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**American Bar Association
Business Law Section
Corporate Committee
European Subcommittee**

„Shareholders' Rights in Europe – Work in Progress”

Boston, April 6, 2002

Presenter: **Prof. Dr. Gerhard Wegen**
Gleiss Lutz Hootz Hirsch
Stuttgart / Germany

CORPORATE GOVERNANCE

Germany

Gerhard Wegen / Christian Cascante / Michael Arnold
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Sources of Corporate Governance Rules/Practices

1. What are the primary sources of law and regulation relating to corporate governance, and the government agencies or the other entities responsible for enforcement?

Regulations with an impact on corporate governance of a German stock corporation (*Aktiengesellschaft*) are found in various corporate and securities laws. The primary source of law relating to corporate governance of German stock corporations is the Stock Corporation Act (*Aktiengesetz*).

Other relevant rules can be found in the following statutes:

- Securities Trading Act (*Wertpapierhandelsgesetz*): including insider trading rules, disclosure requirements in relation to price sensitive information, and reporting and publication requirements in respect of changes in holdings of voting rights.
- Take-over Law (*Wertpapiererwerbs- und Übernahmegesetz*): Take-over bids, rights and duties of the management of the target company
- Stock Exchange Admission Regulation (*Börsenzulassungsverordnung*)
- Commercial Code (*Handelsgesetzbuch*) and Civil Code (*Bürgerliches Gesetzbuch*): both containing basic regulation.
- Co-Determination Act (*Gesetz über die Mitbestimmung der Arbeitnehmer*).
- Works Council Act (*Betriebsverfassungsgesetz*).

There are no specific government agencies responsible for enforcement of corporate governance rules.

2. To what extent are corporate governance structures or practices mandated through listing rules?

Apart from specific notification requirements (e.g. for companies which want to be listed at the Neuer Markt), listing rules do not mandate specific corporate governance structures or practices in Germany.

3. To what extent do voluntary codes of governance best practice influence corporate governance practices?

Voluntary codes of governance best practice influence corporate governance practices in Germany. However, the extent is difficult to assess. The most influential codes are the Code of best practice / corporate governance principles by the German panel on corporate governance (*Grundsatzkommission Corporate Governance: Corporate Governance Grundsätze für börsennotierte Gesellschaften*) and the German Code of Corporate Governance by the Berliner Initiativkreis. The principles of corporate governance of the OECD have also influenced the corporate governance principles developed in Germany.

While some of the principles merely reflect the current legal status, the codes are not statutory law but only have an impact on the discussion of corporate governance in Germany and require acceptance/submission by companies in order to have effect.

Rights and equitable treatment of shareholders

4. What legal rights and responsibilities do shareholders have?

Under the German Stock Corporation Act, each shareholder has, notwithstanding the percentage of registered share capital he holds, the following rights in particular:

- a right to participate and express one's opinion in general meetings;
- a right to require information from the corporation (§ 131);
- a right of action to enforce his right to be informed by the corporation (§ 132 section 2, §§ 131 and 326);
- a right to vote in general meetings (§ 134);
- a right to contest resolutions of the general meetings (§§ 243, 245 and §§ 241, 249);
- a right of action in order to contest the validity of the composition of the Supervisory Board (§ 98 section 2 No. 3);
- a right of action to appoint a member of the Supervisory Board (§ 104 section 1);
- a right of action to have a court determine the compensation due under a profit transfer agreement (§ 304 sections 4 and 3).

In principle, the power to block certain decisions to be taken by the company is granted only to shareholders who hold a certain percentage of the shares in the company. For example, statutory law requires the consent of at least 75% of the registered share capital represented at the General Meeting (*Hauptversammlung*) for resolutions aimed to amend the Articles of Association.

The Articles of Association may provide that certain measures (such as the amendment of the articles of association) require the consent of 100 % of the registered share capital.

A general meeting shall be convened if shareholders whose aggregate holding is not less than one-twentieth of the registered share capital (or less if the articles of association state so) demand such meeting. Shareholders, whose shares amount in aggregate to not less than one-twentieth of the registered share capital or represent a proportional amount of not less than €500,000 may ask for items to be included on the published agenda, too.

Shareholders may only inspect the share register with respect to information relating to themselves, except the articles of association of non-listed companies provide otherwise.

Generally, each resolution of the general meeting shall be recorded in minutes of the proceedings in a notarial form. Immediately after the meeting, minutes are to be delivered to the Commercial Register and can be inspected by the public.

In general, shares are freely transferable. However, the articles of association may provide that the transfer of registered shares shall require the consent of the company.

