Corporate Governance Provisions of the Hungarian Company Act of 2006

Dr. András Kecskés PhD
Assistant Professor
University of Pécs Faculty of Law
Department of Business and Commercial Law

The past decade brought special focus to corporate governance. The process was largely effected by experiences deriving from frauds and corporate scandals. As a part of the 2006 Hungarian company law reform many of the Anglo-saxon corporate governance provisions where adopted in the new Hungarian Company Act. The flexible implementation of those rules neared the system of Hungarian corporate governance to the International and European standards offering the investors a broad scale of various practices.

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I. **The system of the regulation pertaining to corporate governance: *soft law* and legislation**.

The legal framework of corporate governance comprises two types of regulation in Europe and in Hungary. There has been no need for central regulation in the EU. Nevertheless, the *European Corporate Governance Forum* encouraged the Member States through its recommendation to apply the so called *comply or explain* model in the course of drafting their own corporate governance recommendations. Its core is that the body of corporate governance regulation has not been created at statutory level but as so called *soft law* in the form of recommendations. When making these recommendations, EU Member States generally[1] avoided involving governments and their content was mainly defined by expert committees, the members of which were prominent business persons.[2]

The United Kingdom, where the elaboration of corporate governance recommendations began as early as 1992, subsequent upon the *Robert Maxwell*[3] corporate

[1] In Germany the recommendations (Deutsche Corporate Governance Kodex), though also destitute of statutory status, were created by a government committee (Regierungskomission) led by Gerhard Cromme.
[2] Wymeersch, Eddy, *Implement of the Corporate Governance Codes,* 403-419 in Corporate Governance in Context Corporations, States and Markets in Europe, and the US (Hopt, Klaus J.- Wymeersch, Eddy- Kanda, Hideki- Baum, Harald (eds.), Oxford University Press, 2009)
[3] Ian Robert Maxwell (1923-1991) was a Brit media-magnate of Czechoslovakian origin, who built up his huge enterprise by fraudulent transactions and manipulations through pension funds. The empire built up by him collapsed soon after his death due to his fraudulent dealings.

scandals, and well before the EU focused on this area, was in the forefront of this process. In 1998 the work of the *Cadbury, Greenbury and Hampel Committees* led to the adoption of the *Combined Code on Corporate Governance* (*UK Corporate Governance Code* from 2010), which as a so called *code of best practice* can be regarded as a recommendation on exemplary practice. The small binding force of these recommendations stems from the fact that in respect of their application stock exchanges (in the case of the *UK Corporate Governance Code* the *London Stock Exchange*) stipulate requirements for listing. The core of the *comply or explain* approach is that compliance with the recommendations is not a precondition to get listed on the stock exchange, but non-compliance must be explained. This solution sharply contrasts with the model adopted in the United States, where the strictest statutory binding force prevails in these fields. (The *Sarbanes-Oxley Act* was adopted in 2002, the violation of its provisions may even entail criminal responsibility.)[4]

The content of *corporate governance soft law* (recommendations and reports) is obviously determined by the respective Member State committees in line with EU directives and recommendations. Since 2002 (in other words in the *post-Enron* era) the EU has been showing an ever-intensifying interest in regulating this field. Transparency in and control of the working of corporations, the appointment and remuneration of directors, auditing, internal control, committee work and the applicability of governance models are at the heart of the content of regulation.[5]

Although the recommendations adopted at Member State level (*UK Corporate Governance Code* – United Kingdom, *Deutscher Corporate Governance Kodex* – Germany, *Vienot Reports* – France,[6] *BÉT Corporate Governance Recommendations* – Hungary, etc.) are not statutory instruments, in respect of their content they should fit into the legal system of the given state. Accordingly, some states may regulate the place of certain legal institutions by the recommendations, whilst others may regulate the same institutions in the framework of statutory regulation. An excellent example of this is the issue of corporate governance models (one-tier and two-tier models) which is dealt with in detail at the level of recommendations in the United Kingdom whilst in Hungary it is part of company law.

At this point our train of thought has reached the issue constituting the core of this study, namely the other type of regulation pertaining to corporate governance. It comprises the legal institutions which are defined at statutory level and not at the level of recommendations. These provisions govern the institutions of corporate governance as binding statutory regulation and not as *soft law*. A number of such provisions have been

[4] See Garrett, Allison Dabbs, *A Comparison of United Kingdom and United States Approaches to Board Structures*, The Corporate Governance Law Review (2007) Vol. 3. 93-114.

[5] Davies, Paul L., *Enron and the Corporate Law Reform in the UK and the European Community* 163-190. in Corporate Governance in Context Corporations, States and Markets in Europe, and the US (Hopt, Klaus J.- Wymeersch, Eddy- Kanda, Hideki- Baum, Harald (eds.), Oxford University Press, 2009.)

