No Stock Options for Supervisory Board Members of a German Stock Corporation: A Comment on *In re Mobilcom AG*, BGH II ZR 316/02 of 16 February 2004

By Dirk Reidenbach*

A. Introduction

On February 16th, 2004 the German Federal Court of Justice (*Bundesgerichtshof, BGH*) delivered a judgment concerning stock options for members of the supervisory board of Mobilcom AG, a major German telecommunications company organized as a stock corporation[1]. As is well known, German stock corporations have a two-tier board, consisting of the management board and the supervisory board.[2] This decision by the BGH sheds again a new light on the much discussed and much disputed management structure of German stock corporations.[3] After this decision, there are now only limited ways in which members of the supervisory board may be compensated with stock options, if at all. In the near future, even these possibilities might be foreclosed by new regulation. The following comment will give a brief overview of the case, the reasoning of the Court, the law as it stands, and finally the law as it might become.

B. The Case and the Decisions of the Lower Courts

In the 2001 Annual General Meeting of Mobilcom AG, the articles of association of this company were changed to grant its supervisory board members every year a certain number of stock options (*naked warrants*) as part of their remuneration pack-

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[1] Reported in DB 2004, 696; ZIP 2004, 613, WM 2004, 629.

[2] See only Hopt, The German Two-Tier Board: Experience, Theory, Reforms, in: Hopt/Kanda/Prigge/Roe/Wymeersch (eds.), Comparative Corporate Governance - The State of the Art and Emerging Research, Oxford University Press: Oxford/New York 1998, 227.

[3] See hereto e.g. Baums, Interview: Reforming German Corporate Governance: Inside a Law Making Process of a very new nature, 2 German Law Journal No. 12 (16 July 2001), available at: www.germanlawjournal.com (search author: Baums).

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age. The company was authorized to purchase its own shares according to § 71 (1) No. 8 (5) of the Stock Corporation Act (AktG)[4] for granting these subscription rights. The subscription rights of the shareholders were excluded under § 186 (3), (4) AktG.

In their capacity as shareholders of Mobilcom AG, members of the "*Deutsche Schutzvereinigung für Wertpapierbesitz*" (DSW), an association for private investors, filed a suit against this shareholders' resolution.

In the first instance judgment, the *Landgericht* (Regional Court) Flensburg (6 O 53/01) held that the Stock Corporation Act only allows the purchase of a corporation's own shares to fund stock options for members of the management board and employees, but not for supervisory board members. For that reason, the decision of the shareholders' meeting was declared void (§§ 241 No. 5, 243 AktG).

On appeal, this decision was upheld by the *Oberlandesgericht* (Higher Regional Court) Schleswig (5 U 164/01)[5] on other grounds. The Court did not reach the conclusion that the Stock Corporation Act prohibits this way of compensating members of a supervisory board. Instead, the Court declared the resolution void due to insufficiencies in the compulsory management's report to the shareholders' meeting under § 186 (4) (2) AktG.

C. The Ruling of the German Federal Court of Justice (*BGH*)

The Federal Court of Justice upheld the decision of the *Oberlandesgericht* without, however, following its reasoning. Instead, the Court argued similarly to the judges of the entry court, the *Landgericht*. According to the BGH, a company may not purchase its own shares for distributing them to members of the supervisory board in a stock option plan.
In addition, in *dictum*, the BGH casts doubt on all remaining possible ways of compensating supervisory board members with stock options.

I. The Reasoning

By its ruling, the *BGH* answered a question that had caused for much dispute among German corporate law scholars in recent years. The question was -in simple words- how a company may acquire or issue shares to supply a stock option plan

[4] A translation of the German Stock Corporation Act can be found in Zschocke, The German Stock Corporation Act, 3rd ed. 2001. This edition does not, however, include the most recent reforms.

[5] Published in NZG 2003, 176.

for supervisory board members. This question is, at least at first glance, of quite a technical nature and for this reason shall only be mentioned briefly here. In theory, five ways are possible to "create" shares for a stock option plan: 1) A conditional capital increase for supplying the subscription rights (*naked warrants*), 2) a conditional capital increase for supplying convertible bonds, 3) the company repurchasing its own shares, 4) authorized capital and 5) capital increase for contributions. The last two options seem to be ruled out for many practical reasons[6], so they will be ignored here.