5. What corporate decisions does the law reserve to the shareholders?

The General Meeting may only decide on such matters as expressly provided by statutory law or in the articles of association. Among the most relevant are the following:

- the appointment and dismissal of supervisory board members (only those who represent the shareholders and not those who are appointed according to Co-Determination Law);
- the appropriation of distributable balance sheet profit (*Bilanzgewinn*);
- the approval/ratification of the acts of the members of the management board and the Supervisory Board;
- the appointment of auditors in certain cases (§ 318 Section 1 Commercial Code, § 142 Section 1 *Aktiengesetz*);
- amendments of the articles of association, including capital increases and reductions and the dissolution of the AG;

- Restructuring (mergers, splits, changes of form), integration of a company into the AG and corporate agreements, particularly domination and profit transfer agreements;
- consent to agreements, whereby the company undertakes to transfer all (or substantially all) of its assets;

Furthermore, the courts have developed a doctrine whereby the General Meeting has to decide on certain decisions of fundamental importance. However, the details of this “*Holz Müller*” doctrine are a matter of lively legal debate.

The general meeting is only entitled to approve the financial statements if the management board and the Supervisory Board decide so or if the Supervisory Board does not approve the financial statements.

6. To what extent are disproportionate voting rights allowed?

The general principle is “one share one vote”. Preferred shares with no voting rights may be issued. However, only half of the registered share capital of a corporation may be composed of preferred shares without voting rights. Preferred shareholders may participate in general meetings and are granted a (mostly dividend related) preference as a compensation for the lacking voting rights.

Multiple voting rights (*Mehrstimmrechte*) and maximum voting rights (*Höchststimmrechte*) were allowed in Germany in the past and designed primarily to serve as protection against foreign control and hostile takeovers. Since few years - based on the *KonTraG* a law which amended several provisions relevant for corporate governance -, multiple voting rights are prohibited, as are maximum voting rights in companies admitted to the stock market. However, special transitional provisions apply to multiple and maximum voting rights which were already in existence.

7. Are there any special requirements for shareholders to participate in AGM or vote?

In 2001, the “law on registered shares” (*NaStraG*) introduced several amendments to German law which made it easier for shareholders to exercise their vote in General Meetings. As a general matter, voting in a GM requires the person who exercises the voting rights to be present at the meeting. However, the person exercising the rights must not be “the” or even a shareholder. Voting rights may be exercised by a proxy. The power to exercised the vote has to be granted in writing. However, under the new rules, shareholders may delegate authority to other persons, follow the General Meeting on the internet and deliver specific orders on how to vote by e-mail.

8. Do controlling shareholders owe duties to the company or to non-controlling shareholders? If so, can an enforcement action against controlling shareholders for breach of these duties be brought?

Any shareholder owes duties to the company and to other shareholders. This is a general principle which has been developed by the courts. Such principle includes a duty to promote the purpose of the company, a prohibition to damage the company and a further duty to execute the rights and possibilities shareholders have to exert influence in a responsible manner.

Minority shareholders may contest shareholder resolutions which violate the shareholder duties (according to the courts in an analogy to § 243 Sec. 2 *Aktiengesetz*). Based on said violation, minority shareholders may also bring an action for damages, for omission, for information or for certain actions against the majority shareholder.

The company may also bring an enforcement action against shareholders based on their violation of shareholder duties.

9. In the event of a merger, takeover, privatisation, or other corporate transaction, what are the rights of minority shareholders?

The rights of minority shareholders vary depending on the kind of corporate transaction which may affect them. In the event of a statutory merger, shareholders of the transferring company become shareholders of the acquiring company. As a result of such merger, the shareholders of the merging company, which ceases to exist in the course of the merger, have a claim to additional cash payments, if the shares do not grant an appropriate compensation for the loss of their old shares. Furthermore, a merger requires a 75 per cent of the registered share capital represented at the general meeting. Thus, minority shareholders may impede the merger if they exceed the required thresholds. However, only shareholders of the acquiring company may bring a shareholder law suit against the merger resolution based on the allegation that the conversion rate is too low.

In the event of a public takeover, the target shareholders “vote on the merger” via their decision to either tender their shares or keep them.

As a general matter, most restructuring or other major transactions require a 75 per cent majority. If a shareholder resolution is required, minority shareholders have a chance to challenge such resolution. In the event that the registration of the resolution is a requirement for validity of the transaction - as is the case for example with a merger - a challenge may impede and delay registration and therefore validity of the transaction.

