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COVID 19 and Management Board remuneration

Review of reduction of the remuneration by the Supervisory Board

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# COVID 19 and Management Board remuneration – Review of reduction of the remuneration by the Supervisory Board

As part of its general supervisory activity, the Supervisory Board must carefully examine the effects of COVID 19 Pandemic on the company's situation. This entails a duty to examine the need for reducing the remuneration of the members of the Management Board (eg in accordance with Section 87 (2) of the German Stock Corporation Act).

## COVID 19 and executive board remuneration: expectations and legal implications

The German Act Implementing the Second Shareholders' Rights Directive (ARUG II), which came into force at the beginning of the year, has only recently brought issues relating to executive board remuneration at listed companies onto the agenda of the Supervisory Board. According to the newly introduced § 87a of the German Stock Corporation Act (AktG), the Supervisory Board must resolve a qualified remuneration system for the Management Board.

Due to the COVID 19 Pandemic, Supervisory Board members must once again deal with questions of Management Board remuneration. This applies first and foremost, and in particular, to companies that have taken advantage of or intend to take advantage of state support from individual federal support programmes (see only the general Deloitte Legal-Client Alert on COVID 19: <https://www2.deloitte.com/dl/en/pages/legal/articles/rechtliche-themen-covid-19.html>). For these companies, members of the federal government have articulated clear expectations of the remuneration systems and their implementation:

- "Management must also make a contribution, the amount of which must be clarified in each individual case." (Peter Altmaier in an interview with Deutschlandfunk on 27 April 2020 on the expectation of management participation in measures to overcome the economic consequences of the COVID 19 pandemic for companies).
- "For loans of 500 million euros or more, companies are expected to make a voluntary commitment that excludes bonus payments or variable remuneration for 2020 for members of the Management Board". (Answer of the Federal Ministry of Economics and Energy dated 22 April 2020 to the question of the MdB D. Bartsch, how many of the listed companies, which applied for state support on the occasion of COVID 19, pay bonuses to their Board Members in the current financial year).<sup>1</sup>

At least in part, these political programmes sentences have already been included in the relevant KfW conditions.

There are also repeated calls for bans on the distribution of profits and dividends and on the payment of bonuses, including in the context of other government support measures, such as the use of short-time working allowances.

However, even in the case of stock corporations that do not make use of government support schemes, the Supervisory Board must deal with possible implications for Management Board remuneration in connection with the effects of the COVID 19 Pandemic on the company. Specifically, it must examine whether it must reduce the remuneration of the Board of Management.

### Duty to reduce executive board remuneration

According to Section 87 (2) of the German Stock Corporation Act (AktG), the Supervisory Board shall reduce the remuneration of the members of the Management Board to an appropriate level if the situation of the company deteriorates and the continued granting of the (unchanged) remuneration is inequitable.

The power to reduce remuneration pursuant to Section 87 (2) AktG includes a right to determine the amount – the law entitles the Supervisory Board in a crisis to intervene



<sup>1</sup> [https://www.bmwi.de/Redaktion/DE/Parlamentarische-Anfragen/2020/4-203-204.pdf?\\_\\_blob=publicationFile&v=2](https://www.bmwi.de/Redaktion/DE/Parlamentarische-Anfragen/2020/4-203-204.pdf?__blob=publicationFile&v=2).

unilaterally in the contractual relationship with the Management Board. The wording "shall" in the wording must not create a false impression and must not obscure the fact: In the crisis, the Supervisory Board is obliged to reduce the remuneration, unless there are exceptional circumstances that justify continuing to grant the remuneration at the previous level. In this respect, the possibility of a reduction pursuant to Section 87 (2) AktG, as well as the associated duty of the Supervisory Board to perform an examination, cannot be excluded or impeded either by the Statutes or by an individual agreement with the member of the Board of Management.

### The conditions for the reduction: Deterioration of the situation of the company and inequity of the continuation of the remuneration in the same amount

Any deterioration in the company's situation, irrespective of the cause and without it having to be particularly significant, is sufficient for the reduction.

The yardstick for the deterioration of the situation is the situation of the company at the time of the conclusion of the service agreement – economic difficulties which were already known at the time of the conclusion of the service agreement therefore do not constitute a right to reduce the remuneration – and also no obligation of the Supervisory Board to reduce the remuneration.

In addition to the deterioration, it must be inequitable to continue to pay the existing remuneration. This is undoubtedly the case in crises that threaten the company's existence, in particular in the event of imminent over-indebtedness or insolvency.

