The Executive Remuneration Review

Fifth Edition

Editors
Arthur Kohn and Janet Cooper

Law Business Research

The Executive Remuneration Review

Fifth Edition

Editors

Arthur Kohn and Janet Cooper

Law Business Research Ltd

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGER
Thomas Lee

SENIOR ACCOUNT MANAGERS
Felicity Bown, Joel Woods

ACCOUNT MANAGERS
Jessica Parsons, Jesse Rae Farragher

MARKETING COORDINATOR
Rebecca Mogridge

EDITORIAL ASSISTANT
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Jo Morley

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
© 2016 Law Business Research Ltd
www.TheLawReviews.co.uk
No photocopying: copyright licences do not apply.
The information provided in this publication is general and may not apply in a specific situation, nor does it necessarily represent the views of authors' firms or their clients. Legal advice should always be sought before taking any legal action based on the information provided. The publishers accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as of October 2016, be advised that this is a developing area.
Enquiries concerning reproduction should be sent to Law Business Research, at the address above. Enquiries concerning editorial content should be directed to the Publisher – gideon.roberton@lbresearch.com

ISBN 978-1-910813-31-7

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

THE LAW REVIEWS

THE MERGERS AND ACQUISITIONS REVIEW

THE RESTRUCTURING REVIEW

THE PRIVATE COMPETITION ENFORCEMENT REVIEW

THE DISPUTE RESOLUTION REVIEW

THE EMPLOYMENT LAW REVIEW

THE PUBLIC COMPETITION ENFORCEMENT REVIEW

THE BANKING REGULATION REVIEW

THE INTERNATIONAL ARBITRATION REVIEW

THE MERGER CONTROL REVIEW

THE TECHNOLOGY, MEDIA AND TELECOMMUNICATIONS REVIEW

THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

THE CORPORATE GOVERNANCE REVIEW

THE CORPORATE IMMIGRATION REVIEW

THE INTERNATIONAL INVESTIGATIONS REVIEW

THE PROJECTS AND CONSTRUCTION REVIEW

THE INTERNATIONAL CAPITAL MARKETS REVIEW

THE REAL ESTATE LAW REVIEW

THE PRIVATE EQUITY REVIEW

THE ENERGY REGULATION AND MARKETS REVIEW

THE INTELLECTUAL PROPERTY REVIEW

THE ASSET MANAGEMENT REVIEW

THE PRIVATE WEALTH AND PRIVATE CLIENT REVIEW

THE MINING LAW REVIEW

THE EXECUTIVE REMUNERATION REVIEW

THE ANTI-BRIBERY AND ANTI-CORRUPTION REVIEW

THE CARTELS AND LENIENCY REVIEW

THE TAX DISPUTES AND LITIGATION REVIEW

THE LIFE SCIENCES LAW REVIEW

THE INSURANCE AND REINSURANCE LAW REVIEW

THE GOVERNMENT PROCUREMENT REVIEW

THE DOMINANCE AND MONOPOLIES REVIEW

THE AVIATION LAW REVIEW

THE FOREIGN INVESTMENT REGULATION REVIEW

THE ASSET TRACING AND RECOVERY REVIEW

THE INSOLVENCY REVIEW

THE OIL AND GAS LAW REVIEW

THE FRANCHISE LAW REVIEW

THE PRODUCT REGULATION AND LIABILITY REVIEW

THE SHIPPING LAW REVIEW

THE ACQUISITION AND LEVERAGED FINANCE REVIEW

THE PRIVACY, DATA PROTECTION AND CYBERSECURITY LAW REVIEW

THE PUBLIC-PRIVATE PARTNERSHIP LAW REVIEW

THE TRANSPORT FINANCE LAW REVIEW

THE SECURITIES LITIGATION REVIEW

THE LENDING AND SECURED FINANCE REVIEW

THE INTERNATIONAL TRADE LAW REVIEW

THE SPORTS LAW REVIEW

THE INVESTMENT TREATY ARBITRATION REVIEW

THE GAMBLING LAW REVIEW

THE INTELLECTUAL PROPERTY AND ANTITRUST REVIEW

THE REAL ESTATE, M&A AND PRIVATE EQUITY REVIEW

THE SHAREHOLDER RIGHTS AND ACTIVISM REVIEW

www.TheLawReviews.co.uk

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

BAKER & McKENZIE

BONN STEICHEN & PARTNERS

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CREEL, GARCÍA-CUÉLLAR, AIZA Y ENRÍQUEZ SC

DLA PIPER

GORRISSEN FEDERSPIEL

HANNES SNELLMAN

HERBERT SMITH FREEHILLS

HERZOG FOX & NEEMAN, LAW OFFICE

LENZ & STAEHELIN

MATTOS FILHO ADVOGADOS

TAPESTRY COMPLIANCE LLP

TRAVERS SMITH LLP

VIEIRA DE ALMEIDA & ASSOCIADOS

CONTENTS

Editor's Preface v
Arthur Kohn

Chapter 1 AUSTRALIA 1
Sean Selleck, John Walker, Erica Kidston, Jonathan Kelt and Alexandra Stead

Chapter 2 BELGIUM 19
Loïc Peltzer and Nikolaas Van Robbroeck

Chapter 3 BRAZIL 34
Isabel Bueno, Renato Tastardi Portella and Dario Abrahão Rabay

Chapter 4 CHINA 45
Julia Gorham and Alan Wang

Chapter 5 DENMARK 59
Morten Skjønnemand, Lars Fogh, Ditte Grundtvig Larsen and Claus Aschou Johannesen

Chapter 6 EU OVERVIEW 69
Janet Cooper, Lorna Parkin and Matthew Hunter

Chapter 7 FINLAND 83
Johanna Haltia-Tapio, Lauri Lehmusoja and Anniina Järvinen

Chapter 8 GERMANY 97
Michael Brems, Jens Hafemann, Boris Witt and Martin Begiebing

Chapter 9 HONG KONG 120
Rowan McKenzie, Steven Sieker, Karen Man and Rashi Narayan

Chapter 10 ISRAEL.. 134
Shachar Porat, Orly Gerbi, Keren Assaf, Michal Lavi and Efrat Tzur

Chapter 11 ITALY 146
Gianluca Russo

Chapter 12 JAPAN 165
Tomohisa Muranushi, Takeshi Nishida and Shinichi Kobayashi

Chapter 13 LUXEMBOURG.. 174
Anne Morel, Christine Beernaerts and Pierre-Alexandre Degehet

Chapter 14 MEXICO.. 187
Alejandro Santoyo and Francisco J Peniche Beguerisse

Chapter 15 PORTUGAL... 197
José Pedro Fazenda Martins, Tiago Piló, Inês Gomes Ferreira and Rita Magalhães

Chapter 16 SPAIN... 208
Eduardo Gómez de Enterría

Chapter 17 SWITZERLAND 218
Matthias Oertle, Franziska Stadtherr-Glättli and Patrick Schärli

Chapter 18 UNITED KINGDOM... 231
Mahesh Varia

Chapter 19 UNITED STATES 247
Arthur Kohn, Kathleen Emberger and Jonathan Reinstein

Appendix 1 ABOUT THE AUTHORS.. 263

Appendix 2 CONTRIBUTING LAW FIRMS' CONTACT DETAILS....... 279

EDITOR'S PREFACE

Executive remuneration encompasses a diverse range of practices and is consequently influenced by many different areas of the law, including tax, employment, securities and other aspects of corporate law. We have structured this book with the intention of providing readers with an overview of these areas of law as they relate to the field of executive remuneration. The intended readership of this book includes both in-house and outside counsel who are involved in either the structuring of employment and compensation arrangements, or more general corporate governance matters. We hope that this book will be particularly useful in circumstances where a corporation is considering establishing a presence in a new jurisdiction and is seeking to understand the various rules and regulations that may govern executive employment (or the corporate governance rules relating thereto) with regard to newly hired (or transferring) executives in that jurisdiction.

The most fundamental considerations relating to executive remuneration are often tax-related. Executives will often request that compensation arrangements be structured in a manner that is most tax-efficient for them, and employers will frequently attempt to accommodate these requests. In order to do so, of course, it is critical that employers understand the tax rules that apply in a particular situation. To that end, this book attempts to highlight differences in taxation (both in terms of the taxes owed by employees, as well as the taxes owed – or tax deductions taken – by employers), which can be the result of:

a the nationality or residency status of the executives;

b the jurisdiction in which the executives render their services;

c the form in which executives are paid (e.g., cash, equity (whether vested or unvested) or equity-based awards);

d the time at which the executives are paid, particularly if they are not paid until after they have 'earned' the remuneration; and

e the mechanisms by which executives are paid (e.g., outright payment, through funding of trusts or other similar vehicles or through personal services corporations).

