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## The Third Act on Business Associations – Law Conceived in the Spirit of Deliberate Progress

**Abstract.** The study examines the new act on business associations passed in 2006. It concludes, that the general principles, the structure of the Hungarian corporate law have remained unchanged since 1988, however, because of the practical demands and the European legal harmonization requirements a new act on business associations was necessary. The new act introduced several entrepreneur-friendly legal institutions and carried out a significant deregulation as well.

**Keywords:** codification, company law, business associations, firmregistration

On 1<sup>st</sup> July, 2006, the new Act on Business Associations (hereinafter: ABA) took effect. It is by that time the third pertinent act framed in this field, since the first ABA was promulgated as Act VI of 1988, the second one was adopted as Act CXLIV of 1997, and finally, Act IV of 2006 was adopted as the third ABA.

### 1. A New Act in Its Form—Supplementary Law in Substance

Legislation concerning business associations in the recent 20 years has had a specific history in Hungary.

The first ABA was framed nearly two years before the political transformation, in a period, which was marked by an economic policy purported to introduce mixed economy in the framework of a liberal, albeit socialist political establishment, according to which, in line with the non-corporate “socialist sector”, private business associations (Hungarian enterprises and joint ventures) would operate as a second sector, essentially in a similar manner to the current

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working of the economy in China and Vietnam.<sup>1</sup> However, due to minor amendments (under Act XIII of 1989 and Acts LIII, LIV and LV of 1992), the first ABA was still applicable, when, *in lieu of* the mere change of the economic model, political transformation ensued in the autumn of 1989, furthermore, it could adequately ground the operation both of partially privatised, formerly state-owned companies and of the formerly rudimentary small-scale enterprises (economic working communities (GMKs), entrepreneurial working teams (VGMKs), small-cooperatives, specialised groups) in prevailing forms of post-transformation business associations. The ABA of 1988 proved to be progressive in several branches of business law, as well, primarily *in re* the Company Act of 1989, the Competition Act of 1990, the Act on Securities, Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution (hereinafter: ABP) and the Act on Accountancy. Owing to the adoption of the ABA, Hungary gained a remarkable competitive edge over neighbouring former socialist states. As the above demonstrate, fundamental law substantiating the newly evolving bourgeois market economy was drafted preceding the mid-nineties, which facilitated that more foreign working capital flowed into Hungary before 1995, than into other European former socialist states *en masse*.

As regards the second ABA, which took effect on 16<sup>th</sup> June, 1998, it was designed to prepare the entry of Hungary in the European Union. Accordingly, previous practical experience had been analysed, harmony with associated legal branches, primarily with law pertaining to capital markets and accountancy had been attained. Within the purview of Act XXXIX of 1995, systematic privatisation *en masse* had been in the main accomplished by 1997, consequently, private ownership became predominant in Hungarian proprietary structure, hence, the discrepancies of the first ABA deriving from the regulation of state ownership could be eliminated and the second ABA could be drafted to comply with its original purpose of constituting basic business law in support of the emerging system of modern capitalism. By 1997, the development of the technical and incorporate infrastructure of firmprocedure law accorded with that of the ABA, so far as Act CXLV of 1997 on Firmregistration (hereinafter: Firmregister Act) qualified as ancillary law of the ABA, wherefore, the rule pertaining to the obligation of *ex nunc* registration of companies, which had incurred numerous anomalies, could be annulled. As a matter of fact, the second ABA complied with most requirements posited by EU directives under

<sup>1</sup> On the process of drafting the first ABA, see, A tulajdonreformról a társasági törvény után (On the Reform of Ownership Following the Adoption of the Act on Business Associations). OKKFT, Budapest, 1989.

company law, therefore, no major amendment of company law was necessary upon the accession of Hungary to the EU.