Never disputed has been the question whether the company can institute a conditional capital increase under § 192 AktG to create shares for a stock option plan for supervisory board members. § 192 (2) No. 3 AktG only allows this technique for stock options for employees and members of the management board, but not for members of the supervisory board[7]. Similarly, at least until now, it has been undisputed whether a conditional capital increase may be adopted for granting conversion and subscription rights to holders of convertible bonds (§ 221 AktG) if these holders are supposed to be members of the supervisory board. As § 192 (2) No. 1 AktG, contrary to § 192 (2) No. 3 AktG, does not restrict the beneficiaries of these subscription rights, this question has been answered in the affirmative[8]. The only remaining question has thus been whether a company is allowed to purchase its own shares for this purpose. Whereas some authors argued that this was allowed[9], the majority denied this possibility[10]. The very technical arguments shall not be of great interest here. At its core, the problem resulted from the fact that the Stock Corporation Act does not explicitly address the situation of the company buying its own shares for the purpose of supplying stock options at all. Instead, the Act deals with this scenario in a more abstract way and through a set of cross references which make the applicable provisions difficult to allocate and apply. It stipulates in § 71 (1) No. 8 AktG that a company may purchase its own shares after a resolution by a shareholders' meeting, provided that this resolution sets forth the lowest and

[6] See Weiß, Aktienoptionspläne für Führungskräfte, 1999, pp. 194-97.

[7] Hüffer, Aktiengesetz, 5th ed. 2002, § 192 annotation 21.

[8] Baums (ed.), Bericht der Regierungskommission Corporate Governance, 2001, p. 104.

[9] Fischer, ZIP 2003, 282, 283; Hoff, WM 2003, 910-11; Schäfer, NZG 1999, 531, 533; Schüppen, in: Seibert/Kiem (eds.), Handbuch der kleinen AG, 4th ed. 2000, p. 333.

[10] Krieger, in: Hoffmann-Becking (ed.), Münchener Handbuch des Gesellschaftsrechts, vol. 4, Die Aktiengesellschaft, 2nd ed. 1999, § 63 annotations 37, 31; Thoma/Leuring, Stock-Option-Pläne und Erwerb eigener Aktien, in: Achleitner/Wollmert (eds.), Stock Options, 2nd ed. 2002, pp. 193, 198; Weiß, Aktienoptionspläne für Führungskräfte, 1999, p. 247; Weiß, WM 1999, 353, 360-61; Wulff, Aktienoptionen für das Management, 1999, p. 45.

the highest price for the shares and that such purchase may not exceed ten percent of the share capital. The shareholders' meeting may also authorize the company to sell the shares without respecting § 53a AktG (Equal Treatment of Shareholders), which is always necessary when shares are only designated for a stock option plan. In this case § 71(1) No. 8 (4) refers to § 186 (3), (4) and § 193 (2) No. 4 AktG which shall apply "accordingly". § 193 (2) No. 4 AktG only mentions subscription rights for members of the management board and employees. It itself refers to § 192 (2) No. 3 AktG, which also only mentions employees and members of the management board.

The resulting question was whether §§ 193 (2) No. 4, 192 (2) No. 3 AktG, if applicable at all in the case of stock options for supervisory board members[11], apply "accordingly" in the sense that only the formal requirements of these sections are relevant (i.e. the content of the necessary shareholders' resolution) or whether the acquisition of shares is only allowed in the explicitly mentioned cases, i.e. for stock option programs for employees and members of the management board, but not for supervisory board members.

The *Landgericht* was of the latter opinion, the *Oberlandesgericht* of the former. Finally, the Federal Court of Justice adopted the latter view. More important, however, than these technical questions concerning the way the references are to be understood are the reasons the Court gives for this conclusion. It mainly argues with the history of the legislation and the intention of the legislator. §§ 71 (1) No. 8, 192 (2) No. 3, 193 (2) No. 4 AktG were introduced/amended by the so-called "*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*" (KonTraG) in 1998[12] to allow stock option programs in the form of naked warrants. Prior to those amendments, only convertible bonds had been allowed. Whereas the first draft of this new law ("Referentenentwurf") suggested to allow stock options in §§ 71 (1) No. 2, 192 (2) No. 3 AktG for members of a company's organ/body[13], the final law did not choose to adopt this broad term, including supervisory board members. The government reasoned that it would otherwise have been up to the supervisory board to decide about the conditions of its own compensation which are not decided upon by the shareholders' resolution under § 193 (2) No. 4 AktG[14]. Regardless of whether or not this would really have been the case, the legislator would at least have been able to amend the law to give the general meeting the power to decide

[11] Hereto, see the critique by Fischer, ZIP 2003, 282, 283.