In addition to matters relating to the taxation of executive remuneration, employment law frequently plays a critical role in governing executives' employment relationships with their employers. There are a number of key employment law-related aspects that employers should consider in this context, including:

- *a* the legal enforceability of restrictive covenants;
- *b* the legal parameters relating to wrongful termination, constructive dismissal or other similar concepts affecting an employee's entitlement to severance on termination of employment;
- *c* any special employment laws that apply in connection with a change in control or other type of corporate transaction (e.g., an executive's entitlement to severance or the mechanism by which an executive's employment may transfer to a corporate acquirer); and
- *d* other labour-related laws (such as laws related to unions or works councils) that may affect the employment relationship in a particular jurisdiction.

The contours of these types of employment laws tend to be highly jurisdiction-specific and therefore it is particularly important that corporations have a good understanding of these issues before entering into any employment relationships with executives in any particular country.

Beyond tax and employment-related laws, there are a number of other legal considerations that corporations should take into account when structuring employment and executive remuneration arrangements. Frequently, these additional considerations will relate to the tax or employment law issues already mentioned, but it is important they are still borne in mind. For example, when equity compensation is used, many jurisdictions require that the equity awards be registered (or qualify for certain registration exemptions) under applicable securities laws. These rules tend to apply regardless of whether a company is publicly or privately held. In addition to registration requirements, it is critical for both employers and employees to understand any legal requirements that apply in respect of executives' holding, selling or buying equity in their employers.

Given the heightened focus in many jurisdictions on executive remuneration practices in recent decades – both in terms of public policy and public perception – the application of corporate governance principles to executive compensation decisions is crucial to many companies. Decisions about conforming to best practices in the field of executive remuneration may have substantial economic consequences to companies and their shareholders and executives. Corporate governance rules principally fall into two categories. The first concerns the approvals required for compensatory arrangements; a particular remuneration arrangement may require the approval of the company's board of directors (or a committee thereof) or even, in certain circumstances, the company's shareholders. The second concerns the public disclosure requirements applicable to executive remuneration arrangements; companies should be aware of any disclosure requirements that may become applicable as a result of establishing a new business within a particular jurisdiction, and in fact may wish to structure new remuneration arrangements with these disclosure regimes in mind.

Finally, we would be remiss in discussing the topic of executive remuneration without highlighting the financial services industry. The global financial crisis has, of course, led to a worldwide effort in recent years to more stringently regulate the manner in which those working within the financial services industry are paid.

We hope that readers find the following discussion of the various tax, statutory, regulatory and supervisory rules and authorities instructive.

Arthur Kohn
Cleary Gottlieb Steen & Hamilton LLP
New York
October 2016

Chapter 8

GERMANY

Michael Brems, Jens Hafemann, Boris Witt and Martin Begiebing[1]

I INTRODUCTION

The term 'executive' typically relates to the members of management boards of stock corporations and the managing directors of limited liability companies (management board members), as well as to senior employees with management functions within the meaning of the German Works Constitution Act. While the latter group is largely subject to labour law legislation in Germany, management board members are not considered employees, with the consequence that the statutory rules, with some exceptions, will not apply to them.

This lack of regulation allows a discernible degree of flexibility as far as the terms of employment of management board members are concerned, and has led to a certain market standard for executive remuneration. In the context of the worldwide financial crisis, however, features of executive remuneration, such as an over-proportional variable and share-based compensation, over-generous retirement benefits and severance payments, became the focus of both the general public and the German legislator's attention. This resulted in the implementation of new corporate governance and regulatory rules that are supposed to ensure that executive remuneration is better aligned to the situation and benefit of the employing company and that apply, in particular, to management board members of stock corporations as well as executives of banks, financial services firms and insurance companies (see Sections VII and VIII, *infra*, for further details).

In Germany, executive remuneration is usually stipulated in an individual service or employment agreement between the executive and the employing company. Certain

1 Michael Brems is counsel, Jens Hafemann is a senior attorney, Boris Witt and Martin Begiebing are associates at Cleary Gottlieb Steen & Hamilton LLP.

compensation elements, such as short-term and long-term incentive payments and retirement benefits, are commonly addressed in a side agreement or a general plan document applying to a broader group of executives.

Executives are typically not represented by works councils[2] or trade unions.

II TAXATION

Under German domestic law, German tax residents (i.e., individuals, including non-German citizens, who have a residence or habitual abode in Germany) are generally, and as a starting point, taxable on their worldwide income ('unlimited liability' to German income tax). By contrast, persons that are considered non-residents from a German tax perspective are merely taxable on income from German sources; such German-sourced income generally includes executive remuneration attributable to services performed or used in Germany. In certain situations, for example temporary assignments or deferred compensation that is allocable to services performed both within and outside Germany, Germany's taxation rights may be limited under domestic law or an applicable tax treaty.

This section summarises certain German income tax rules that are generally applicable to executives considered tax-resident in Germany and executives that are non-tax-resident in connection with services performed or used in Germany.

i Qualification of income

In principle, the German Income Tax Act (ITA) does not provide for a special tax regime applicable to executive remuneration. The taxation of executive remuneration depends on whether the relevant compensation item qualifies as:

a income from dependent personal services (Section 19 of the ITA, 'employment income');

b income from independent personal services (Section 18 of the ITA);

c business income (Section 15 of the ITA); or

d investment income (Section 20 of the ITA).[3]

2 Employees with management functions may establish a representative body of their own termed a 'speakers' committee'.

3 Non-arm's-length compensation payments received by executives that hold shares in their employer may also qualify as constructive dividend distributions (i.e., investment income within the meaning of Section 20 of the ITA). If executive remuneration is paid in connection with a sale of a business (e.g., under an earn-out arrangement), it is possible that the compensation will not qualify as employment income but as a retroactive purchase price increase for shares the executive held in the employer. See also BFH BStBl II 11, 948 (i.e., the Federal Fiscal Court decision published in the *Federal Tax Gazette* 2011, Volume II, p. 948). In addition, under the laws currently in effect, special rules may apply to executive remuneration paid as carried interest to managers of a private equity fund (see Section 18(1) no. 4 of the ITA).

In most cases, executive remuneration qualifies as employment income.[4] Exceptions may apply, for instance, if executives are not entitled to continued pay (in the event of sickness, holiday, etc.), work for various enterprises, are entitled to more or less independently determine their place of work and working hours or are not subject to instructions. In such cases, an executive's compensation may qualify as income from independent personal services. If executives qualify as co-entrepreneurs in their enterprise, their compensation may qualify as business income (relevant in case the German employer qualifies as a partnership from a German tax perspective). Where executive remuneration does not qualify as employment income, the income is subject to tax rules differing from the principles that are described below. Most importantly, in such cases, the income should generally not be subject to wage withholding tax or social security charges, but may be subject to trade tax. Further, the services rendered by the executive may be subject to value added tax (VAT).

ii Taxation of employment income

Employment income, including salary, benefits in kind, bonuses, severance payments and other deferred compensation, is generally taxed at the ordinary progressive income tax rate with a maximum rate of 45 per cent[5] plus 5.5 per cent solidarity surcharge thereon (in total 47.475 per cent), and, if applicable, church tax.[6] Executive remuneration paid for several years, for example, income received under long-term incentive schemes with a vesting period of more than one year, may benefit from reduced tax rates applicable to extraordinary income.[7]

Employers are required to withhold applicable income taxes from the cash salary paid to resident and non-resident executives (wage withholding tax) and remit the amounts withheld to the German tax authorities.[8] Resident executives are required to file an annual

4 The tax qualification does not necessarily follow German labour law principles. For example, board members of the management board generally qualify as employees for tax purposes but not for labour law purposes. By contrast, supervisory board members from a tax perspective generally derive income from independent services. Note, that the distinction between the management board members and the supervisory board members originates from the typical German two-tier corporate governance model for stock corporations (only a German societas europaea (SE) can have a one-tier corporate governance system). A German GmbH that is not subject to mandatory co-determination rules generally is not required to establish a supervisory board. The two-tier corporate governance system underlying the distinction between income from independent services and employment income may create specific questions in cross-border scenarios.

