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Can be expensive

D&O insurance policies do not cover payments following onset of insolvency
Managing directors are personally liable

A verdict by Düsseldorf Higher Regional Court (Oberlandesgericht, or OLG) on cover by D&O insurance policies (ruling on July 20th 2018 (4 U 93/16) states as follows: payments to creditors after the onset of a company's insolvency are not insured since they do not give rise to claims for compensation arising from financial loss. A similar provision in the German Stock Corporation Act (Aktiengesetz, or AktG) suggests that this judgement is also relevant to joint-stock companies.

In the underlying case the managing director of a limited liability company (*Gesellschaft mit beschränkter Haftung,* or GmbH) brought a claim against an insurance company. The GmbH had taken out a financial loss indemnity insurance policy for company directors and executive officers (D&O insurance policy) with them. The GmbH had made payment transfers to creditors following the onset of the company's insolvency. Section 64 of the German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung,* or GmbHG) states that indemnity normally exists for such payments (and analogously for joint-stock companies Section 93(3)(6) of the AktG). On this basis the insolvency administrator had successfully brought a claim against the managing director who then reported this as an insured event.

However the insurance company did not pay out, stating that this event was not covered under the terms of the insurance policy. Under those terms, the insurance only applies to claims for damages brought against the insured person as a result of a breach of duties by the GmbH or third party such as an insolvency administrator. Indemnity claims for intentional damages or other deliberate breaches of duty are excluded.

In the underlying case, however, the insurance company took the view that the indemnity claim related to a deliberate breach of duty, since the managing director was aware of the economic position of the GmbH and did not comply with her monitoring obligations. If an insolvency application had been lodged in a timely manner, the payments to which the insolvency administrator's claim related could have been avoided.

After the managing director's claim was rejected by the court of first instance, the OLG Düsseldorf also held that the insurer was not required to provide compensation for the monies transferred after the onset of insolvency. The court did not uphold the lower court's finding that the plaintiff could be shown to have acted with intent, since there was insufficient evidence to show that she was aware of the onset of the company's insolvency. Nevertheless, she was not entitled to indemnification. Grounds: the court held that the claim brought by the insolvency administrator pursuant to Section 64 of the GmbHG was not covered by the insurance contract.

The court alluded to the fact that the payments did not constitute a reimbursal of a financial loss. Section 64 of the GmbHG requires the reimbursal of payments made following the onset of insolvency or over-indebtedness. Payments to a specific creditor following the onset of insolvency would reduce the chance that the other creditors' claims could be settled. However, since from the company's perspective only existing obligations were settled and no new ones were entered into, no financial loss was incurred by it.

The rule is there only intended to protect the creditors. If the concept of loss or damages is interpreted so broadly as to allow such payments to be covered by the D&O insurance policy, not only the specific interests of the policyholder, but also those of all creditors would be protected. The judges held that this would be beyond the scope of an insurer's normal value proposition.

Increased engagement

Draft bill on the Second Shareholder Rights Directive Implementing Act
Supervisory board competences unaffected

In mid-October the German Federal Ministry of Justice and Consumer Protection published the long-awaited draft bill on the Second Shareholder Rights Directive Implementing Act (Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie, or ARUG II). It focuses on the remuneration of management board and supervisory board members, identification and informing of shareholders, transactions with related parties and increased transparency with respect to institutional investors, asset managers and proxy advisors. The new provisions strengthen shareholder engagement, but their resolutions continue to be purely advisory. The supervisory board retains its competences.

The Second Shareholder Rights Directive is primarily intended to improve the engagement of shareholders in publicly listed companies and facilitate information flows as well as the exercise of shareholder rights. The draft bill serves to transpose the Directive into German law and the Act must be passed by June 2019.

One focus area is the remuneration of management board and supervisory board members. The former continues to be set by the supervisory board, which must determine a generally comprehensible remuneration policy. Minimum notification requirements are set, for example for the elements of the remuneration policy and how the remuneration contributes to the company's long-term development. However the requirements are purely descriptive. For example, when there are no provisions for variable remuneration the information requirements do not apply.

New "say on pay" rules are intended to increase shareholders' right to have their say on setting remuneration levels. Under these rules the general meeting must vote on the remuneration policy for management board members. This vote must be held following significant changes but at least every four years. The shareholders' right to have their say is also to be strengthened, with a vote on the remuneration report for the preceding business year. The vote of the general meeting is not optional as previously but mandatory, though it continues to be only advisory.