The new Takeover Law also introduced an amendment to the Stock Corporation Act according to which a shareholder holding more than 95 per cent of the registered share capital can demand that the general meeting resolves on the expulsion of the minority shareholders against fair cash compensation. Their shares are transferred by law to the principal shareholder. Shareholders cannot attack the squeeze-out resolution based on the allegation that the cash compensation is unfair but bring a claim for additional cash payments before court.

Corporate Control

10. Are anti-takeover devices prohibited or allowed?

In principle, there is a number of mechanisms that can be put in place by the management board or the general meeting of German stock corporations in order to frustrate hostile bidders, although there are several legal restrictions on what can be done. While the most effective protection of German corporations is offered through structural devices such as the two tier board-system and the Co-determination, additional measures to be considered include:

- premature use of ad-hoc disclosure;
- restricting the information the target provides;
- making negative (but reasoned) comments in response to the offer;
- existing shareholders can conclude agreements to vote uniformly to establish a blocking minority against certain decisions. Such agreements may be void and even if valid, will not render invalid any votes exercised in violation of the agreement;
- converting ordinary shares into preference shares without voting rights. Only 50% of the registered share capital of the company may be made up of preferred shares and the resolution has to be approved by the affected shareholders;
- issuing new preference shares or convertible bonds to certain shareholders (meaning that pre-emptive rights of existing shareholders would have to be excluded, which is difficult to realise);
- employees holding a high percentage of shares (because such employees traditionally vote against hostile bids);
- buying back shares: this procedure was simplified and therefore made more attractive in 1998, but is still limited to 10 per cent of the company registered share capital and subject to other restrictions;
- increasing the company's registered share capital and excluding the pre-emption rights (*Bezugsrecht*) of the old shareholders. This can merely be done with 75 per cent consent of the general meeting and most effectively only if the new share capital has been authorised beforehand and if there are reasons other than the takeover which allow for exclusion of pre-emptive rights of existing

shareholders. Furthermore, the duty to treat all shareholders equally has to be complied with;

- acquiring other companies;
- making structural changes to the company: this is subject to a consent requirement at the general meeting;
- cross-shareholdings (which are subject to several statutory restrictions);
- 'golden parachute' provisions: these can lead to liability of the management or supervisory board and therefore, are not workable in practice. Furthermore, they are now expressly forbidden in the Takeover Act;
- disposing of strategic assets ('crown-jewel defence'): this can be subject to a consent requirement at the general meeting and lead to liability of the management board;
- staggered board defence;
- granting the right to certain shareholders to appoint supervisory board members;
- requiring high qualified majorities for certain decisions (for example, composition of the supervisory board, amendment to the articles of association, proposed mergers or structural changes to the corporation);
- having registered shares and making their transfer subject to the consent of the company (*vinkulierte Namensaktien*). Because the consent of all other affected shareholders is necessary, this is only possible in practice if it was established in the company formation documents (the original articles of association);
- obligatory restrictions on the transferability of shares, for example, a right of first refusal. If breached, these result in liability on the part of the transferor although the transfer is valid;
- the use of the poison pill defences (for example, "flip-in" or "back-end" provisions) is restricted by the target's duty to treat all shareholders equally.

Permitted Actions under the new Takeover Act

As of January 1, 2002, a new Takeover Act came into force, stating that after the decision to launch the offer was published, the management board is subject to a general duty of neutrality. Thus, it must not take any action which could frustrate the success of the bid. However, the Act expressly permits the following actions of the Management Board (without further approval of the General Meeting):

- searches for white knight;
- actions which would have reasonably been taken if no offer had been launched, e. g. measures in the ordinary course of business; measures to execute contractual obligations entered into before the bid;
- any action approved by the supervisory board.

The last permit has been introduced by the German government in a last minute amendment in November 2001 and has significantly changed the balance of the provision, shifting competence from the shareholders to the board.

Furthermore, the general meeting may authorize the management board to take actions in order to prevent the success of takeover bids before and independent from any takeover offer. Said authorisation is valid only for 18 months and requires a qualified majority (75 per cent) of the registered share capital represented at the general meeting. Actions have to be approved by the supervisory board.

Due to the last minute amendment referred to above, only “the kind” of action has to be set forth in the shareholders’ resolution. The former draft provided for a detailed description of the proposed actions.

The last-minute amendments introduced in November have significantly changed the situation regarding hostile takeovers and disregard findings of economic theory. However, their negative impact could be mitigated by the fact that the pressure by institutional shareholders will prevent most listed companies from using the mechanisms available.

11. Are share-transfer restrictions allowed?

Share transfer restrictions are not allowed. However, there is one exemption: The transfer of registered shares may be subject to the consent of the company (§ 68 Section 2 *Aktiengesetz*). Said restriction needs to be resolved via the general meeting and set forth in the articles of association of the corporation.