5 The highest tax bracket of 45 per cent applies to taxable income in excess of €254,447 for single individuals (or twice that amount for married couples filing jointly). The second highest tax bracket of 42 per cent applies to taxable income in excess of €53,666 for single individuals (or twice that amount for married couples filing jointly).

6 The church tax varies between the states, and generally ranges between 8 and 9 per cent of the income tax.

7 Section 34 of the ITA.

8 The employer is generally liable for wage withholding taxes and social security charges underwithheld (Section 42d of the ITA, Section 28e SGB IV). In addition, underwithholding may result in criminal charges. If in doubt, an employer may decide to file an application

income tax return. The wage tax withheld is credited as a prepayment against the assessed income tax. By contrast, the tax liability of non-resident executives is generally satisfied with the deduction of the wage withholding tax (see Section II.vi, *infra*).

iii Social security charges

In general,[9] employment income is subject to social security charges (pension insurance, unemployment insurance, health insurance, long-term care insurance),[10] if and to the extent the applicable contribution thresholds are not exceeded.[11] The employee's share of the social security charges is withheld by the employer (together with the wage withholding tax). Special rules apply to employees temporarily assigned abroad: Germany has entered into various social security treaties with countries in and outside the EU; in addition, a number of EC regulations[12] must be observed.

iv Capital gains

Capital gains are not subject to wage withholding tax or social security charges and may benefit from special tax rates. For instance, capital gains derived from the sale of corporate shares,[13] capital claims and various other financial instruments may qualify as investment income (Section 20 of the ITA). Investment income is generally subject to a flat tax rate of

for a wage withholding tax ruling (Section 42e of the ITA). If the executive's monthly cash wage is lower than the wage withholding tax to be withheld (e.g., if an executive is receiving substantial benefits in kind under an employee share ownership programme), the executive needs to provide the employer with the cash required to remit the wage withholding tax to the tax authorities. If the executive fails to do so, the employer is required to inform the tax authorities (Section 38(4) of the ITA).

The employer may also be required to withhold wage taxes if the executive remuneration is paid by third parties (e.g., an affiliate of the German employer) (see Section 38(1)3 of the ITA). For example, this needs to be observed if a foreign parent company grants stock options or other incentives to the employees of a German company. In the context of an M&A transaction, the payment of exit bonuses made by the seller to key employees of the German target company may require wage withholding at the level of the target company.

9 Exceptions apply, for example, to management board members of stock corporations, who are generally exempt from statutory social security charges (assuming that they take out private health insurance).

10 As of 2016, the social security charges amount to 18.7 per cent (pension insurance), 3 per cent (unemployment insurance), 2.35 per cent (long-term care insurance; 2.6 per cent for childless persons) and approximately 14.6 per cent (health insurance). The health insurance rate varies from insurance to insurance. Approximately half of the total social security charges must be borne by the employer.

11 As of 2016, the contribution thresholds generally amount to €74,400 (€64,800 for east Germany) for pension and unemployment insurance, and €50,850 for long-term care and health insurance.

12 In particular, Regulation (EC) No. 883/2004, Regulation (EC) No. 987/2009 and Regulation (EC) No. 465/2012 are relevant.

13 Different rules apply to the sale of partnership interests.

25 per cent (plus 5.5 per cent solidarity surcharge thereon and, if applicable, church tax). As an exception to this rule, capital gains from the sale of corporate shares are generally taxed in accordance with the partial income system (Section 3 no. 40 of the ITA), under which only 60 per cent of the capital gains are subject to tax at ordinary progressive income tax rates if, at any time during the five years preceding the sale, the executive held a substantial participation of at least 1 per cent in the share capital of the relevant company (Section 17(1) of the ITA). By contrast, employment income does not benefit from the flat tax regime applicable to investment income; nor does it qualify for the benefits under the partial income system. Therefore, it is important to distinguish between the benefits in kind received by an executive that qualify as employment income and any capital gains income derived subsequently.

For example, if an executive purchases a small amount of stock from his or her employer at a discount granted by the employer (but otherwise receives beneficial ownership of the fully unencumbered stock at that point), and several years later the stock is sold at a gain, then the executive derives a capital gain from the sale. Note, however, that the benefit resulting from the originally discounted acquisition price qualifies as employment income (and is taxable at the time of the purchase, subject to wage withholding tax, etc.). When realised as a result of the sale, the difference between the sales price and the fair market value of the stock at the time of its acquisition qualifies as investment income subject to the flat tax regime (assuming that the partial income system does not apply).[14]

v Accounting for tax (relevant point in time when income is taxed)

Executives are required to account for their income on a calendar-year basis. Employment income is usually accounted for on a cash basis (i.e., executives are not generally required to pay income taxes on employment income until they have actually received a benefit in cash or in kind). Consequently, the mere entitlement to receive employment income (even if the respective claim of the executive against the employer is due and payable)[15] does not generally result in a taxable event. The cash-based accounting method can be used for tax-planning

14 It should be noted that a decision of the German Federal Tax Court (BFH, VIII R 20/11) focuses on the existence of good and bad leaver provisions in the terms of a compensation instrument. Good and bad-leaver provisions distinguish certain events (such as ordinary old-age retirement as a good event and termination for cause as a bad event) and provide that the return that the executive will generate from the instrument will be higher in the case of good-leaver and lower in the case of bad-leaver events. Although the decision only dealt with a specific question relating to a participation right, it is unclear whether the tax authorities may interpret it to establish a broader principle to the end that the existence of good and bad leaver provisions in compensation instruments generally indicate that the return qualifies as income from employment (and not as capital gain or investment income). The underlying argument would be that the distinction between good and bad-leaver events evidences a connection of the income received with the employment relationship. As a practical consequence, in cases where it is contemplated to provide for good or bad leaver provisions in the terms of compensation instruments, this decision should be carefully analysed, and it may be advisable to obtain an advance wage withholding tax ruling.

15 By contrast, the grant of a claim against a third party (e.g., insurance) may result in a benefit in kind that is taxable upfront (BFH BStBl. II 07, 579).

purposes (e.g., to reduce progressive tax rates, one-time payments can be shifted to calendar years where the expected overall income is comparably low, for example, in a retirement scenario).

vi Non-resident executives

Non-resident executives are subject to tax in Germany if their compensation is attributable to services performed or used in Germany.[16] Compensation received in the capacity as a general manager or member of the management board of a company managed in Germany is always subject to tax in Germany.[17] Generally, the tax liability is satisfied with the deduction of the wage withholding tax.[18] Non-resident executives who are tax-resident citizens of another EU Member State or an EEA country may apply for a tax assessment.[19] The limited tax liability of non-resident executives results in certain disadvantages compared with the unlimited tax liability of resident executives. Most importantly, non-resident executives are not entitled to the splitting tariff (i.e., the lower tax rates applicable to married couples filing jointly)[20] or an allowance for children.[21] Non-resident executives who are citizens of another EU Member State or an EEA country, and who have to tax at least 90 per cent of their income in Germany, may consider filing an application for a deemed unlimited tax liability in order to benefit from the splitting tariff or an allowance for children.[22]

Capital gains derived by non-resident executives from the sale of shares in their German-resident employer are only subject to tax in Germany (in accordance with the partial income method) if the executive held (or are deemed to hold) a substantial participation of 1 per cent or more at any time during the five years preceding the sale (see Section II.iv, *supra*) and are not protected under an applicable tax treaty.[23]

16 Section 49(1) No. 4 of the ITA. Services of non-resident executives who work outside Germany may be used in Germany if a German employer is furnished with the results of the non-resident's work. For example, the Federal Fiscal Court decided that market analyses, that were prepared by an employee outside Germany but used by the employer's German management, may result in a German tax liability for the employee residing abroad (BFH BStBl. II 87, 379). Under German domestic law, the compensation paid to non-resident management board members and authorised signatories of companies having their place of management in Germany also qualifies as German-source income. However, Germany's taxation right may be excluded under an applicable tax treaty (see Section II.vii, *infra*).

17 Section 49(1) No. 4 lit. d of the ITA.

18 See Section 50(2)1 of the ITA.

19 See Sections 50(2)2 No. 4(b) and 50(2)7 of the ITA. For example, eligible non-resident executives may decide to apply for a tax assessment in order to claim a deduction for income-related expenses, which may result in a lower tax base and therefore in overall tax savings.

