



## **- THE DIVISION OF POWERS BETWEEN ADMINISTRATIVE AND SUPERVISORY BOARD -**

### **Introduction**

This paper focuses on the distribution of powers between administrative and supervisory board in public companies. It concentrates on dangers due to influences of the supervisory board on the management of the administrative board and its avoidance.

In Germany the two-tier system applies. Therefore, the managing administrative board is supervised by the supervisory board. Firstly, the supervisory board only had a supervising function, which has changed to a supervising and consultancy function. Recently, the role of the supervisory board has been strengthened due to amendments to the German Stock Corporation Act (AktG). As a result, e.g. the possibility of the supervisory board to define transactions which are subjected to its agreement has changed into an obligation, § 111 Abs.4 S. 2 AktG; and the body has to hold meetings more frequently. Therefore, the supervisory board is able to advise, to direct and to participate in management decisions. However, the enlargement of possibilities to supervise the administrative board leads to the problem of too much influence on the management of the company, as § 111 para.4 S. 1 AktG defines, that it is forbidden to transfer transaction of management to the supervisory board.

### **Administrative Board**

Leading duties of an administrative board in a public company are management, § 76 para. 1 AktG, as well as judicial and non-judicial representation of the company, § 78 para. 1 AktG. Management means that the body is responsible for any decisions internally. Representation includes judicial and non-judicial representation. The powers can only be limited internally, not against third parties. The administrative board is not subjected to directives of the supervisory board, the general meeting or third parties. The supervisory board is responsible for appointment, withdrawal, employment and cancellation of the members of the administrative board. The following table gives an overview of duties and responsibilities of the administrative board of a public company in German law.

<b>Duties and Responsibilities of the Administrative Board to the Company</b>		
<b>Due to the Body</b>		
<b>Leading Duties</b>	<b>Loyalty Duties</b>	<b>Other Duties</b>
Management, § 77 para. 1 AktG	Obligation of secrecy, §93 para. 1 s. 2 AktG	Accountancy, § 91 para. 1 AktG and reporting, § 264 para. 1 HGB, as well as presenting the balance sheet, §§ 172 et sqq AktG
Judicial and non-judicial representation, § 78 para. 1 AktG	Keeping to the non-competition clause, § 88 AktG	Establishing of a controlling system, § 91 para. 2 AktG
	Keeping to the formal and approval requirements for essential transactions due to the statute, § 119 para. 2 AktG	Reporting and information, §§ 90, 131 AktG; for listed public companies: §§ 15, 15a WpHG, § 161 AktG
		Maintenance of capital, §§ 57 ff., 71 ff. AktG, cp. also § 93 para. 3 AktG
		Risk limitation and timely file for bankruptcy, § 92 AktG
		Preparation to and convening of the general meeting, §§ 83, 121 para. 2 AktG
		Issue of a compliance statement (together with supervisory board), if listed on the stock market, § 161 AktG
<b>Due to the Employment Contract</b>		
<b>Leading Duties</b>	<b>Loyalty Duties</b>	
Provide manpower in total	(Post-contractual) non-competition clause	
Forbiddance or obligation to obtain an permit or duty to assume an office or additional business	Disclosure of conflicts of interests	
Obligation of secrecy		
Returning of documents after leaving the company		
<b>Duties and Responsibilities of the Administrative Board to Business Partners and to the General Public</b>		
Informing about company crises	Observing of singular forbidding laws	Respecting of objects of legal protection of third parties

## Supervisory board

The supervisory board is responsible for supervising and controlling as well as advising the administrative board, § 111 para. 1 AktG. It is not possible to transfer management transaction to this body, § 111 para. 4 s. 1 AktG. Furthermore,

members are not allowed to take more than ten seats in different supervisory boards. The position as chairman counts twice towards the maximum of seats.

The following table gives an overview of the duties and responsibilities of the supervisory board. Please The obligations to business partners and to the general public are identical to those of the administrative board.