12. Are compulsory share repurchase rules allowed? Can they be made mandatory in certain circumstances?

Previously it was only possible for a company to repurchase its own shares in exceptional cases. The *KonTraG* has significantly relaxed the general prohibition. Companies may now repurchase their own shares on the basis of an authorization by the shareholders' meeting, which is valid for a maximum of 18 months. This authorization must establish the lowest and highest purchase price, as well as the amount of the registered share capital to be acquired, which must not exceed 10 % of the company’s registered share capital. The authorization may, but need not, state the purpose of the acquisition, e.g. for subsequent redemption or to service stock option plans for members of the company's management. However, the purpose cannot be to trade in one's own stock.

Owing to the principle of equal treatment of shareholders, a resale must, as a rule, be offered to all the shareholders; however, this requirement is fulfilled if the shares are acquired and sold on the stock market. Should the General Meeting wish to allocate the shares freely or to certain third parties in deviation from the equal treatment principle, this can only be done under very strict conditions. In particular, the shareholders' resolution must meet a $\frac{3}{4}$ majority and have an objective justification.

Responsibilities of the board (supervisory)

13. Is the predominant board structure for listed companies best categorised as one- or two-tier?

In Germany, only stock corporations (AG) and – very occasionally - companies limited by shares (KGaA) can be listed on the stock exchange. AGs always have a two-tier structure with an (executive) management board and a supervisory board.

Decision-making ability in relation to a German Stock Corporation is split between its three organs and can be summarized as follows:

- Management Board (*Vorstand*): day-to-day business of the corporation;
- Supervisory Board (*Aufsichtsrat*): supervision of corporation (including of Management Board) without having the competence to make any executive decisions in relation to the corporation; and
- Shareholders in General Meeting (*Hauptversammlung*): decision-making ability and mandatory prior approval only if statutory provisions or the Articles of Association of the corporation provide for it, the Management Board asks the General Meeting to decide, or if the Management Board cannot reasonably assume that it is entitled to take the relevant decision exclusively in its own responsibility because of its significant impact on the corporation or the rights and interests of its shareholders.

It is important to appreciate that the two boards (Management Board and Supervisory Board) are distinct organs (e.g. they cannot have members in common) having different rights and duties.

The mandatory rules of corporate governance in Germany prescribe that the general meeting appoints and removes the members of the Supervisory Board, which in turn appoints and removes exclusively the members of the Management Board. The General Meeting cannot directly remove and appoint any member of the Management Board. The control over the executives is secured via the Supervisory Board. In the case that German Co-determination rules apply, the members of the Supervisory Board are partly appointed by the employees. These members cannot be removed or appointed by the General Meeting at all.

14. What are the board's primary legal responsibilities?

The supervisory board is responsible for the appointment and dismissal of members of the board of directors. It is also and primarily responsible for supervising the management, and hence the management board (§ 111 AktG), and for representing the AG towards the members of the board of directors (§ 112 AktG). Since the *KonTraG* entered into force, the Supervisory Board has commissioned auditors to perform the audit of the annual financial statement (§ 111 Section 2 *Aktiengesetz*).

15. Who does the board represent and to whom does it owe legal duties?

(The company? Employees? Other stakeholders?)

The Supervisory Board, like the Management Board has to act in the interest of the company, not of its shareholders.

16. Can an enforcement action against directors be brought on behalf of those to whom duties are owed?

An enforcement action against the Management Board members may be brought by the Supervisory Board members on behalf of the company. In some cases actions must be brought by them. The Supervisory Board must (i) check whether there is a claim and whether it is enforceable, and (ii) check whether it should be enforced. The discretion as to this is according to the German High Court relatively limited. Unless there are overriding interests of the company claims must be enforced. In general, there is a business judgement rule concept with respect to the scope of the conduct of the business.

Claims of the company for damages against board members which have arisen in connection with the management must be asserted if the general meeting so resolves by simple majority or if a minority, whose aggregate holdings are at least one-tenth of the registered share capital so requests. However, the concept of direct law suits brought by shareholders against the management board is still subject to legal dispute.

Furthermore, in some events creditors of the company may bring actions against the management board.

As regards the Supervisory Board members, actions may be brought by other supervisory board members or by Management Board members on behalf of the company, in few cases by shareholders or creditors of the company.