20 See Section 26(1) of the ITA.

21 See Sections 50(1)3 and 32 of the ITA.

22 See Sections 1(3) and 1a of the ITA.

23 In such situation, the executive may consider holding the substantial participation through a personal holding company in order to benefit from a tax treaty, or a 95 per cent participation exemption under German domestic law applicable to corporations deriving capital gains

vii Allocation of income in cross-border situations

Executives who are or become resident executives under German domestic tax law (because their residence or habitual abode is located in Germany) are generally liable for German income tax with their worldwide income.[24] Executives who, in addition, maintain a permanent residence or habitual abode outside Germany (and who may, because of these or other criteria, be treated as tax residents under the domestic laws of one or several other countries) may be protected from multiple taxation if a double tax treaty applies. Tax treaties entered into by Germany generally include a 'tie-breaker' provision, pursuant to which the tax residency of an individual may, *inter alia*, be determined by the individual's 'centre of vital interests'.[25] Executives who do not want to tax their worldwide income in Germany should therefore carefully monitor the development of their personal and economic ties with Germany.

Germany's tax treaties generally include a 183-day clause governing the allocation of taxation rights in respect of employment income. In principle, employment income may only be taxed in the executive's state of residence (to be determined in accordance with the aforementioned 'tie-breaker' provision), unless the employment is exercised in the other contracting state.[26] In this case, the employment income is taxable in the other state where the employment is exercised.[27] As an exception to this rule, employment income is taxable only in the executive's state of residence, if the conditions of the 183-day clause are met.[28] The application of the 183-day clause by-and-large requires that the executive does not stay or work for more than 183 days per year in the other state where the employment is exercised.[29] Moreover, the executive remuneration must not be borne by an employer resident

---

from the sale of corporate shares. The use of personal holding companies requires careful tax planning. In particular, substance requirements need to be observed. The 95 per cent participation exemption may also not be available in certain scenarios.

24 See Section 1(1) of the ITA.

25 For example, see Article 4(2) of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. For further details, see also Federal Ministry of Finance Circular IV B 2 - S 1300/08/10027 of 12 November 2014 (Ann. 9 et. seq.).

26 See Article 15(1) of the OECD Model Tax Convention.

27 If the employment income is taxable in the state where the employment is exercised, the state of residence frequently does not exercise its taxation right and applies the so-called exemption method (cf. Article 23A of the OECD Model Tax Convention). In other cases, a tax credit is granted by the state of residence (cf. Article 23B of the OECD Model Tax Convention). Certain tax treaties provide that the exemption method only applies if the income was actually subject to tax in the state where the employment is exercised (subject-to-tax clause). Moreover, German domestic law provides that the exemption method shall only be applied if the executive can demonstrate that the employment income was either taxed abroad or that the other state has waived its taxation right (cf. Section 50d(8) of the ITA).

28 See Article 15(2) of the OECD Model Tax Convention.

29 The exact calculation mechanism can vary depending on the specific tax treaty concerned (e.g., the 183-day limit may either relate to the tax year or the calendar year; the 183-day limit sometimes relates to the employee's presence in the relevant state and sometimes to the duration of the employment).

(or maintaining a permanent establishment situated) in such other state. It should be noted that Germany has concluded tax treaties that contain certain modifications to the 183-day clause.[30] Consequently, executives should check their individual tax situation carefully.

If the employment is exercised both in and outside Germany and the 183-day clause does not apply, the compensation received by the executive must be allocated between the countries concerned. Generally, the compensation should be allocated in accordance with the compensated service in the specific case. In the absence of more appropriate (non-quantitative) criteria, the compensation might have to be prorated on the basis of contractually agreed working days or hours.[31] In practice, if an executive works for several group entities located in more than one country, it may be useful to enter into separate (arm's-length) employment agreements in order to facilitate the allocation of the compensation received (salary splitting).

The apportionment of non-recurrent payments (e.g., bonus payments or deferred compensation under employee incentive schemes) constituting subsequent compensation for earlier work performed both in Germany and abroad may be of particular importance. From a German perspective, the attribution of taxation rights does not generally depend on the time and place of payment of the compensation, but solely on whether the compensation is paid for work carried out or utilised in Germany.

If an executive initially working in Germany subsequently moves to another state and receives deferred compensation while he or she resides in such other state, a double tax situation may occur where the other state claims a taxation right solely based on the time and place of payment of the compensation. In particular, if an executive is not protected from double taxation under a tax treaty, proper tax planning may require that the agreed time and place of payment of deferred compensation is determined in accordance with the local particularities of the jurisdictions concerned.

viii Tax consequences of certain typical equity compensation awards

Stock options and stock appreciation rights

The granting or vesting of non-tradable stock options does not qualify as a taxable event, and therefore does not result in employment income (i.e., no upfront taxation). The same applies to non-tradable, cash-settled stock appreciation rights (SARs), virtual stock options or similar awards under which the employer enters into a contractual promise to pay to the executive the future value of a notional stock option. By contrast, the actual exercise (or other realisation)[32] of the stock option or the actual cash payment under SARs qualifies as

30 For example, Germany's tax treaties with Denmark and Switzerland contain special rules for certain high-level executives pursuant to which executive remuneration can be taxed in the employer's jurisdiction of residence. Various other German tax treaties contain special rules for management board members and cross-border commuters.

31 BFH BStBl. II 86, 479.

32 According to Federal Fiscal Court decision (BFH BStBl. II 2013, 289) the executive may consider to realise the value of a stock option upfront (when it may still have a rather low intrinsic value) by contributing it to a personal holding company. A subsequent realisation of additional gains at the level of the holding company could then benefit from lower corporate tax rates and, possibly, a 95 per cent participation exemption (which is not available in all cases). The holding company should not be solely used to acquire the option, given increased

a taxable event (taxation at maturity). In the case of stock options, the executive must tax (as employment income) the fair market value of the stock received upon exercise minus the option exercise price paid.[33] Any subsequent appreciation in the value of the received stock is treated as capital gains income (see Section II.iv, *supra*). In the case of SARs or similar cash-settled awards, the cash payment received by the executive qualifies as taxable employment income. The granting of tradable stock options and SARs should not generally result in an upfront taxation (i.e., only the exercise, settlement or sale of such awards should qualify as a taxable event).[34]

Restricted stock and restricted stock units

The award of restricted stock granted unconditionally and merely subject to a contractual restraint on disposal until the expiration of a predetermined minimum holding period is generally taxed upfront. This means that the fair market value of the stock at the time of delivery (not taking into account the restraint on disposal), minus the purchase price paid for the stock, qualifies as taxable employment income.[35] If, however, the restraint on disposal is structured such that a disposal is not only forbidden by agreement but legally unfeasible (e.g., because the executive requires a resolution of the employer to effect a transfer of title), the taxable realisation event is postponed as long as the restraint on disposal exists.[36] The exact criteria for the distinction between contractual and absolute restraints on disposal are still subject to discussion.[37]

risk that the structure is disregarded. The valuation of the option (and, therefore, the determination of the wage withholding tax base at the time of the contribution of the option) can be difficult if the underlying consists of non-listed shares. Arguably, the Black-Scholes formula can be used for valuation purposes in such cases.

33 See Ministry of Finance Circular IV C5-S 2347/09/10002 of 8 December 2009 (Ann. 1.3) for further details regarding the determination of the stock's fair market value. A tax-free allowance of up to €360 per annum may apply to the non-discriminatory grant of discounted stock (including under a stock option programme). Executive incentive schemes frequently do not meet the non-discrimination requirement for such tax-free allowance. More importantly, stock options and SARs with a vesting period of more than one year may result in extraordinary income (Section 34(2) no. 4 of the ITA) potentially benefiting from reduced tax rates depending on the individual circumstances.

34 Federal Ministry of Finance Circular IV B 2 – S 1300/08/10027 of 12 November 2014 (Ann. 195). The Federal Fiscal Court does not generally distinguish between tradable and non-tradable stock options (BFH BStBl. II 09, 382).

35 BFH BStBl. II 09, 282. See also Ministry of Finance Circular IV C5-S2347/09/10002 of 8 December 2009 (Ann. 1.3, 1.6).

36 Federal Fiscal Court decision of 30 June 2011 (BFH BStBl. II 11, 923). Federal Ministry of Finance Circular IV B 2 – S 1300/08/10027 of 12 November 2014 (Ann. 214).