[12] BGBl I (1998), p. 786.

[13] A reprint can be found in ZIP 1996, 2129, 2137.

[14] In the case of § 71 (1) No. 2 not even this resolution would have been necessary.

about all conditions of the stock option program[15]. According to the BGH, the fact that this was not done shows that the legislator did not want to extend stock option programs to supervisory board members. In addition, the Court's reasoning goes, the same considerations apply in the case concerning the company purchasing its own shares under § 71 (8) AktG where only the technique of "creating" shares is different, but not the potential conflict of interests.

Even more remarkable is how the reasoning of the Court reveals the general skepticism of the Judges with regard to stock options in general. Contrary to the *Oberlandesgericht* that stressed, in a surprisingly extensive opinion, the potential beneficial effects stock options may have as a corporate governance instrument[16], the BGH took the opposite position. In the Court's view the legislator did not want the remuneration of supervisory board members to be in line with the managers' compensation. According to the BGH, this is especially the case, as stock prices can be influenced or even manipulated and do not necessarily reflect the true (intrinsic) value of the stock or the long term success of the company. By this, the Court stressed that the supervisory role should not be influenced by the same incentives as managers have. With those statements the Court, arguably, went one step further than necessary for ruling on this case[17]. It made clear its very critical view of such stock option programs for supervisory board members in general. Even more, the Court did not stop there but went further to issue an obiter dictum.

II. The Obiter Dictum

Towards the very end of its opinion, the Court made a comment about the admissibility of stock options for supervisory board members in general. The only remaining (practical) legal way for stock options programs for supervisory board members after the judgment would have been through the issuance of convertible bonds. As already mentioned, until now, there was hardly any doubt as to the legality of this

[15] Claussen, WM 1997, 1825, 1830.

[16] OLG Schleswig NZG 2003, 176, 179. The Court even went as far as to utilize the German Corporate Governance Code to interpret sections of the Stock Corporation Act. As this code is not binding, this approach might at best be called surprising. Besides, the code does not mention stock options for supervisory board members as opposed to members of the management board, see No. 4.2.3 and 5.4.5 of the code. The German Corporate Governance Code is accessible online: http://www.corporate-governance-code.de/eng/download/DCG_K_E200305.pdf.

[17] Another more general effect of the Court's judgment is that it strengthens the independent supervisory role of the supervisory board that is a prominent characteristic of the German corporate governance system. For a recent discussion of the convergence/divergence debates of different corporate governance regimes, see Zumbansen, Innovation und Pfadabhängigkeit. Das Recht der Unternehmensverfassung in der Wissensgesellschaft, Frankfurt 2004, *forthcoming*.

approach. This, however, might change in light of the Court's ruling. The Court held in *obiter* that the intention of the legislator not to extend the new legislation of 1998 to members of the supervisory board might indicate that even convertible bonds might not be a legal means of compensating supervisory board members. Of course, the *obiter dictum* is not binding, as is, strictly speaking, neither the entire judgment except for the decided case. In practice, though, this decision will probably mean the end of almost all stock option programs for supervisory board members who will not be very likely to accept them as part of their remuneration package, in light of the doubt cast on their legality by the BGH[18].

In addition, it is difficult to predict the effects of this judgment. Although only stock options are affected by the decision, the discussion is already spreading further. For example, there is uncertainty among legal advisors whether the reasoning of the Court can also have some influence on other remuneration schemes like "phantom stocks", which are not stock options but cash payments that are calculated on the basis of real stock options[19].