<b>Duties and Responsibilities of the Supervisory Board to the Company</b>		
<b>Controlling Body</b>	<b>Administrative Duties</b>	<b>Obligations of secrecy</b>
Supervising of the management, § 111 para. 1 AktG	Appointment, withdrawal, employment and cancellation of the members of the administrative board, assessing of adequate payment, §§ 84, 87 AktG	Obligations of secrecy, §§ 93 para. 1 s. 2, 116 s. 1 AktG
Concretion of duties of the administrative board to provide reports and information, § 111 para. 2 AktG	Appointment of auditor, § 111 para. 2 s. 3 AktG	
To place the audit assignment, § 111 para. 2 s. 3 AktG	Representation of the company to the administrative board, § 112 AktG	
Duty to define transactions which are subjected to agreement, § 111 para.4 s. 2 AktG (mixture of controlling and management)	Representation of the company by actions (together with the administrative board), §§ 246 para. 2 s. 2, 249 para. 1 s. 1 AktG	
	Auditing and declaration of the annual report, §§ 171, 172 AktG and involvement in returned earnings, § 58 para. 2 AktG	
	Convening of the general meeting, when the good of the company requires it, § 111 para. 3 AktG	
	Decision about granting a loan to members of the administrative board, § 89 AktG	
	Issue of a compliance statement (together with administrative board), if listed on the stock market, § 161 AktG	

### **Duty of Supervision and Consultancy of the Supervisory Board**

The supervisory board has to supervise the administrative board. Nowadays, this duty combines supervision, which can be defined as control of the past, and consultancy, which is future-oriented.

The supervisory board has to control everything, which has to be reported to him by the administration board. Therefore, the term management in § 111 para. 1 AktG is

not as wide as the term management used in § 76 para. 1 AktG. An example of this supervisory duty is controlling of the annual report. The body shall gain an independent opinion about the management of the administration body.

The aim of the future-oriented consultancy of the administrative board is to avoid mistakes, which can lead to crisis in the future. For this purpose the supervisory board is a constant partner and consultant of the administrative board.

There are different instruments which can be used for supervision and consultancy by the body. However, the use of these instruments can easily lead to major problems, especially when they are used in an inappropriate way.

### **Selection of three important Supervising Instruments and Dangers**

#### **- Members of the Administrative Board**

The supervisory board is responsible for appointment, withdrawal, employment and cancellation of the members of the administrative board, § 84 AktG. This competence could become a problem, if the supervising body uses this power to steer the company on its own course. For example, the supervisory board can only appoint or re-appoint members, which act as wanted by the supervising body. Additionally, the threat of withdrawal can lead to dependent decisions of the administrative board, following the opinion of the supervisory board. If a member has faced trouble with the supervisory board or has been known as "queer fellow", he might decide as the supervisory board wishes, to maintain his current position.

Furthermore, the supervisory board assess an adequate payment for the members of the administrative board and may appoint the chair. As an exception, the supervisory board is allowed to delegate one of its own members to the administrative board to replace a permanent absent member.

In conclusion, these competences can lead to an indirect influence and navigation of companies politic instead of pure supervising by the supervisory board.

#### **- Organisation of the Work in the Administrative Board**

Necessarily, internal work of the administrative board has to be organised. For this purpose, the supervisory board is entitled to give internal rules of procedure to the administrative board due to the constitution of the company or due to own initiative. Internal rules of procedure given by the administrative board before, will be replaced by rules, given by the supervisory board. The competence of the administrative board is therefore subsidiarily. The rules can define working procedures as well as occupational distribution.

On the one hand, it can be an advantage to be given internal rules of procedure by an outstanding body, as this body does not have own interests. On the other hand, it can be a problem, as a third person does not know the requirements as well as a member of the body. Furthermore, the rules can be close meshed. In consequence, the administrative body will not be able to act as needed.

To conclude, the organisational powers of the supervisory board can convert the duty of supervising factual into a leading position of this board.

## **Definition of Transactions which are subjected to Agreement**

Due to § 111 para.4 s. 2 AktG, the supervisory board has to define transactions which are subjected to its agreement. This instrument is a binding duty since 2002. Therefore, the supervisory board has to take over a higher degree of responsibility for the company and has to act more active. Transactions which need to be agreed upon, can either be defined in the statute of the company or in the internal rules of procedure of the administrative board. However, the supervisory board has to agree upon this transactions in both cases. If it refuses the agreement, the administrative board has the right to ask the general meeting to replace the refused agreement with a permitting resolution. Nevertheless, the refused agreement is only binding internal, not external.