37 See also Federal Ministry of Finance Circular IV B 2 – S 1300/08/10027 of 12 November 2014 (Ann. 214 et. seq). In addition, the international allocation of taxation rights with respect to restricted stock subject to an absolute restraint on disposal is not free from doubt.

By the same token, the granting of restricted stock that is subject to a forfeiture condition (such as continued employment or financial performance), pursuant to which the stock has to be returned in case such conditions apply, should also result in a taxable event upfront if there is no absolute restraint on disposal (i.e., a condition subsequent should not prevent upfront taxation).[38] However, the return of the stock, in the event the forfeiture condition occurs and the stock is returned, should result in negative employment income.

Restricted stock units (or phantom stocks), under which the employer promises to deliver stock or cash equal to the value of a specified number of shares, are subject to different tax rules. Similarly to stock options and SARs, executives must recognise employment income only at the point in time when the shares are actually delivered or the cash is actually paid. The tax basis is the value of the shares at the time of delivery or the amount of cash received.

ix Tax deductibility for employers

Executive remuneration generally qualifies as a tax-deductible business expense and therefore reduces the corporate income and trade tax base of a German employer.[39] If the executive remuneration is not paid by the employer but by an affiliated entity (e.g., a foreign parent company), cost transfer agreements are frequently required to achieve a reduction of the German employer's tax burden. Such scenarios also generally trigger the requirement to withhold and remit wage withholding tax by the German employer, although it may not be involved in the payment processes. Careful structuring is required in such tripartite situations. Awards of stock options that merely dilute the shareholders' equity do not result in a tax-deductible expense.[40]

III TAX PLANNING AND OTHER CONSIDERATIONS

Typical considerations in connection with payments of executive remuneration include the following:

a making use of the cash-based accounting method by determining a favourable time for non-recurrent payments or bundling several tranches of payments, for example, in order to benefit from special tax rates for extraordinary income (see Section II.ii, *supra*), reduce tax progression (see Section II.v, *supra*) or avoid double taxation with respect to remuneration previously earned in another jurisdiction (see Section II.vii, *supra*);

b using salary splits to facilitate the allocation of executive compensation between various jurisdictions (see Section II.vii, *supra*);

38 See BFH BStBl. II 09, 282.

39 Special rules, which restrict the tax deductibility of compensation payments made to supervisory board members and similar persons, do not apply to ordinary executive remuneration (see Section 10 No. 4 of the Corporate Income Tax Act).

40 BFH BStBl. II 11, 215. By contrast, virtual stock option or phantom stock programmes result in a tax-deductible expense.

c organising the executive's individual tax situation, for example, by avoiding an undesirable unlimited tax liability in Germany (see Section II.vii, *supra*), by applying for an intended deemed unlimited tax liability (see Section II.vi, *supra*) or by making use of the 183-day clause (see Section II.vii, *supra*); and

d making use of personal holding companies to shelter capital gains income in exceptional situations (see footnotes 22 and 32); although recent legislative efforts may make such structures less efficient (portfolio exemptions).

IV EMPLOYMENT LAW

i Severance payments

Executives do not generally have a statutory severance claim upon termination of their service or employment relationships; any entitlements in this respect need to be stipulated in their individual service or employment agreements.

a Agreements with employees with management functions will only occasionally include severance clauses, because this group of executives is subject to statutory protection against wrongful dismissal under German labour law. Accordingly, a termination by the employer requires a justified reason, such as a severe misbehaviour, a continuing incapacity or redundancy. Absent a justified reason, the employer will have to reach a settlement with the employee in the course of legal proceedings that employees in Germany typically institute after receiving notice of termination from their employers. The severance amount to be paid to make the employee accept his or her dismissal is subject to negotiation, and usually depends on how the parties evaluate their chance of succeeding in the pending legal proceedings. Generally, severance payments by employers in Germany range between one-half and one full month's salary (including *pro rata* variable payments) for each completed year of employment, but may actually be significantly higher if the employer has a weak case.

b While not unheard of, it is also not very common that service agreements with management board members of non-listed companies provide for severance payments or change in control provisions. Although management board members do not benefit from statutory protection against wrongful dismissal, their service agreements frequently run for a fixed term during which they can only be terminated for good cause, which is a rather strict test under German law.[41] A company intending to terminate the service relationship with a management board member prematurely without such good cause will have to negotiate a termination agreement with such management board member, including offering him or her a severance package. The outcome of the negotiations will largely depend on the remaining term of the service relationship.

c Notwithstanding the fact that service agreements with management board members of listed companies are typically entered into for a fixed term of up to five years,

41 Service agreements, however, occasionally give the management board member the right to receive a severance payment if the company does not renew the agreement beyond its original term without having cause for the non-renewal.

these types of executives are more commonly entitled to severance payments under their service agreements upon a termination without good cause. Pursuant to Section 4.2.3 of the German Corporate Governance Code (GCGC),[42] such severance payments, including fringe benefits, should be capped at the lower amount of (1) two times the management board member's last annual remuneration (severance pay cap) or (2) the remuneration that such management board member would have earned during the remaining term of the service agreement.

ii Change in control provisions

Under German law, there is no statutory termination right on the part of the company or the executive if the ownership structure of the company significantly changes. Both parties continue to be bound by the terms and conditions of the existing service or employment agreement, including any fixed term agreed therein.

Listed companies often grant their management board members the right to terminate the service relationship prematurely within a certain time frame following a change in control event and to collect a predefined severance. Pursuant to the GCGC, such severance payment should be capped at three times the management board members' last annual remuneration, which corresponds to 150 per cent of the severance pay cap.

The terms of share-based compensation and retirement benefit plans may provide for a vesting or acceleration of rights if the service relationship with a management board member is terminated as a result of a change in control.

iii Confidentiality

Executives in Germany are by virtue of the law required to treat as confidential all trade and business secrets that they become aware of during the term of their service or employment relationship. The particulars of this confidentiality obligation are typically stipulated in greater detail in the executive's service or employment agreement.

It is customary in Germany that employers impose continued confidentiality obligations on their executives that shall also survive termination of the service or employment relationship. While this practice is generally acknowledged, the relevant confidentiality clauses will only be enforceable if they do not impede the executive's professional advancement in an unreasonable manner. As a consequence, employers intending to protect their customer base or market share from poaching attempts of a former executive will usually have to make the executive accept a post-termination non-compete undertaking (see Section IV.v, *infra*).

42 The GCGC is a non-binding set of recommendations summarising best practices for the management and supervision of listed companies. It is reviewed and updated annually by a corporate governance commission appointed by the federal government. Listed companies must disclose on an annual basis whether they comply with the recommendations of the GCGC ('comply or explain').

iv Non-compete obligations during the term of service or employment

During the term of their service or employment relationships, executives are not permitted to engage in competition with their employer.[43]

Accordingly, executives must not do business, carry out transactions or support any activities in the employer's line of business on their own behalf or on behalf of third parties without the consent of the employer. Executives violating this obligation may face disciplinary actions and become liable for damages.

In addition to the statutory rules, it is customary to further specify the statutory obligations in an executive's service or employment agreement by means of explicit non-compete and non-solicitation clauses.

v Post-termination non-compete clauses

Apart from generally applicable unfair competition rules, executives in Germany are, as a matter of law, not bound by competition restrictions after termination of their service or employment relationships. Any such restrictions therefore need to be put on a contractual basis by entering into a post-termination non-compete or non-solicitation (or both) arrangement with the executive.

German courts take the view that post-termination non-compete clauses are only enforceable if there is a legitimate interest on the part of the employer, and the further professional career of the executive is not unreasonably restricted by the territorial and temporal scope of the non-compete obligation.[44] While the German Commercial Code sets a specific legal framework for post-termination non-compete arrangements with regular employees (including employees with management functions),[45] the relevant rules do not apply to management board members. As a practical matter, however, any post-termination non-compete clauses in service agreements of management board members are typically drafted along the lines of the statutory provisions in the German Commercial Code.