In future, the general meeting will also have a mandatory vote on the supervisory board members' remuneration, which shall take place at least every four years. If the vote on the remuneration policy for management board or supervisory board members is not approved, a revised version must be submitted to the next general meeting.

Other innovations apply to the disclosure of remuneration. In future a generally comprehensible report on remuneration granted or owed must be compiled. Specific minimum information requirements are set and the completeness of the report must be ascertained by the auditor. The new rules replace the requirements under commercial law regarding disclosure of the remuneration for publicly listed companies.

Another focus area is the arrangements for improving shareholder identification and information. Communication between companies and shareholders is made difficult by complex intermediary structures. The new "know your shareholder" rules are intended to change this. They govern the flow of information from companies via intermediaries to shareholders and vice versa. The term "intermediary" refers to anyone who trades securities for shareholders.

Under the Directive, approval is required for related party transactions. The German legislators have rules that this approval shall be provided by the supervisory board and – in special exceptional cases only – the general meeting. Another new provision is that these transactions must be disclosed on an ad hoc basis, not only in the annual report. The supervisory board must also create an appropriate procedure for reviewing such transactions independently, for example by forming a committee or contracting external experts. The rules are designed to prevent financial assets being transferred to related parties to the detriment of shareholders.

For greater transparency, institutional investors, asset managers, and proxy advisors will henceforth be subject to extensive disclosure obligations. For instance, institutional investors and asset managers must in future publish an engagement policy based on the "comply or explain" approach and report on its implementation.

The new rules also take account of the increased use of proxy advisors. Proxy advisors must not only publish information once a year on their work, including information sources or voting policy, but must also disclose whether they have complied with a code of conduct or why they failed to do so.

The draft bill also already contains various transitional provisions. However no firm date has been set for the new Act to enter into force.

Focus on the essential

Reform of the German Corporate Governance Code

Consultation phase launched

The government commission on the German Corporate Governance Code (Deutscher Corporate Governance Kodex, or DCGK) issued a draft of the revised Code for consultation on November 6th 2018. The new version is more compact and has a different structure based on principles instead of quoting legislative texts. New recommendations relate to the tasks of supervisory board members, in particular the setting of management board remuneration and board appointments. They also focus on the composition of the board, especially the independence of the shareholder representatives. Other innovations relate to reviewing the efficiency of the supervisory board, with external support to be obtained in future.

As announced by the Commission some time ago, the Code has been considerably shortened and its structure has also been changed fundamentally. The recommendations and proposals are no longer preceded by recitals of the relevant legislative texts but by principles. These set out the key points of the legal rules and are based on standards of good governance. The "apply and explain" approach underlying the principles is entirely new and is formulated as a recommendation: Management board and supervisory board members should explain how they implement the Code's principles in the declaration on corporate governance. The commission states that a standard text is not sufficient.

The "comply or explain" principle continues to apply to the recommendations within the declaration of compliance. So any deviation should also be explained there if no "apply and explain" approach is used. Suggestions can also be omitted without any disclosure obligation.

The chapter headings in the new code are based on the governing bodies' tasks:

A. Management and supervision
B. Composition of the supervisory board
C. Appointments to the management board
D. Remuneration of the management board and supervisory board members

There have been significant changes made to the contents regarding appointments to the supervisory board. Supervisory board members who are not members of a company's management board shall not accept more than five supervisory board posts in publicly listed companies, those who are active members of the management board may only accept two such posts. In the latter case they may also not be chair of a supervisory board. The term of office for shareholder representatives shall be reduced to three years. The same applies to first-time appointments of management board members.

The requirements for the independence of supervisory board members have been made more specific. In addition to the chair of the audit committee, the chair of the supervisory board and the chair of the remuneration (control) committee, as well as more than half of the shareholder representatives, shall be independent from the company and its management board. In addition, the chair of the audit committee and – for supervisory boards composed of more than three members – at least two shareholder representatives shall be independent of the controlling shareholder.

Supervisory boards shall review their independence based on the criteria set out in the new Code. These state for example that independence does not apply if the member of the supervisory board has been a member of the company's management board in the last two years or has been a member of the supervisory board for more than twelve years. If the supervisory board considers that a member of the supervisory board is independent despite the relevant criteria applying, the reasons for this shall be given in the declaration on corporate governance. There have been significant revisions with respect to management board remuneration. The principles and recommendations relating to this have been adjusted to take account of the forthcoming changes in the Second Shareholder Rights Directive implementing Act (*Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie*, or ARUG II). Under the new Act, the recommendations regarding the remuneration report and the DCGK tables are now obsolete and have been deleted.