The third ABA was adopted by Parliament in December, 2005, nevertheless, its full recognition as well as political culture required that it did not take effect preceding parliamentary elections. However, the basic principles, framework and structure of company law established within the scope of the first ABA in Hungary were not modified under the third ABA. This also results from the fact unparalleled in the history of the codification of Hungarian business law, i.e., each ABA was drafted by the same Codification Committee, last time joined by young colleagues headed by Gábor Gadó.<sup>2</sup> Basically, at the end of the 1980s, we elaborated the codification technique of protecting the integrity of the ABA from political influence so far as possible, therefore, we laid down that

- its annual amendment, which is customary *in re* law concerning the capital market and accountancy, shall be avoided,
- the revision of the ABA in re its institutions shall be accomplished every 6–10 years and the required amendments shall be introduced,
- such revision eventuating in drafting new law shall be optimally scheduled by the end of the third year of government sessions, since the least forthcoming amending drafts submitted to Parliament are expectable in that period,
- the new law shall be submitted for acceptance both by business federations and the government opposition, so that the contingently ensuing change of government does not incur the comprehensive amendment of the ABA. This *modus operandi* worked well both in 1998 and in 2006.

The revision of the ABA approximately every 8 years is also deemed inevitable, because

- a) the company law of the EU is still developing, as it incessantly changes and its progress is cyclic. On the one hand, long-standing directives are amended (e.g., the amendment of Directive no. 2 on the Formation of Corporations and Assets is permanent) as well as new directives are framed (for instance, in trust law), on the other hand, supranational corporations regulated under Union law (e.g., European corporations may

<sup>2</sup> In all of the three cases, it was Tamás Sárközy (responsible for the general part) that headed the Codification Committee with the participation of members, such as György Wellmann [responsible for the chapters on unlimited partnerships (kkt.) and limited partnerships (bt.)], Gábor Komáromi [responsible for the chapters on limited liability companies (kft.)], Tamás Sándor [responsible for the chapter on companies limited by shares (rt.)] and János Kálmán.

- be formed in Hungary) operate as competitors of companies regulated by domestic law,
- b)* the reach of technical development is significant, with respect to the gradual introduction of electronic company procedures, electronic exercise of members' rights, digitalisation of the operation of company organs,
  - c)* the development of associated legal branches must be taken into account, such as competition law upon framing trust law, accountancy law upon the regulation of company assets, as well as requirements set forth under law concerning the capital market upon the codification of law concerning public limited companies,
  - d)* finally, the periodical assessment of experience obtained in the course of the application of company law by attorneys, the Court of Registration and during judicial proceedings is necessary.

In view of the fact that both the second and the third ABAs are supplementary law in substance, the technical justification for drafting new law was required. Since it is not only lawyers, but also enterprises, tax advisors and auditors whose work is comprehensively and directly determined by the rules of the ABA, we assumed that the development of the ABA into a labyrinth of rules (such as the Act on the State Budget and the Act on Capital Markets are) had to be prevented. Consequently, the reformulation of the ABA had to be accomplished in terms of the revision of its institutions. The requirement of lucidity was further supported by the observance of the following rules:

- a)* The ABA shall be formulated in accordance with classical codification principles. Therefore, it is specified as a principal rule that an article may consist of a maximum of 6 paragraphs, a paragraph may consist of max. 3 sentences and the combined justification of max. 2 articles is permitted. The latter rule was breached in some cases as a result of ministerial harmonisation and parliamentary debate (see, Article 202 regulating the share register as a pertinent instance).
- b)* No enforcement decree issued by an organ of public administration may be appended to the ABA. (As an apparent exception, we must mention the government authorisation related to Company Law Advisory Bodies, which, however, does not affect the substance of company law.)

In the course of the codification process in 2005, the former textual scope of the ABA could be basically retained, in spite of the fact that the number of articles during the administrative harmonisation and parliamentary debate, marked by newly prevalent legislative vehemence, increased by approx. 10 p.c. Unfortunately, the objective of public administration to extend its scope of authority could also just partly be curtailed. Therefore, the scope of the activity of the Service of the Ministry of Justice Providing Information about Companies

and Assisting Electronic Firm Procedures (an appalling designation) (IM Cég-információs és Elektronikus Cégeljárásban Közreműködő Szolgálat) was considerably extended as per Para. (2) of Article 1 of Firmregistration Act (by, e.g., the provision of legal advisory service), furthermore, upon the motion made by an MP, in support of the work of the Ministry of Justice, a Company Law Advisory Body was established as per Article 332 of ABA, which may consist of as many as 100 members and renders expert opinions of “scholarly character” in three-member committees. The Advisory Body may contest the role of arbitration courts, which is a barely agreeable tendency. Over-meticulous regulation is more distinguishable in the Firmregistration Act, than in the ABA, albeit, excessive attentiveness to details results naturally from the character of procedural law.