Post-termination non-compete arrangements usually run for a period of between one year and two years following the termination date of the executive's service or employment agreement (two years being the maximum post-termination non-compete period permitted under German employment law). An extended garden leave period that immediately precedes the termination date may actually require a shorter non-compete period or may even render a post-termination non-compete undertaking entirely unenforceable if the aggregate amount of time during which the executive was kept out of business would practically put an end to his or her professional career in the relevant industry. There are no strict guidelines as to when a garden leave that is forced on the executive would affect the scope and substance of

43 While the non-compete obligation of the management board members of a limited liability company is considered to be a part of their fiduciary duty towards the company, Section 88 of the German Stock Corporation Act includes an explicit regulation for the management board members of a stock corporation. The statutory non-compete obligation of regular employees is derived from Section 60 of the German Commercial Code.

44 BGHZ 91, 1, 5.

45 Sections 74 to 75d of the German Commercial Code.

a subsequent post-termination non-compete undertaking. Rather, any potential risks in this respect will have to be assessed based on the facts and circumstances of each individual case, and in particular, the situation in the market or business area concerned.

In order to be valid and enforceable, a post-termination non-compete arrangement must provide for an adequate financial compensation to be paid to the executive during the non-compete period. German mandatory law[46] requires a minimum non-compete compensation for regular employees that is equal to 50 per cent of their last total remuneration under the employment agreement (including all monetary and non-monetary benefits).[47] As stated above, this legal requirement is not relevant for post-termination non-compete arrangements with management board members; however, there is a common understanding among legal practitioners that non-compete compensation must be offered to these persons as well. The non-compete compensation provided in post-termination non-compete arrangements with management board members typically varies between 50 per cent of their last fixed salary and as high as the full amount of their last total remuneration. It is also not uncommon to link the non-compete compensation to the reason for termination and grant a higher amount if the termination of the service relationship had not been caused by the management board member.

Other work-related income that an executive earns during the non-compete period may, to a certain extent, be deducted from the non-compete compensation, and the executive must regularly inform his or her previous employer about such earnings.

V SECURITIES LAW

i Prospectus requirements in connection with the offering of securities to employees

Many typical executive compensation arrangements are considered to involve the offer of securities. The German Securities Prospectus Act implementing European Prospectus Directive 2003/71/EC, as amended by Directive 2010/73/EC, requires that an offer to the public of listed or non-listed securities may only be made in Germany after publication of a prospectus approved by the German Federal Financial Supervisory Authority (BaFin), or by an authority of another EEA country after having notified the BaFin of such approval.

There are a number of exemptions from the requirement to publish a prospectus when offering securities in Germany.[48]

46 Section 74(2) of the German Commercial Code.

47 If the employee is released without cause on his or her part (such as in the event of redundancy), the post-termination non-compete arrangement will only be enforceable if the employer offers an increased compensation of 100 per cent of the employee's last total remuneration under the employment agreement.

48 When relying on an exemption to publish a prospectus in the context of an offer of securities to the public, it is important to bear in mind that a prospectus may nevertheless be required with respect to the admission to trading on an EU-regulated market of such securities.

First, a specific employee offering exemption is available under the German Securities Prospectus Act for securities[49] that are offered or allotted to existing or former directors (including management board members) or employees by their employer or by an affiliated undertaking, provided that the company has its registered office in the EEA or is listed on a regulated market, and further provided that an information document is made available containing information on the number and nature of the securities and the reasons for and details of the offer.[50] This exemption is also available for companies established outside the EEA whose securities are admitted to trading either on an EU regulated market or on a third-country market regarded as equivalent to an EU regulated market by the European Commission.

Second, there are private placement exemptions, including, in particular, a prospectus exemption if securities are offered to fewer than 150 persons per EEA country.[51]

The German Securities Prospectus Act also provides for a prospectus exemption with respect to the admission to trading on a regulated market of securities offered in employee offerings, provided, *inter alia*, that such securities are of the same class as the securities already admitted to trading on the same regulated market and that an information document is made available.[52]

ii Managers' transactions

Since becoming effective on 3 July 2016, Section 19 of the new Regulation (EU) No. 596/2014 (Market Abuse Regulation, MAR) has expanded restrictions on directors' dealings in Germany, which had previously been governed by the German Securities Trading Act (GSTA). According to the MAR, 'persons discharging managerial responsibilities' (including management board members and those employees with regular access to inside information and the power to make certain managerial decisions) as well as persons closely associated with them, must notify the company and the BaFin of certain types of transactions promptly and no later than within three working days (instead of five working days as under the GSTA). These transactions now include not only those concerning shares of the company or related financial instruments (in particular, derivatives), but also those relating to debt instruments and emission allowances.

As before, the company is obligated to immediately publish the notification,[53] including the executive's name, the price and volume as well as the date and place of the

49 If the instrument offered should not qualify as a security within the meaning of the German Securities Prospectus Act, a public offer of such instrument may nonetheless require a prospectus pursuant to the German Asset Investment Act. The German Asset Investment Act, however, provides for a comparable employee offering exemption.

50 The European Securities and Markets Authority has published recommendations as to the content of such information document.

51 Note, however, that a prospectus may be required in connection with the admission to trading on an EU regulated market of such securities.

52 This exemption is particularly relevant for issuers with a listing on an EU regulated market.

53 However, the obligation to publish managers' transactions does not apply as long as the total amount of the transactions by an executive and the persons closely related to him or her remains below a threshold of in total €5,000 (no netting) within the calendar year. The BaFin may increase this threshold to €20,000.

transaction, and to notify the BaFin of the publication and submit the information to the Company Register. Additionally, companies must now draw up a list of persons discharging managerial responsibilities and persons closely associated with them and notify the persons discharging managerial responsibilities of their obligations in writing. Persons discharging managerial responsibilities must notify the persons closely associated with them.

The MAR now provides for a statutory 'closed period' of 30 days before the announcement of an interim financial report or a year-end report, during which no transactions may be conducted at all, subject to hardship exemptions. Pursuant to ESMA guidance, the relevant announcement for purposes of the closed period is the public statement whereby the issuer announces, in advance of the publication of the final year-end report (or the final interim report, as the case may be), the preliminary financial results agreed by the management body of the issuer.

There are no statutory requirements under German law that executives must hold stock of their employer.

iii Insider trading and market manipulation

Since 3 July 2016, the MAR also governs insider trading and market manipulation, following to a large extent the substance of the previous rules under the GSTA. Pursuant to Article 7 of the MAR, inside information is, *inter alia*, non-public information of a precise nature, relating to companies or financial instruments, which, if made public, would likely have a significant effect on the prices of those financial instruments or related derivatives. Following a decision by the European Court of Justice,[54] where inside information concerns a process that occurs in stages, each stage of the process can already constitute inside information.

It is considered unlawful insider dealing for a person to use inside information to acquire or dispose of, for the person's own account as well as for a third party, directly or indirectly, financial instruments to which that information relates. Going beyond the GSTA regime, cancelling or amending an order that has been placed before acquiring the inside information is now also considered insider dealing. Moreover, the use of recommendations or inducements can now amount to insider dealing in cases where the person knows or should have known that it is based on inside information. However, certain 'legitimate behaviours' may serve as a justification for actions that would otherwise be deemed insider dealing.

The MAR's market abuse rules set forth an enumeration of definitions, examples and indicators in order to determine whether a person manipulated the market using false or misleading information. Unlike before, a failed attempt already qualifies as market manipulation. Certain 'accepted market practices' promulgated by national regulators and accepted by ESMA pursuant to certain procedures may provide exemptions.

Breach of insider trading or market manipulation rules may qualify as a criminal or administrative offence. The sanctions have become much more severe in connection with MAR. They include very substantial amounts for fines and public naming and shaming of violations and violators.

There are no specific German rules with respect to short swing trading of executives.

54 Case C-19/11 *Geltl v. Daimler* [2012].

iv Anti-hedging rules

Under German law, there is no general prohibition for executives to hedge themselves against risks to variable elements of their compensation. German law only provides anti-hedging rules with respect to executive remuneration by financial institutions[55] and insurance companies.[56] According to these rules, financial institutions and insurance companies must take appropriate measures to ensure that executives do not limit or cancel out the risk in connection with their risk-oriented compensation elements through hedging.