17. Do board duties include a care/prudence element or a loyalty element?

Yes. The board has to act in the best interests of the company. In the event that there is a conflict of interests, other interests must be subordinated to the ones of the company. The Supervisory Board members are also subject to a duty of care set forward in §§ 116, 93 Section 1 *Aktiengesetz*. The board members have to fulfill their tasks and pursue their duties personally and responsible and must not delegate them to third parties (§§ 101 Section 3 Sentence 1, 108, Section 3 und 111 Section 5 *Aktiengesetz*). The Articles of Association may, however, provide, that the Supervisory Board members grant written power of attorney to other persons, if they are not in the position to participate in Supervisory Board meetings.

The Supervisory Board may delegate its tasks to committees, with the exceptions that a committee may not resolve on, but prepare:

- election of the chairman of the Supervisory Board and his substitute;
- discharging the Chairman of the Supervisory Board;
- election of members to the Management Board;
- election of a Chairman of the Management Board;
- determination of consent requirements for certain actions of the Management Board.

18. To what extent can the board delegate responsibilities to management, a board committee or person?

The Supervisory Board can generally delegate tasks to committees consisting of Supervisory Board members, subject to the limitations outlined above in Question 17. However, committees which *decide* for the Supervisory Board may at least consist of three members. In general, tasks of the Supervisory Board may not be delegated to the Management Board nor third parties.

19. Is there a minimum number of “non-executive” and/or “independent” directors required by law, regulation, or listing requirement? If so, what is the definition of “non-executive” and/or “independent” director?

Assuming that all members of a Supervisory board are non-executive, the minimum number for members in an AG is three. However, statutory law draws no distinction as to executive or non-executive board members.

20. Do law, regulation or listing rules require separation (or joining) of the functions of board chairman and CEO?

Members of the Supervisory Board must not be members of the Supervisory Board at the same time. Thus, the Chairman of the Supervisory Board can never be the CEO of the company. Furthermore, no measures of daily management of the company may be delegated to the Supervisory Board.

21. What board committees are mandatory? What board committees are allowed?

(Specify for what functions) Are there mandatory requirements for committee composition (e. g. “independence”)?

There are no mandatory board committees. The only exception is a mediation committee (*Vermittlungsausschuss*) according to § 27 Section 3 Co-determination Act. This committee is implemented, if election of a member to the Management Board is not completed on the first attempt and only applies to companies subject to the Co-determination Act.

The Supervisory Board is free to implement any other board committees to prepare its meetings. With the restrictions mentioned above, the board is also free to install committees which are competent to decide specific issues. Committees must be composed of Supervisory Board members.

22. Is a minimum or set number of board meetings per year required by law, regulation or listing requirement)?

In stock corporations listed on a stock exchange, at least four board meetings per year are required. The Supervisory Board shall meet at least once a quarter and must meet twice in any calendar half year.

23. Is disclosure of board practices requires (committee structure, number of meeting, attendance etc.) by law, regulation or listing requirement?

Only the composition of the Supervisory Board must be disclosed.

24. What role do employees play in corporate governance?

The German co-Determination system leads to a relatively strong position of employees with respect to corporate governance. Pursuant to § 76 of the Works Council Constitution Act (*Betriebsverfassungsgesetz - BetrVG*) of 1952 in connection with § 129 of the Works Council Constitution Act of 1988, if an AG has between 500 and 2,000 employees, one third of its supervisory board must consist of representatives of the employees who have been elected by them in a general, secret and direct election. In calculating the number of employees, the employees of units of a group company are deemed to be employees of the dominant company if a control agreement exists between the companies or the dependent company is integrated into the dominant company (§ 77a *Betriebsverfassungsgesetz* of 1952). Employees of foreign subsidiaries are not relevant for the number of employees with respect to Codetermination. There are no other particularities in this regard.

If the AG has more than 2,000 employees, it is subject to the Co-determination Act (*Mitbestimmungsgesetz*). That means that half of the Supervisory board members must be representatives of the employees. If the AG is the dominant company of a group, in calculating the number of employees, the employees of the group company are deemed to be employees of the dominant company (§ 5 *Mitbestimmungsgesetz*). Foreign employees are not counting.

Disclosure and transparency

25. Are the corporate charter and by-laws of companies publicly available? What are companies required to publicly disclose?

Corporate information of a company is available from the commercial register where the company is registered. The name, seat and registered share capital of the company, the composition of the Management and Supervisory Board and certain corporate transactions, like domination agreements, statutory mergers have to be disclosed in the commercial register. Furthermore, the articles of association have to be filed with the commercial register and are publicly available.

Depending on where the company is listed, financial results have to be disclosed on a quarterly basis or are at least available and will be sent at request by the company.

An electronic register where information on all companies is available is in preparation.