New recommendations have also been introduced: For example, long-term variable remuneration should exceed short-term variable remuneration. Whilst the targets for short-term variable remuneration should be derived from the operational annual budget, the long-term variable remuneration should be derived from current strategic planning. It should be paid in the form of shares that must be retained for a minimum of four years. When determining the target remuneration, the supervisory board shall in future conduct a peer group comparison with other companies and disclose the composition of the peer group. The recommendation regarding the so-called efficiency review is also amended: Supervisory boards shall be supported externally at least every three years. The government commission intends to send the final version to the Ministry of Justice in April 2019.

No change

Composition of supervisory boards in SEs

Rules applicable prior to conversion still apply

The Frankfurt Higher Regional Court (Oberlandesgericht, or OLG) rules: Following the conversion of an Aktiengesellschaft (AG) to a Societas Europaea (SE), the legally required conditions for the previous entity shall determine the scope of co-determination. Therefore, if the company was previously obliged to provide co-determination in its supervisory board, this obligation shall continue to apply. This applies even if co-determination was not previously implemented in practice (ruling of August 27th 2018 – 21 W 28/18).

Following the conversion of an AG into an SE, a shareholder asked the court to rule on the composition of the supervisory board. The court was asked to rule that the principle of parity actually applied in law to appointments to the board.

Section 35(1) of the SE Participation Act (*SE-Beteiligungsgesetz*, or SEBG) states that "the co-determination policy applicable prior to conversion shall be retained". The state court interpreted "co-determination policy" as referring to how the co-determination rules were actually applied in practice. Since the supervisory board of the AG was not subject to co-determination prior to the conversion, the state court formed the view that there was no requirements to appoint workers' representatives to the supervisory board after the conversion. It therefore rejected the application to the court.

Two months previously the Munich Regional Court (*Landesgericht*, or LG) had issued the same ruling in a comparable case (ruling of June 26th 2018 – 38 O 15760/17).

In the Frankfurt case the shareholder submitted an appeal to the OLG, which was upheld. The OLG reversed the state court's judgement and referred the matter back to the state court. It stated that the legally valid target conditions applicable prior to conversion with respect to worker participation were decisive – and not the practice prevailing at that time.

The interpretation of Section 35 of the SEBG was disputed in the literature. However, the OLG found that the use of the term "policy" indicated that the legal status was inferred.

The sense and purpose of the paragraph also suggested that the legal position was decisive. Section 1(1) of the SEBG and Recital 18 of the SE Directive state that the workers' acquired rights to participation in company decisions are secured. "Acquired rights" according to the OLG also apply even if they have not been exercised prior to the conversion. Therefore, the co-determination must be secured even though it was not practised prior to conversion.

The court further held that the principle of true and fair representation argued against the actual status as practised prior to conversion being decisive. For if this interpretation were adopted, an unlawful status could be transferred to the SE. If so, the scope of co-determination after conversion would no longer be dependent on the law but on chance.

It was now for the state court to test whether one of the co-determination acts applied to the company prior to conversion. The number of employees is decisive here. The Aktiengesellschaft itself employed approximately 200 employees at the conversion date. It was therefore not subject to the Co-determination Act (*Mitbestimmungsgesetz*, or MitBestG) or the One-third Employee Participation Act (*Drittelbeteiligungsgesetz*, or DrittelbG).

Legally, however, employees of Group companies must also be included when calculating – using different methods in each case – the number of employees. Under MitbestG, for companies with more than 2,000 employees the workers in subsidiaries also count as employees of the controlling company (Section 5 MitbestG). Under the DrittelbG, for companies with more than 500 employees, additional employees would also have to be included where a dominance agreement was in place or the subsidiary is incorporated in the controlling company (Section 2 DrittelbG).

It was now up to the state court to answer which of these inclusions should be brought to bear for the AG under consideration and which form of co-determination was required at the conversion date.

It remains to be seen whether a decision will be given at a higher court in the Munich case referred to above and whether a ruling by the supreme court will ultimately be required.

Upward trend

2018 study on remuneration

Economy favourable for management and supervisory board remuneration

This year's PwC study on remuneration shows: over the last four years management board remuneration has risen steadily in the four key stock market indexes. Supervisory board remuneration has also risen since 2014 despite interim falls. Jumps or falls in remuneration are mostly due to changes in the composition of the indexes. Board chairs or speakers are still rarely female. Gender distribution is different in supervisory boards. Here women are increasingly found as deputy chairs of the supervisory board and chairs of audit committees.