VI DISCLOSURE

German generally accepted accounting principles,[57] Section 4.2 of the GCGC and, as the case may be, International Financial Reporting Standards, require extensive annual public disclosure concerning the remuneration of a company's management board members. The disclosure forms part of the notes to the annual financial statements and must also be reflected in a remuneration report, which forms part of the management report and provides detailed information on the principles and the amount of the remuneration of the management board members. Disclosure comprises the total annual remuneration with a breakdown for each management board member, divided into fixed and variable compensation components.[58]

Privately held companies are generally subject to the same disclosure obligations; however, the remuneration of each individual management board member need not be disclosed. Certain further disclosure exemptions may apply for small companies.[59]

Moreover, the general shareholders' meeting of a stock corporation may resolve, with a three-quarters majority of the votes cast, that certain remuneration-related information (in particular, a breakdown of the remuneration of each individual management board member) need not be disclosed for a period of up to five years.

There is no requirement to make the full text of the service agreements between the company and its management board members publicly available.

55 Section 8(1) of the German Ordinance regarding Remuneration in Financial Institutions.

56 Section 4(4) of the German Ordinance regarding Remuneration in Insurance Companies.

57 Section 285 No. 9 and Section 314(1) No. 6 of the German Commercial Code.

58 Disclosure must also set forth separately the amounts attributable to base salaries, options and other share-based compensation components, insurance premiums paid by the company, expense allowances and other benefits, severance arrangements and change in control provisions.

59 Sections 288(1), 267(1), 293 of the German Commercial Code.

VII CORPORATE GOVERNANCE

As a reaction to the worldwide financial crisis, the German parliament adopted legislation in 2009 changing certain rules on the remuneration of management board members of stock corporations in Germany.[60] These changes are supposed to set incentives in favour of the sustainable development of enterprises and to prevent excessively high levels of remuneration.

i Appropriateness of remuneration and shareholder rights

The supervisory board of a stock corporation determines the remuneration of the management board members. It must ensure that the remuneration is appropriate in relation to the management board members' duties and responsibilities, their performance and the situation of the company; and does not exceed the customary remuneration that is granted in comparable companies without good reasons for such excess.

The German Stock Corporation Act[61] provides that the general shareholders' meeting of a listed company may adopt a non-binding resolution on the remuneration system for the management board members. The governing political parties undertook in their coalition agreement of November 2013 to implement a mandatory and binding shareholder vote on the remuneration system ('say-on-pay') based on the recommendation of the supervisory board. A new legislative procedure on this subject has not yet been initiated,[62] because the European Commission has meanwhile proposed an amendment[63] to the Shareholder Rights Directive pursuant to which the general shareholders' meeting shall vote at least triennially on the remuneration of the management board members with binding effect. Since late 2015, there is an informal trialogue between the Commission, the Council and the Parliament, which has led to significant progress concerning the draft of the amendment. However, recent developments indicate that the say-on-pay provision will likely be only voluntary for the member states. It remains to be seen whether in such a scenario the government will hang on to its plans from the coalition agreement to implement a mandatory and binding shareholder vote on the remuneration system.

According to amendments to the GCGC, a non-binding code that listed companies may either comply with or explain publicly why they do not comply with it (comply or explain), German stock corporations should generally set forth a maximum amount for each part of the management remuneration (e.g., for bonus payments and stock options).[64] The recently amended GCGC also expands disclosure obligations regarding management remuneration.[65]

60 The Act on the Appropriateness of Management Board Remuneration, *inter alia*, amended Section 87 of the German Stock Corporation Act.

61 Section 120(4) of the German Stock Corporation Act.

62 The first legislative initiative in Germany on a mandatory and binding say-on-pay decision by the shareholders' meeting was abandoned in September 2013.

63 COM/2014/0213 final.

64 Section 4.2.3 of the GCGC.

65 Sections 4.2.4 and 4.2.5 of the GCGC.

ii Variable compensation, stock options, and directors' and officers' liability insurance

In the case of a listed company, any variable compensation granted to the management board members must be determined according to a long-term evaluation base covering several fiscal years. Short-term bonus payments that only consider the performance within a single fiscal year continue to be permissible, as long as they are combined with a long-term bonus element and the overall metrics of the variable compensation offer an adequate incentive for the management board members to pursue the sustainable development of the company with a longer perspective.[66]

There is a mandatory four-year waiting period before stock options granted to a management board member may be exercised and shares acquired thereby may be sold.[67]

Directors' and officers' insurance that a stock corporation takes out on behalf of its management board members to cover risks arising from the performance of their duties and responsibilities must provide for a deductible to be borne by the management board member of at least 10 per cent of the amount of the damages (capped at one-and-a-half times such management board member's fixed annual salary).[68]

iii Reduction of remuneration

Pursuant to the German Stock Corporation Act,[69] the supervisory board should reduce the management board members' remuneration if the company's situation deteriorates in a manner such that it would be unreasonable to continue compensating the management board members at the agreed level. A reduction may be justified by adverse economic developments due to which the company is significantly losing money, has to make general pay cuts or must carry out collective dismissals.

The management board members concerned may challenge such reduction by filing an action for specific performance. Additionally, they may terminate their service agreements with the company as of the end of the next calendar quarter by giving at least six weeks' notice.

VIII SPECIALISED REGULATORY REGIMES

Reforming the principles of executive remuneration in financial institutions and insurance companies has been a key topic on the agenda of the German legislator and the BaFin.

66 Section 87(1) of the German Stock Corporation Act.

67 Section 193(2) No. 4 of the German Stock Corporation Act.

68 Section 93(2) of the German Stock Corporation Act. However, board members may take out private insurance to close the gap.

69 Section 87(2) of the German Stock Corporation Act.

i CRD IV

In this context, Germany has implemented the new requirements as set forth by CRD IV (including the widely discussed bonus caps) by amending the German Banking Act as well as the German Ordinance regarding Remuneration in Financial Institutions (GORFI), which originally came into force in 2010.[70]

Remuneration principles

German remuneration principles are substantially in line with the requirements as currently set forth by the European Union. Moreover, Germany to a great extent complies with the remuneration requirements as set forth by CRD IV as from 1 January 2014. The ratio between fixed and variable compensation for employees of financial institutions is thus capped at 100 per cent of the fixed remuneration, subject to an increase to 200 per cent if explicitly approved by the financial institution's shareholders. The scope of application for such bonus caps is broader than required by the EU Directive ('gold-plating'), given that all employees (and not just risk-takers) are subject to the cap in Germany.[71]

However, pursuant to the principle of proportionality set forth by CRD IV,[72] the scope of certain provisions of the GORFI is currently limited to 'significant' institutions in Germany with an average balance sheet total of at least €15 billion in the past three years. As a result, the numerous smaller German banks are exempted from various obligations, e.g., the identification of internal risk-takers or the deferral of at least 40 per cent (60 per cent in case of a member of the management board or the next lower management level) of variable remuneration components over a period of at least three years. On 21 December 2015, the European Banking Authority (EBA) published an opinion on the application of the principle of proportionality[73] in which it disagrees with this interpretation, stating that although Member States may introduce less complex rules for smaller institutions, they may not waive the requirements of CRD IV entirely. However, the EBA acknowledges the cost and burden as well as the absence of clear beneficial effects that a complete application would mean for smaller institutions. Therefore, it advocates a legislative amendment to CRD IV providing for the opportunity of exemptions, which would also harmonise the application of the principle of proportionality throughout the Union. The European Commission partly consented to these considerations in a report dated 28 July 2016[74] and took into account a waiver of, *inter alia*, the deferral requirement. However, it declares such an amendment contingent on the outcome of an upcoming impact assessment.

Meanwhile, the BaFin has been considering an amendment to the GORFI, in which it plans to retain the existing exemptions despite the deviating opinion of EBA and Commission. However, the draft dated 10 August 2016 provides for the obligation to

70 The German Ordinance regarding Remuneration in Financial Institutions applies to German credit institutions, German financial services institutions and German branches of non-EEA financial institutions.

71 See Section 25a of the new German Banking Act. For more detailed information on the European background, please see the EU Overview chapter of this publication.

72 Article 92(2) of CRD IV.

73 EBA/Op/2015/25.

74 COM(2016) 510 final.

identify risk-takers even in smaller institutions. It also provides for a mandatory clawback of variable remuneration already paid out if the risk-taker proved to have a negative impact on the overall success of the company. These clawback elements may add up to the full amount of the bonus if the risk-taker is personally responsible for significant losses for the company or regulatory sanctions against it, or in the case of a serious breach of external or internal rules relating to personal conduct. Clawback provisions have already been introduced by various financial institutions, but it is uncertain whether they comply with German statutory law. This uncertainty would vanish once the amendment is passed. It remains to be seen whether the BaFin will take further steps soon or whether it will await the results of the amendment process regarding CRD IV.