[6] Charreaux, Gérard; Wirtz, Peter: *Corporate Governance in France* 301-310. in Corporate Governance (N. Kostyuk- U.C. Braendle- R. Apreda (eds.), Virtus Interpress 2007)

See also Storck, Michel, *Corporate Governance a la Francaise – Current Trends,* European Company and Financial Law Review (2004) Vol. 1. 39., Gal, istvan Laszlo: The Fight against Money Laundering in Hungary (=Journal of Money Laundering Control Volume Eight, Number Two, December 2004., UK, London, 186-192. p., társszerző: Dr. Tóth Mihály)

See also J. Hopt, Klaus, *Le gouvernment d'entrprise – Expériences allemandes et européennes,* Rev. sociétés (2001) 1.

introduced or reconsidered since the reform of Hungarian company law in 2006. It is typical that a great number of Western-European (including distinctly Anglo-Saxon) legal institutions have been transplanted. In addition, the objectives of the legal policy of the EU (simple, swift and cheap market entry and operation) have also been included in the regulation, which has made it more flexible – think of the increase in the proportion of dispositive provisions at the expense of cogent ones. The rest of this study is devoted to the analysis of some marked *corporate governance* provisions of Hungarian company law examining whether their adoption was of a campaign-like nature for the semblance of modernisation and compliance or they organically fit into the structure of Hungarian corporate governance.

II. The institutions of corporate governance in the Hungarian Companies Act

1. The impact of the general meeting held by conferencing and telecommunication and information technology on the rights of investors

In 2006 the provisions of the companies act pertaining to the supreme body made it possible for members or their proxies to exercise their rights by the help of modern telecommunication devices and not only in person. A meeting held by video-conferencing is called a general meeting held by conferencing, nevertheless not only public limited companies may hold such meetings. It should be noted that the law allows for such an option only subject to provisions to this effect in the articles of association.

In respect of corporate governance a general meeting held by conferencing is an effective and swift way of exercising proprietors' rights. Obviously, in practice its applicability facilitates the exercise of membership rights entailed by concentrated investments.

It should be highlighted that in respect of the exercise of shareholders' rights, in addition to the provisions ensuring procedural rights, there is also a need for content guarantees. The example of big investors having concentrated shareholdings can sharply be set against the example of small investors. This issue should be dealt with since the procedural provision should set an example concerning the content issues of transparency as well. As modern means of telecommunication, the internet and electronic data communication have become general, in several cases small investors' rights to information have – unfortunately –been harmed instead of having been facilitated.

On the one hand it can be claimed that a part of information, communications and analyses placed on the internet may contain false (or untrue) information or may display data filtered subjectively. New IT possibilities play an important role in respect of the liquidity of the securities market while facilitating the accessibility (and popularity) of the markets for small investors. However, non-professional small investors my encounter a great number of fundamental and technical analyses by self-appointed analysts which might mislead them when making decisions on investment.

On the other hand it is well worth emphasising that neither do undertakings appear to be motivated enough to strengthen investors' rights and enhance transparency through using the internet.

2. Discharge of liability

Discharge of liability, which is provided for in the companies act of 2006 among the general rules pertaining to executive officers, is an institution transplanted from German company law.[7] The essence of the solution is that it excludes the possibility of retroactive legal disputes between the owners of the company and its executive officers. Concerning corporate governance, it can be regarded as a legal institution strengthening the status of the executive officer (restricting its liability).[8]

Any discharge of liability can be granted under the provisions of the memorandum of association (charter document). In this respect it can be classified as an internal – contractual – aspect of corporate governance and as such it does not affect liability towards third persons.[9]

The company's supreme body may decide on granting any discharge of liability to certain executive officers under a provision to this effect in the memorandum of association. The work of the executive officers in the previous financial year is assessed in the framework of a procedure depending on which the supreme body decides on granting or denying the discharge of liability. By granting a discharge of liability the supreme body verifies that the executive officers have performed their work during the period under review by giving priority to the interests of the company. This excludes the possibility of the issue constituting a ground of dispute in the future.

Obviously, the objectives of legal policy being in the background of the discharge of liability can prevail only if the working of the company is transparent enough for its owners. Otherwise the supreme body is not in the position to evaluate the quality of the executive officers' work. Thus a discharge of liability may subsequently be abolished if a court declares that the data on which its granting was based were false or insufficient.

[7] Sándor, István: A társasági jog története Nyugat-Európában [The history of company law in Western-Europe] (KJK-KERSZÖV Publishing House for Law and Business Ltd. Budapest, 2005) 200-202.
[8] Nochta, Tibor: A magánjogi felelősség útjai a társasági jogban [The directions of private law liability in company law] (Dilaóg Campus Publishing House, Bupapest-Pécs, 2005) 105-200.
[9] Nochta, Tibor: Társasági jog [Company law] (Dilaóg Campus Publishing House, Bupapest-Pécs, 2007) 155-156.