The inherent objective of the third ABA to safeguard continuity is highlighted by the fact that its effect pertains merely to new business associations founded on deeds of association that were submitted to the Court of Registration subsequently to 1st July, 2006. Business associations that had submitted data for registration and operated before 1st July, 2006 may continue operation within the purview of the second ABA either until the first change effected in their data or until 1st September, 2007, the latest. Under the ABA of 1997, no ultimate deadline for adjustment was determined for associations, which incurred disturbances in practice. Nonetheless, business associations that operated upon the adoption of the third ABA have been guaranteed a period of nearly two years for adjustment. This, in case of the majority of associations, probably implies that they will adopt deeds of association (Memoranda and Articles of Association of Companies) that comply with the third ABA at ordinary general/members’ meetings assembling in the spring of 2007. We cannot fail to mention that in re the third ABA, which stipulates very few cogent rules in comparison with the second ABA, adaptation in the majority of cases will implicate benefiting from the specified additional options and their introduction into the deeds of association of already operating companies. Associations that will fail to implement the new cogent rules of the third ABA by 1st September, 2007 will be coerced in the scope of legality supervision proceedings conducted by the Court of Registration either to institute a valid legal framework for their operation or to ultimately terminate operation under Article 81 of Company Act.

In order to demonstrate that no emergency to codify the third ABA obtained, we must point out that provisions incurring momentous changes in social-economic circumstances will take effect subsequently to 1st July, 2007, that is, one year later, than the date of taking effect of less consequential provisions. A relevant instance is the revocation of the regulation of non-profit companies

(kht.) under Act IV of 1959 on the Civil Code (hereinafter: Civil Code) and the concurrent introduction under the third ABA of the non-profit character as an option to pertain to all forms of business associations after 1st July, 2007. Non-profit companies (kht.) that will still operate at that date shall be permitted to continue operation for a further period of two years. A second instance is the omission of the regulation governing joint enterprises as a form of business associations under the third ABA, since no new joint ventures were established following 1990, whereas, the joint enterprises registered before the third ABA took effect (more, than 100 companies) would be permitted to continue operation in concert with the second ABA without time limitation. To conclude the array of instances, the termination of the employment of executive officials as such of unlimited partnerships (kkt.), limited partnerships (bt.) and limited liability companies (kft.) is prescribed within the purview of the third ABA, which in fact guarantees a provisional period of five years for compliance subsequently to its taking effect. We expect that the application of the third ABA will admit equal flexibility in practice.

With respect to terminology, the designation of various organs of business associations was in several cases simplified and unified under the third ABA. For instance, in re business unions, the term of members' meeting was introduced instead of the misleading term of the board of managers. As for the regulation of unlimited and limited partnerships (kkt. and bt.), the alternatively used "general meeting" and "members' meeting" were uniformly superseded by the term of "members' meeting", which serves to underline the emphatic vagueness concerning the main organ of the simplest forms of association as opposed to that of the Ltd. On condition that it is only in these formal respects that the deeds of association of unlimited partnerships and business unions depart from the new law, we can barely assume that explicit emendation will be deemed necessary (for instance, the substitution of the established term of general meeting by members' meeting). Scilicet, bureaucratic formalism should be duly avoided in company law, even if technical problems may arise in the trade register as a consequence.

## **2. The Relation of the ABA to Other Significant Regulations of Business Law**

The reformulation of the ABA allowed the reconsideration of its relation to other regulations of basic business law.

- a) In the course of re-codification, the Codification Committee intended to more systematically incorporate substantive provisions into the ABA and procedural provisions into the Company Act, thereby, to circumvent

repetitions and overlaps. Accordingly, the ABA includes merely general provisions pertaining to the legality supervision of business associations, since the detailed provisions are set forth in the Firmregistration Act, given that these are special proceedings conducted by the Court of Registration. The provisions specifying the reasons for the invalidity of deeds of association are basically formulated in the ABA, whereas, judicial contestation of the decision on company registration on grounds of the invalidity of deeds of association is admissible pursuant to Article 69 of Firmregistration Act on “action for the establishment of the nullity of company foundation”. Nevertheless, in some cases, with regard to the objective of safeguarding the uniformity of regulation, the ABA also specifies rules of procedure (such as the rule of the judicial contestation of decisions adopted by business associations and the plea in expulsion), at the same time, the Firmregistration Act also includes substantive provisions pertaining to, e.g., the name of the company, the company seat and registered offices.

