGB.

92 *Harbarth/Kienle*, European Company Law 3 (2006), 90, 93.

majority at the annual general meeting.[93] Such a resolution can only be adopted every five years, though.[94] Additionally, section 289 para. 2 no. 5 HGB stipulates that the annual report should also outline the main features of the remuneration policy of a company. And provision 4.2.3 s. 6 of the German Corporate Governance Code states that the chairman of the supervisory board should inform the shareholders at the annual general meeting about the main features of the remuneration policy. The foregoing shows that the far-reaching recommendations of the EU Commission have only partly been implemented in German law.

V. Assessment and Conclusion

While in the past a material assessment of what is reasonable compensation was deemed to be viable and appropriate, recent developments hint at the opposite. The high profile cases in Germany and the U.S. concerning director's compensation, such as the Mannesmann proceeding, have raised considerable doubts whether courts and lawmakers can determine a "reasonable" compensation. The U.S. courts retreated already in the 1970's and scrutinize remuneration only in terms of waste – which is almost impossible to prove.

Instead of the "reasonableness" of compensation, focussing on the pay-setting process has become increasingly important. Hence, remuneration committees consisting of independent or primarily of independent directors, informed decision making and other "procedural" prerequisites have been introduced by the law. These requirements are much easier to prove and such an approach takes into account that remuneration decisions are ultimately business judgments which fall under the realm of the business judgement rule.

Moreover, recent developments in law-making demonstrate the preference of the law-makers for transparency. This has also affected the debate on directors' compensation. Thus, companies have to disclose more and more details about their director's compensation. While such an approach leaves the decision on the appropriateness of a director's compensation ultimately to the investors – the principals who eventually have to pay the compensation –, the current design in Europe and the U.S. does have risks. The extent and the detail demanded by the new laws and regulations in

93 Section 286 para. 5 s. 1 HGB.

94 Section 286 para. 5 s. 2 HGB.

Europe and the U.S. are considerable. It might give competitors, politicians who run for elections and others opportunities to exploit the provided information for their own benefit in a manner that might ultimately hurt the disclosing companies. Hence, it is necessary to strike an appropriate balance among the interests of the companies and the individual directors as well as the needs of the markets

The convergence of the regulatory approaches to company directors' compensation in the EU and the U.S. demonstrate the similar need in finding appropriate answers to the dramatically increasing payments for company directors. And the "globalized" answer addressing the fundamental changes in the global economy responsible for the pronounced changes in executive remuneration practices worldwide needs to focus on establishing procedural requirements for the pay-setting process and on disclosure.

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Rad direktora kompanija i njihova primanja - uporedni prikaz stanja u Nemačkoj, EU i Sjedinjenim Državama -

Suštinske promene u svetskoj ekonomiji dovele su do značajnih promena širom sveta u praksi pravnog uredjivanja primanja direktora kompanija. Primanja direktora su drastično porasla i postala predmet rasprave. Da bi se izbegla preterivanja po pitanju kompenzacije za rad direktora, pronadjena su različita pravna rešenja. Ranije su primanja direktora bila razumna i predstavljala su odgovarajuću nadoknadu za ostvareni rad, dok je u poslednje vreme, naročito kada se radi o pojedinim, izuzetnim, slučajevima od velikog značaja, tendencija upravo suprotna. Stoga se zakonodavac značajno preorijentisao na postupak namirenja. Sem toga, kod zakonodavaca su primećene odredjene tendencije i u pogledu uvodjenja obaveze otkrivanja informacija. Dok svi ovi pristupi imaju i prednosti i mane, ustanovljavanje procesnih zahteva za postupak namirenja i uvodjenje sofisticiranih pravila o otkrivanju informacija su "globalizovani" odgovor kroz koji se mogu sagledati značajne promene u praksi kojom se uredjuje materija primanja direktora.
Ključne reči: primanja direktora; informacije; Nemačka; EU; SAD