3. Solvency statement

The provision on solvency statement (solvency test) is a novelty of the companies act imposing a surplus liability on the executive officer under the memorandum of association. The core of the Anglo-Saxon legal institution is that if the articles of association provides so the executive officer shall issue a written statement to the supreme body declaring that the disbursement in question will not jeopardise the company's solvency or the creditors' interests. If any disbursement is made in the lack of such statement or the content of the statement is false, the executive officer will be held liable for any losses caused under the general provisions pertaining to the liability of executive officers.

The legal institution regulated by this provision is one of those which aim to strengthen the guarantees of creditor protection. It should be noted though, that the regulatory system of creditor protection in the companies act cannot be regarded as well-considered. This claim is further verified by the fact that the principle of the independence of executive officers, which is laid down in the companies act, cannot prevail in full due to the strong control by owners typical of continental practice. The solvency statement can serve as a ground for the liability of executive officers, but in the case of concentrated ownership control the majority owner (dominant member) can have the final say in the issues of disbursements and transactions in an informal setting. Considering all this, the application of the provision of the companies act providing that if the company is on the brink of insolvency, the executive officer shall perform his work giving priority to the creditors' and not to the company's interests is even more difficult.

4. One-tier and two-tier models of corporate governance in Hungarian company law

Under the scope of the companies act of 1997 one-tier board of directors could not be applied. This solution meant the obligatory operation of an institution deemed to be unnecessary by Anglo-Saxon investors: the supervisory board. In business practice it entailed that companies with Anglo-Saxon interest regarded the work of the management board meaningful while the operation of the supervisory board merely an inevitable obligation. Consequently, the work phases of supervisory boards lacked any kind of practical function in such companies.

Naturally, the legislator took notice of this issue, thus the companies act of 2006 offered a choice between the two governing systems: the one-tier and the two-tier models. The solution is quite up-to-date since the regulation pertaining to the European Company (SE) also contains this possibility and the regulation in effect is similar in several Member States.[10]

[10] Hopt, Klaus J., *The German Two-Tier Board: Experience, Theories, Reforms* 227-228. in Comparative Corporate Governance: The State of the Art and Emerging Research (Hopt, Klaus J. and others (eds.), Oxford, 1998.)

Nevertheless, it is remarkable that both the United Kingdom and Germany insist on traditions and in the same manner as the *Combined Code on Corporate Governance* does not allow the application of the two-tier model, the German *Aktiengesetz* és *Deutsce Corporate Governance Kodex* does not allow the application of the one-tier model.[11]

The one-tier model based on Anglo-Saxon traditions is the monistic conception of corporate governance, according to which companies have only one governing body, the board of directors. Its duties comprise strategic and operative management as well as supervision. It means that the same body manages the company and supervises management. However, the members of the board of directors can have two types of status: executive and non-executive directors. The former are responsible for managing functions and the latter for supervision.[12]

The two-tier model based on German traditions is the dualistic conception of corporate governance, according to which the company is managed by the management board and the supervisory functions are performed by an independent body: the supervisory board.

Hungarian company law, which is closer to the German traditions, intended to create a framework capable of accepting Anglo-Saxon capital (and investors) by introducing the one-tier governing system. This solution is amongst the favourable changes of the companies act of 2006. There was a genuine need on the part of Anglo-Saxon investors to exercise corporate governance within their own familiar and tested institutional framework.

However, the concurrent applicability of the two systems in Hungarian company law brings up an essential though rather theoretical problem, for the two models have differences in both form and content. The most significant of them is the issue of employee representation. In case the annual average of the number of the company’s employees reaches 200, the representatives of the employees shall comprise one-third of the members of the supervisory board. In the case of a one-tier system of governance the manner of exercising the right of employees in supervising the company’s management is to be laid down in an agreement between the board of directors and the works council. A single board of directors apparently allows the operation of a less democratic system of employee control. In practice, however, the contrast is far less significant. The management board is likely to develop a wary approach towards a supervisory board with members representing employees. In practice it might mean that if the directors do not want to share a particular item of information with the employees’ representatives, they withhold it from the whole supervisory board (or might convey face-lifted or carefully selected information). It is more difficult to withhold information from non-executive directors, consequently the application of the one-tier model may result in a more efficient solution than the application of the two-tier model in respect of exercising supervisory functions.

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[11] Jungmann, Carsten, The *Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems*, European Company and Financial Law Review (2006) 426-474.

[12] Davies, Paul L., *Board Structure in the UK and Germany: Convergence or Continuing Divergence?* 1-24. Accessible: SSRN: http://ssrn.com/abstract=262959 or DOI: 10.2139/ssrn.262959.