- b) Interference with other legal branches could be avoided within the scope of the third ABA, for instance, the stipulations that guarantee tax allowances for foreign investors as well as tax-free and duty-free implementation of reorganisation were repealed, since these matters are already regulated under tax law. For political reasons, some exceptions had to be made, e.g., the stipulation that labour relations prevailing at business associations shall be regulated in accordance with the Labour Code was upheld under Article 8 of ABA, which, from a professional viewpoint, is an expressly redundant provision.
- c) Its relation to the new, currently reformulated Civil Code became unambiguous. It is definite that the endeavour to integrate the ABA into the Civil Code was obstructed, since the uniformity and substantiveness of the ABA as a code must be retained even following the completion of the new draft Civil Code, in re firstly, company law constitutes a complex legal branch, secondly, its textual scope and technical character. To that effect, the specificity of company law is now adequately articulated under Para. (2) of Article 9 of ABA, according to which, although, the Civil Code constitutes secondary law substantiating the ABA, in cases related to business associations, the Civil Code shall be not literally, but “appropriately” applicable. As the Supreme Court reasonably ruled, according to the solution based on the principle of *clausula rebus sic substantibus*, Article 241 of the Civil Code shall not be applicable in case of deeds of association concluded for an indefinite period. Scilicet, Part 4 of the Civil Code on Contract Law is modelled

on bilateral barter agreements, whereas, deeds of association specifically establish multi-entity organisational liability.

As a matter of fact, the effect of company law on Part 2 on Entities of the currently formulated new Civil Code can be positively discerned.<sup>3</sup> Its constructive aspect is that several solutions of company law (e.g., pre-association posited as pre-legal entity or reorganisation by universal legal succession) that were met by reluctance on the part of experts of civil law back in 1988 are being abstracted under the new draft Civil Code. Its detrimental aspect, as to my view, is that the draft Civil Code adopts the institutions of company law in extraneous areas, as well. Namely, by reason of the recent radical curtailment of the permitted period for company registration, the import of pre-associations has also remarkably decreased in company law, therefore, the regulation of the formation of, e.g., “pre-foundations” under the new Civil Code seems even more problematic. In contrast with company law, in which considerable deregulation was effectuated under the third ABA, the Chapter of the draft Civil Code on Legal Entities (as an overextended counter-effect of former under-regulatedness) is incredibly over-regulated, so far as it completely unnecessarily introduces institutions of company law under provisions concerning ideal legal entities, such as the supervisory board and the auditor, which have gradually become discretionary in company law, as well.<sup>4</sup>(4)

- a) In the course of drafting the third ABA, we focused on the requirement of harmony with accountancy law, which was all the more deemed imperative, since EU company law directives abound in accountancy rules. To that effect, the observation of the terms of accountancy is more relevant under rules governing procedures of reorganisation, capital increase and reduction in the third ABA, than in its antecedents. Nonetheless, we intended to manifest that it is accountancy law that needs to be adjusted to basic solutions of company law, not vice versa. Therefore, when a business association is finally registered by the Court of Registration, the pre-association shall be finally and automatically established as a business association, i.e., the prescription of “a closing accountancy measure” is regarded as an excessively bureaucratic measure and to be abolished.

<sup>3</sup> The Chapter of the draft Civil Code on Entities has been introduced for professional debate by the Ministry of Justice on its home page.

<sup>4</sup> See, the critique by Sárközy T.: Alternatív javaslat „A jogi személyek általános szabályaira” (Alternative Proposal for “the General Regulation Pertaining to Legal Entities”), *Polgári Jogi Kodifikáció*, nos. 4–5/2005.