D. Future Regulation

Albeit the Federal Court of Justice in its *obiter dictum* touched upon the question whether or not stock options for supervisory board members are illegitimate in their entirety, this question might soon be answered by the German legislator. On January 28th, 2004, the German Ministry of Justice proposed a law called "*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*" (UMAG) that puts forward several amendments to provisions in the Stock Corporation Act (*Aktiengesetz*). The main focus of the law is on shareholder suits and the introduction of the "business judgment rule" into written German law. According to a representative of the Ministry of Justice, one part of these amendments would also have the effect of foreclosing all ways of remunerating supervisory board members with stock options[20]. This conclusion is quite difficult to extract from the proposed amendments, however, and the intention cannot be found in the accompanying explanatory material either. According to the proposed law, § 193 (2) No. 4 AktG

[18] This uncertainty is criticized by Wiechers, DB 2004, 698.

[19] *BGH stellt Aktienoptionen für Aufsichtsräte generell in Frage*, BÖRSEN ZEITUNG, March 16th, 2004, p. 6. Daimler Chrysler AG had plans to put such phantom stocks for its supervisory board members to a vote at the upcoming shareholders' meeting (April 7th 2004). Due to these uncertainties, Daimler Chrysler AG will now abstain from the introduction, see *Daimler verzichtet auf Phantomaktien - Aktionärsschützer pochen auf Transparenz*, BÖRSEN ZEITUNG, March 24th, 2004, pp.1. 11.

[20] Professor Ulrich Seibert, head of the company law section at the German Federal Ministry of Justice, as cited in: *Berlin schließt Tür für Optionen an Aufsichtsräte*, BÖRSEN ZEITUNG, March 12th, 2004, p. 6.

would be amended in a way to be read in association with § 192 (1) No. 1 AktG. As an effect this would empower the shareholders' meeting to decide about the principles of conversion and subscription rights for holders of convertible bonds. In addition, this reference in § 193 (2) No. 4 AktG would be supplemented by the words "to grant subscription rights to employees and members of the management". Accordingly, this reference would not include supervisory board members. Especially in light of the judgment of the Federal Court of Justice, the result would likely be that the last possible way to provide supervisory board members with stock options, i.e. through convertible bonds, would also be inhibited.

E. Conclusions

After the judgment of the Federal Court of Justice, supervisory board members may not be remunerated with stock options (naked warrants) in the cases where the necessary shares are derived from a conditional capital increase or an acquisition by the stock corporation of its own shares. Arguably, as follows from the *obiter dictum*, even the issue of convertible bonds stands to be affected by the ruling. In addition, the legislator might clarify the latter and altogether ban stock options for supervisory board members. At the very least this would end the discussion about the legality of stock options for supervisory board members and eventually prepare the field for more coherence. Certainly, the prudence of introducing such a strict law should be open to more and thorough discussion in the weeks and months to come. This debate has gone for quite a while already, and one of the prominent voices, the German Government Commission on Corporate Governance (*Regierungskommission Corporate Governance*), chaired by Professor Theodor Baums, did not see any reason for a prohibition. Instead, the Commission did not recommend the introduction of naked warrants for supervisory board members as it thought convertible bonds to be sufficient[21]. In fact, stock options for remunerating supervisory board members might have some beneficial effects in some cases. For example, venture capital companies/start-ups might not have any other means for attracting qualified people for the supervisory board as liquidity might be low[22]. In that respect, it could be better to leave it up to the company and its shareholders to decide over the merits of introducing such a scheme, and to grant the shareholders' meeting the power to decide about the principles of such convertible bonds (§§ 193 (2) No. 4, 192 (2) No. 3 AktG). Although convertible bond schemes might contain many complicated elements with regard to communicating their value to the shareholder assembly, this might be less a problem in closely held companies. In addition, to exclude short-

[21] Baums (ed.), Bericht der Regierungskommission Corporate Governance, 2001, p. 104.

[22] See Baums (ed.), Bericht der Regierungskommission Corporate Governance, 2001, p. 239-40.

termism and the risk of manipulation, the company could decide on other criteria (benchmarks) that have to be met for these stock options.

It would also be possible to amend the German Corporate Governance Code accordingly. The German legislator, however, does not seem to have entirely warmed to the idea of self-regulation through a code of conduct. Instead, it seems, binding law and prohibitions are the preferred methods, at least for this particular issue.
Stock options might not be an appropriate way of compensating members of supervisory boards in most cases, but it may also be that strict legislation is not a good method of resolving this problem.

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