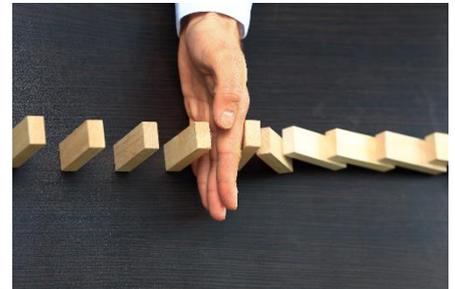
However, even below this threshold, in individual cases there may be an inequity that enables the company and obliges the Supervisory Board to refrain from continuing to pay the unchanged remuneration. To this end, the Supervisory Board must conduct an equitability review based on the circumstances of the individual case. In doing so, it must take into account the extent to which the company's situation has deteriorated since the date of conclusion of the service agreement, as well as the extent to which the deterioration is attributable to the member of the Management Board. On the Management Board member's side, the Supervisory Board must assess the personal circumstances of the Management Board member concerned. Any breaches of duty on the part of the Management Board member with regard to the deterioration of company's situation must also be taken into account, yet the existence of breaches of duty is not necessary for the assumption of inequity.

In view of the COVID 19 pandemic, an inequitable deterioration of the company's situation will have to be assumed in the individual case,

- if operational business operations had to be partially or even completely discontinued due to the Pandemic, for example due to restrictions imposed to contain the Pandemic,
- the company has suffered significant Pandemic-induced bad debt losses,

and these circumstances have a lasting effect on the economic (earnings) situation of the company, at least with regard to the continued planning for the current financial year and the following financial year.

As indications of a sustained adverse effect on the company's earnings position, measures that the company takes to avoid such effects may also be considered. This includes, for example, a dividend reduction (down to zero), the use of government support schemes, especially from the relevant COVID 19 aid programs (to a significant extent), the ordering of short-time work and the use of short-time benefits (on a large



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scale) or personnel measures such as (mass) redundancies or permanent wage cuts for employees.

## The specific duties involved in the reduction of remuneration

If the conditions for a reduction are met, the Supervisory Board must adjust the remuneration.

In doing so, it must reduce the remuneration to the commensurate level. In doing so, it must take into account and weigh up all circumstances, i.e. the reason, severity and duration of the deterioration of the company's situation as well as the personal circumstances of the individual member of the Board of Management concerned.

Many details have not yet been conclusively clarified in legal literature and case law – also and especially because comparable cases have been rather rare, at least in the last 12 years. Therefore, a careful and individual decision by the Supervisory Board is required.

According to the case law of the Federal Court of Justice (BGH), the supervisory board has no discretion or scope of assessment in respect of the setting of the new remuneration levels. The relevant assessment criterion for the target amount of the reduced remuneration is the total remuneration which the individual member of the Management Board could agree with the company as appropriate remuneration within the meaning of Section 87 (1) AktG when concluding the Management Board service agreement at the time of the Supervisory Board's decision on the reduction.



On the basis of Section 87 (2) AktG, in particular the current remuneration not yet paid can be reduced. In contrast, it is disputed whether recourse may be made to bonuses from the previous year that have not yet been paid but have been earned.

In any case, if the Management Board also receives performance-related variable remuneration, the Supervisory Board must examine whether this is worth less in the current financial year – in view of the non-fulfilment or only partial fulfilment of individual performance parameters.

In such cases, under certain circumstances, the associated reduction in total remuneration alone may eliminate the inequity of continuing the existing remuneration system, so that an additional reduction in current remuneration is not (no longer) necessary.

In the event of a persistent deterioration in the situation of the company, the Supervisory Board must also examine a reduction in benefits from a company pension commitment (BAV commitment) in individual cases – which then affects the further pension entitlements of the Management Board member (Future Service).

Finally, however, the Supervisory Board must also take into account the fact that the members of the Board of Management whose remuneration is reduced have a special right of termination, according to which they can terminate the employment relationship with the company with a notice period of six weeks to the end of the next calendar quarter (Section 87 (2) sentence 3 AktG). It may therefore be in the interest of the company in individual cases not to reduce the salary of a Management Board member who is important for coping with the crisis, in order not to create the risk of a termination declared by him or her.

The Supervisory Board must comprehensively document its specific dealings with questions of Management Board remuneration and the course and results of the ex-

amination of a possible reduction in remuneration pursuant to Section 87 (2) AktG (including the resolution on the reduction) in order to make its specific decision transparent and – in view of a possible judicial review – comprehensible under stock corporation law. In particular, the documentation must contain the specific considerations which the Supervisory Board included in the specific equitable measures in its decision on the reduction of the remuneration and a possible new determination of its amount. The documentation shall also serve the Supervisory Board as evidence of the proper performance of its executive duties in accordance with Sections 93, 116 AktG and thus also serves the purpose of avoiding liability risks for the members of the Supervisory Board.

## Summary

The consequences of the COVID 19 Pandemic may, in individual cases, have an impact on the (level of) remuneration of the members of Management Boards of stock corporations. The Supervisory Board is obliged to examine whether the agreed remuneration is still appropriate or whether it is to be regarded as unfair, in view of the consequences of the Pandemic. The Supervisory Board shall conduct this review on the basis of a sufficiently reliable forecast of the effects of the COVID 19 Pandemic on the situation of the company and shall weigh the matter up on a case-by-case basis. If it fails to do so, there is a risk that the members of the Supervisory Board will expose themselves to liability risks and make themselves liable for damages.

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