The study published by PwC and Frankfurt Goethe University analyses management board and supervisory board remuneration for all DAX 160 companies (DAX 30, MDAX, SDAX, TecDAX) since the introduction of the German Corporate Governance Code (*Deutscher Corporate Governance Kodex*, or DCGK) sample table, ie, for 2014 up to 2017.

The analyses of management board remuneration reveal an upward trend for overall remuneration over the reporting period in all four indexes with the highest rises in overall remuneration recorded in the SDAX. DAX 30 CEOs' remuneration increased far more than remuneration for their colleagues on the boards. The situation is reversed in the MDAX: the increase in remuneration for other board members is almost twice that of the CEOs over the multi-year reporting period. The pay gap between board chairs or speakers and their board colleagues is lowest in SDAX companies. However, the largest gap was recorded in the TecDAX.

The findings on supervisory board remuneration were as follows: in most of the indexes remuneration has risen continuously since 2014 despite falls in the interim, mostly caused by changes in the composition of the index. The highest increases in overall remuneration were seen for deputy supervisory board chairs on DAX 30 supervisory boards.

Supervisory board chairs in the SDAX experienced far higher percentage increases than those in the other indexes. By contrast, relatively moderate increases were recorded for MDAX supervisory boards. Their chairs' median earnings for 2017 were even slightly lower than in the previous year, due in no small part to numerous changes to the composition of the index. There was no continuous increase for all members in the TecDAX, either: Following a decline in median remuneration in 2015, overall remuneration of ordinary supervisory board members was still below the 2014 level in 2017. The overall remuneration multiple of a supervisory board chair versus his deputies and versus the ordinary supervisory board members remained relatively stable across all indexes: A supervisory board chair receives 1.4 to 1.6 times more than his deputy and 2.1 to 2.5 times more overall remuneration than the other supervisory board members.

The study also analyses gender distribution in management boards and supervisory boards, with large differences. Little has changed with respect to CEO appointments in recent years. Across all stock market indexes, out of 119 CEOs, three were female in 2017 (there was one woman out of 108 CEOs in 2014). Of the remaining management board members, the proportion of women in the reporting period increased by three percentage points to 10% across all indexes.

Findings with respect to gender distribution in supervisory boards: Executive positions in 2017 continued almost without exception to be held by men. However, the proportion of women in deputy posts has increased considerably. Compared to 2014 the proportion has actually more than doubled (from 6% to 14%, ie, from 11 to 24 women in absolute terms). The post of audit committee chair was also occupied by a woman twice as often as in 2014 (19 women in 2017 in comparison with 9 women in 2014).

See the link below for a dynamic presentation of the findings of the management board and supervisory board remuneration study: www.pwc.de/de/aufsichtsraete/studie-zur-vorstands-und-aufsichtsratsverguetung-2018-petra-raspels-im-interview.html

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Major differences

Initial application of CSR Directive Implementation Act
Study on practical implementation in DAX 160

A recently published PwC study on the non-financial report of DAX 160 companies published for the first time shows: The options in the CSR Directive Implementation Act are leading to huge differences in how reporting obligations are discharged. However, there is a clear trend emerging on the review of the report by the supervisory board: in two thirds of the companies the supervisory board contracted an external auditor to provide support. Based on the results of the study, PwC has made recommendations for developing the non-financial report and compiled best practice examples.

Non-financial information has previously been published on a voluntary basis. This changed this year when the CSR Directive Implementation Act (*CSR-Richtlinie-Umsetzungsgesetz*, or CSR-RUG) came into force: Certain large capital market-oriented businesses as well as banks and insurance companies now have a mandatory duty to report on non-financial matters. In Germany alone this affects 500 companies. PwC conducted a study on CSR reporting and examined (consolidated) non-financial statements of 129 companies from the DAX 160 (DAX 30, MDAX, SDAX and TECDAX).

The results of the study show that companies are making use of the wide range of options, room for interpretation and structuring allowed under commercial law regulations on the (consolidated) non-financial statement. In practice this leads to considerable differences in reporting.

The study looked at the size of the report, which differed considerably from two to 100 pages, as well as the location of the non-financial statement. Publication of a standalone report came out as clear favourite here, as opposed to inclusion or even complete integration into the management report. The use of frameworks such as the concepts in the Global Reporting Initiative or the German Sustainability Code (*Deutscher Nachhaltigkeitskodex*) was examined and showed that it varies considerably across stock market segments.

The study also considered the supervisory board's audit of the report. This revealed that most supervisory boards, particularly those in DAX 30 companies, obtained the support of an external auditor for the audit. In most cases this was the company's statutory auditor. The audit followed the "limited assurance" approach in almost all companies.