Several institutions across the EU have changed their remuneration policies and introduced 'role-based allowances', which institutions tend to consider as fixed remuneration arguing that such allowances are linked to the position rather than to the performance. Such allowances are payments made in addition to the fixed remuneration (base salary) and the performance-based variable remuneration (bonus). However, the European Banking Authority has taken the view that such 'role-based allowances' should be classified as variable remuneration in case they are either (1) not predetermined, (2) not transparent, (3) not permanent, or (4) revocable, or in case they provide incentives to take risks.[75] With such allowances being considered variable remuneration, the respective remuneration policies would in some cases not comply with the limit on the variable remuneration to 100 per cent of the fixed remuneration (200 per cent with shareholders' approval).

In Germany, the issue might soon disappear, as the BaFin draft for the amendment to the GORFI provides for the abolition of all other types of remuneration other than fixed and variable remuneration elements. If in doubt, an element will be deemed variable remuneration.

Disclosure requirements

All relevant institutions must disclose their remuneration principles on an annual basis, including on their websites.[76] The published information must comprise the aggregate amount of remuneration paid out by the institution, broken down into fixed and variable components, and the number of recipients of variable remuneration. Significant institutions are subject to increased disclosure obligations and must, for example, also disclose the composition, tasks and organisation of their remuneration committee, the aggregate amount of deferred variable compensation and the aggregate amount of severance payments made.

75 Opinion of the European Banking Authority on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances, 15 October 2014 (EBA/Op/2014/10).

76 See Section 16(3) of the German Ordinance regarding Remuneration in Financial Institutions.

ii AIFMD and UCITS

With effect as of 22 July 2013, Germany has introduced a new German Capital Investment Act (GCIA), thereby transposing the AIFMD into German law. Since its incorporation into the GCIA as from 18 March 2016, the following also applies to investment funds governed by UCITS.

Remuneration principles

The GCIA[77] provides for regulations regarding the remuneration of an investment fund manager's senior management and employees who either exercise control functions, whose professional activities have a material impact on the fund's risk profile ('risk-takers') or who receive a total remuneration that takes them into the same remuneration bracket as senior management and risk-takers. In particular, the remuneration system of investment fund managers must promote sound and effective risk management; it must be in line with the business strategy, objectives, values and interests of the fund; any variable remuneration must be assessed over multiple years appropriate to the life cycle of the funds managed by the relevant company; and there must be an appropriate balance between fixed and variable components.

Corporate governance

In the case of 'significant' investment funds (i.e., in general, funds managing assets of at least €1.25 billion in the aggregate and employing at least 50 employees), a remuneration committee has to be established, which advises and controls the company in respect of its remuneration system.

IX DEVELOPMENTS AND CONCLUSIONS

According to the public view in Germany, the worldwide financial crisis and its influence on the current banking and sovereign debt turmoil was, to a large extent, attributable to an executive remuneration system that incentivised short-term risk-taking over long-term sustainability. Therefore, executive remuneration, in particular at financial institutions, continues to be in the focus of public attention, and pressure remains on the German legislator to establish a tight regulatory framework.

Several financial institutions in Germany have meanwhile comprehensively amended their remuneration systems. For instance, they have introduced clawback elements for bonus and other variable payments to their executives and employees. Most financial institutions in Germany have increased the fixed portion of the remuneration, started to pay special allowances to bypass the bonus caps[78] and have introduced creative remuneration structures (e.g., debt-based remuneration instruments that convert into equity). Many of them have meanwhile obtained shareholders' approval for bonuses that amount to twice annual fixed pay.

77 Section 37 of the GCIA.

78 See Section VIII.i, *supra*, concerning the European Banking Authority's view on 'role-based allowances'.

Nonetheless, remuneration systems have become an increasingly controversial topic during shareholder meetings. The average approval rate of voluntary say-on-pay votes held by the 30 DAX companies dropped from 96 per cent in 2014 to only 76 per cent in 2016, which might partly be due to the emerging influence of foreign investors who are traditionally more critical with respect to management remuneration. However, in the light of evident cases of mismanagement such as the Volkswagen scandal there is a decreasing acceptance of high salaries among domestic shareholders as well. Compared with 2015, the remuneration of DAX executives has decreased by 1.8 per cent.[79]

Significant legislative measures on both national and Union level are currently under way. Key issues are mandatory say-on-pay votes for shareholder meetings, the scope of CRD IV for smaller financial institutions, the abolition of role-based allowances and mandatory clawback elements for bonus payments. However, it remains uncertain whether these measures will be finalised within the upcoming year. In any event, stronger regulation of executive remuneration will continue to be a hot topic in Germany.

79 www.handelsblatt.com/unternehmen/management/verguetung-in-dax-und-mdax-aktionaere-rebellieren-gegen-managergehaelter/13842706.html (as of 6 September 2016).

Appendix 1

ABOUT THE AUTHORS

MICHAEL BREMS

Cleary Gottlieb Steen & Hamilton LLP

Michael Brems is counsel based in the Cologne office of Cleary Gottlieb Steen & Hamilton LLP. Mr Brems' practice focuses on mergers and acquisitions, corporate law, and employment law matters. His experience in employment law includes service and employment contracts with senior management (including their termination and settlement), workforce restructurings, pension matters, bonus and incentive plans, and works council issues. He is experienced in domestic and cross-border mergers and acquisitions and employment law matters in an international context.

Mr Brems joined the firm in 1996 and became counsel in 2004. He received an LLM degree from Columbia University School of Law in 1998 and a doctorate in law (Dr iur), *summa cum laude*, from the University of Würzburg in 1995. He passed the second state examination in the state of Bavaria in 1996 and the first state examination at the University of Würzburg in 1992.

He has also worked in the firm's Frankfurt and New York offices. Mr Brems is a member of the Cologne and New York Bars.

JENS HAFEMANN

Cleary Gottlieb Steen & Hamilton LLP

Jens Hafemann is a senior attorney based in the Frankfurt office of Cleary Gottlieb Steen & Hamilton LLP. Mr Hafemann's practice focuses on tax law and corporate transactions.

Mr Hafemann joined the firm in 2008. From 2008 to 2012, he was resident in the Frankfurt office, and from 2012 to 2013, he was resident in the New York office. He received an LLM degree from the University of Cambridge in 2005. He passed his second state examination in the state of Hamburg in 2007 and the first state examination at the Bucerius Law School in 2004. He also received an LLB degree from the Bucerius Law School in 2003.

Mr Hafemann is a member of the Frankfurt am Main Bar. He is also a certified tax adviser.

BORIS WITT

Cleary Gottlieb Steen & Hamilton LLP

Boris Witt is an associate based in the Frankfurt office of Cleary Gottlieb Steen & Hamilton LLP. Mr Witt's practice focuses on domestic and international transactions in which he advises on corporate law as well as employment law matters. He regularly advises clients on senior management contracts, workforce restructurings, pension matters, and bonus and incentive schemes.

Mr Witt joined the firm in 2009. He received an LLM degree from New York University School of Law in 2009. He passed the second state examination in the state of North-Rhine Westphalia in 2008 and the first state examination at the University of Cologne in 2006.

Mr Witt is a member of the Frankfurt am Main and New York Bars.

MARTIN BEGIEBING

Cleary Gottlieb Steen & Hamilton LLP

Martin Begiebing is an associate based in the Cologne office of Cleary Gottlieb Steen & Hamilton LLP. Mr Begiebing's practice focuses on employment law matters. He regularly advises clients on service and employment contracts with senior management (including their termination and settlement), workforce restructurings, pension matters, bonus and incentive plans, and works council issues.

Mr Begiebing joined the firm in 2015. He received a doctorate in law (Dr iur), *magna cum laude*, from the University of Cologne in 2010. He passed his second law examination in the state of North Rhine-Westphalia in 2012 and his first state examination at the University of Cologne in 2008.

Mr Begiebing is a member of the Bar in Cologne.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main
Germany
Tel: +49 69 97 103 0
Fax: +49 69 97 103 199
jhafemann@cgsh.com
bwitt@cgsh.com

Theodor-Heuss-Ring 9
50668 Cologne
Germany
Tel: +49 221 800 40 0
Fax: +49 221 800 40 199
mbrems@cgsh.com
mbegiebing@cgsh.com