The statute does not define which transactions need to be agreed upon due to a wide range of different public companies with different needs. Therefore, such agreements should be called upon for fundamental strategic or financial decisions, but not for every single transaction. Additionally, the supervisory board has the allowance to define ad hoc reservations if necessary.

Those resolutions break the separation of supervisory and management, as the administrative board cannot act without the agreement of the supervisory board. A danger could be capulation of the administrative board and acting as the supervisory board plans to avoid disagreements. Another problem occurs if the supervisory board defines wrong or too close meshed reservations.

## **Conclusion**

In conclusion, the influence of the supervisory board on the administrative board cannot be denied. This leads especially to problems, if the supervisory board uses its instruments improperly.

In addition to the above mentioned problems the supervisory board can also pervert the administrative board of adequate work, if its requests a high amount of or irrelevant reports or uses its right of inspection extensively.

Another problem occurs if a member of the administrative board changes into the supervisory board, which happens quite often in Germany in the meanwhile. The member of the supervising body controls the own former actions and defines its own pensions as well. Otherwise, a former member of the administrative board has valuable knowledge, which can improve the work of the supervisory board. Additionally, it is useful to maintain a cooling-off period of two years. After this period, the danger of personal involvement will be limited and the knowledge can be saved.

To avoid the mentioned problems, it is recommended to be extremely careful with the selection of members of the supervisory and the administrative board. Secondly, it should be assured that all members keep internal and external rules to clear the way for a trustful and responsible cooperation. Additionally, the recommendations of the German Governance Codex should be adhered to, to avoid these problems concerning the separation of powers.

In conclusion, the separation of supervisory and administrative body in the two-tier system is desirable and should be kept. However, it is necessary to assure the independence of the administrative board. Therefore, it has to be assured that the supervising body is only integrated in the management as far as the boundance of taking over management tasks is kept.

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## **Annex: Translation of important paragraphs of the German Stock Corporation Act**

### **§ 76 Leitung der Aktiengesellschaft**

(1) Der Vorstand hat unter eigener Verantwortung die Gesellschaft zu leiten.

### **§ 76 Leading of the Public Company**

(1) The administrative board has to lead the company on its own responsibility.

### **§ 77 Geschäftsführung**

(2) Der Vorstand kann sich eine Geschäftsordnung geben, wenn nicht die Satzung den Erlaß der Geschäftsordnung dem Aufsichtsrat übertragen hat oder der Aufsichtsrat eine Geschäftsordnung für den Vorstand erläßt.

### **§ 77 Management**

(2) The administrative board can issue internal rules of procedure, if the statute has not assigned the issue of internal rules of procedure to the supervisory board or the supervisory board issues internal rules of procedure for the administrative board. [...]

### **§ 78 Vertretung**

(1) Der Vorstand vertritt die Gesellschaft gerichtlich und außergerichtlich.

### **§ 78 Representation**

(1) The administrative board represents the company judicially and non-judicially.

### **§ 84 Bestellung und Abberufung des Vorstands**

(1) Vorstandsmitglieder bestellt der Aufsichtsrat auf höchstens fünf Jahre.

### **§ 84 Appointment and Withdrawal of the Supervisory Board**

(1) Members of the administrative board are appointed by the supervisory board for a maximum of five years. [...]

### **§ 111 Aufgaben und Rechte des Aufsichtsrats**

(1) Der Aufsichtsrat hat die Geschäftsführung zu überwachen.

(4) Maßnahmen der Geschäftsführung können dem Aufsichtsrat nicht übertragen werden. Die Satzung oder der Aufsichtsrat hat jedoch zu bestimmen, daß bestimmte Arten von Geschäften nur mit seiner Zustimmung vorgenommen werden dürfen. [...]

### **§ 111 Duties and Rights of the Supervisory Board**

(1) The supervisory board has to supervise the management.

(4) Management transactions can not be assigned to the supervisory board. The statute or the internal rules of procedure have to declare certain business, which are subjected to an agreement of the supervisory board.