The study also scrutinised the content of the non-financial statements. For example, it looked at the description of the business model, which companies are obliged to provide under the CSR-RUG. Most companies decided to include a link to the business model in the management report.

Specific information provided by the company was also analysed. This includes, on the one hand, companies' accounts of their deliberations on materiality, ie, which non-financial matters to include in the report, and on the other hand the details of the five minimum aspects required (environmental matters, employee-related matters, social matters, respect for human rights, anti-corruption and bribery matters).

The non-financial risks and their management were also considered in the study. Since, however, companies are only required to report on severe risks, most did not provide any information here.

The connections between the (consolidated) non-financial statement and the (consolidated) annual financial statement were also analysed, since CSR-RUG requires references to be made to connections with amounts reported in the annual financial statements, and explanations must be provided if required for the understanding of the (consolidated) non-financial statement. Here again, only a few companies provided information.

The study's findings as well as best practice examples and recommendations on developing the non-financial report are available at: www.pwc.de/de/nachhaltigkeit/studie-erstanwendung-des-csr-richtlinie-umsetzungsgesetzes.html

UK makes severe cuts

New UK Corporate Governance Code

Fewer pages and to the point

The new UK Corporate Governance Code was published in July. Slimmer than its predecessor, it still contains rules on corporate governance and its effectiveness, boards' tasks and responsibilities and on remuneration. The main new additions relate to the inclusion of stakeholder interests, board appointments and the external evaluation of the board. These are of particularly interest in Germany, since its own Corporate Governance Code (Deutscher Corporate Governance Kodex, or DCGK) is currently being revised and under consultation.

The UK code was published by the Financial Reporting Council (FRC) in mid-July. This was preceded by a one-year revision phase including a public consultation. The Code is to be applied by all publicly listed companies in the United Kingdom from the start of 2019.

At first sight, the most striking difference between the new version and the previous one issued in 2016 is its size: the Code has been halved in size to just 15 pages. This makes the new version exactly the same size as the current DCGK.

The UK recommendations are divided into general "Principles" and more detailed "Provisions". Companies must make statements on the Provisions under the "comply or explain" approach.

The Code is divided into five topics:
1) Board Leadership and Company Purpose
2) Division of Responsibilities
3) Composition, Succession and Evaluation
4) Audit, Risk and Internal Control
5) Remuneration

There are also several changes to the contents. One focus area is appointments to the board, where diversity is emphasised. Boards are urged to take a close look at the current composition and succession planning to ensure appropriate diversity of skills and experience. The roles and responsibilities of the nominating committee are strengthened by new recommendations.

An annual evaluation of the performance of the board, its commitees, the chair and the individual members is also recommended. The chair should consider having a regular externally facilitated board evaluation: in FTSE 350 companies this should happen at least every three years. A detailed external report should be provided for the evaluation. The annual report should describe, for example, the outcomes and areas for action from the evaluation, its influence on board composition and details on contact between the external consultant, board and individual members.

Another priority is stakeholder involvement. The annual report should describe how their interests have been taken into account in board decisions. Worker co-determination, a concept long familiar in Germany, also makes an appearance: There should be either a workers' representative on the board or a separate worker's council.

Due to the continuing public debate over executive pay, it is recommended in the new Code that the remuneration committee should take workers' salaries and their policies into account when setting remuneration. The authors of the Code are critical of formulaic calculations of performance-related pay. If this leads to unjustifiably high sums, it should be possible for the remuneration committee to adjust these at its own discretion.

The new Code also emphasises the importance of the company's culture. This is important for aligning company values with the company strategy. The board should therefore pay particular attention to how the values are ensured over the long term. All associated activities should be described in the annual report.

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Information, networking, exchanging views
PwC Boardroom. The programme for supervisory board members.
The responsibility and the significance of regulatory bodies have increased significantly in recent years. This development has been accompanied by numerous regulatory changes and a sharp rise in the expectations of the general public. We have introduced PwC Boardroom to keep you up to date on current issues and offer you an exclusive platform for networking and exchanging ideas and perspectives. The programme is aimed at members of supervisory boards, boards of directors and advisory boards with a monitoring function.

Events
- Regular meetings for supervisory board members:
  Exclusive events give you the opportunity to learn about the latest developments and to network with other supervisory board members from companies like yours. At the same time you can also expand you supervisory board network.
- Workshops and seminars:
  Whether you are interested in training on the fundamentals, updates on accounting standards, or seminars on new regulations concerning the supervisory board's work, we can provide the ideal customised solution, from exclusive one-to-one conversations to events for the entire board.

Imprint

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