- b) Upon the formulation of the Chapter on Companies Limited by Shares in the third ABA, its relation to the permanently evolving and incessantly amended Act of 2001 on Capital Markets (hereinafter: ACM) posed a dilemma. In my view, the ACM represents a peculiarly low quality regulation, its over-regulated and frequently self-contradictory provisions preclude its harmony with the third ABA, which would be a prerequisite of law-making despite the different approaches of the two legal areas. Consequently, we endeavoured to distinctly demarcate the scopes of the ABA and the ACM, to that effect, the scope of trust law under the ABA is restricted exclusively to the regulation of close companies limited by shares (zrt.) and limited liability companies (kft.), whereas, the rules of take-over procedures pertaining to public limited companies are specified under the ACM (redrafted incidentally with particular incoherence), even so, the contradictions in many cases couldn't be resolved without the violation of the rationale of company law. A recent "achievement" consists in the before-mentioned comprehensive amendment of the ACM under Act CLXXXVI of 2005 in December, 2005, which was followed by the latest amendment of the ACM under Act XXII of 2006 in January, 2006. The latter act contains an innovation unparalleled in the history of Hungarian law-making, scilicet, it stipulates under Para. (4) of Article 6 that Paras. (1)–(2) of Article 354 of the third ABA "shall not take effect".

### **3. Deliberate Progress from the Past to the Future**

The third ABA took effect in a period, when the basic trends of the next decade (perhaps decades) were already relatively adumbrated, viz., the accentuation of the requirements entailed by globalisation and information society as well as the consolidation of European integration. We presumed that our principal assignments in this situation were, on the one hand, the sustenance of domestic traditions of company law, on the other hand, continued adjustment to the international development of company law by constant modernisation. In this respect, we had to take into account the following crucial factors.

The efforts of the European Union to create the unity of law, which per se accords with our objectives, by directives that concentrate on guaranteeing the uniformity of rules that govern primarily entities of the world of big business, that is, public limited companies, banks, insurance companies, investment funds, etc., also define the scope in which we need to consider the eventuality that supranational corporations founded in compliance with EU directives will

prevail over business associations founded on domestic law. Furthermore, Union law is more and more intensely overwhelming the national legislation of member states based on continental law with solutions originating in the Anglo-Saxon legal system, which has adverse effects and sometimes entails confusion in domestic law.<sup>5</sup> For instance, at the beginning of this decade, German legislation was also obliged to frame separate law on capital markets and to co-opt a take-over procedure modelled on the US pattern *in re* public limited companies. Consequently, German corporations tend to abandon German company law (therefore, a recent session of the Deutscher Juristentag was marked by bewilderment) and reorganise as European corporations, which admit the board system. Thereby, they can evade the most characteristic institution of modern German company law, that is, the so-called parity *Mitbestimmung* (equally shared decision-making), which implies equal participation by employees in supervisory boards.<sup>6</sup>

In view of the above, the Codification Committee relied on the following conclusions upon framing the third ABA:

- a) Attempts at the trivialisation and homogenisation of traditional forms of small- and medium-scale business associations need to be resisted. For several years, approx. 8,000 unlimited partnerships [(kkt.) as a typical form of micro-enterprises], 120,000 limited partnerships [(bt.) as a form of small-scale enterprises] and 220,000 limited liability companies [(kft.) as a typical form of medium-scale associations] have operated agreeably on grounds of permissive regulation in substance and in effect.<sup>7</sup> The more positively contractual character of unlimited and limited partnerships was upheld and reinforced under the third ABA, while the efforts to declare these two forms of association legal entities were defied. The aspect of ltd.s constituted as associations of entities (e.g., the institution of several managers, but no board of managers is permitted), which distinguishes them from companies limited by shares, was maintained. Without doubt, the rules pertaining to close companies limited by shares

<sup>5</sup> See, e.g., Halbhuber, *Limited Company statt GmbH? Europarechtlicher Rahmen und deutscher Widerstand* (Limited Company in lieu of GmbH? EU Legal Framework and German Resistance), Baden-Baden, 2001.

<sup>6</sup> *Qualität und Preis am Markt für Gesellschaftsformen* (Quality and Price on the Market for Business Associations). *Zeitschrift für Unternehmens und Gesellschaftsrecht*, no. 3/2004.

<sup>7</sup> Para. (1) of Article 9 of ABA established cogency in form as a principal rule, since the efforts to formulate the permissive regulation of unlimited and limited partnerships and ltd.s (kkt.–bt.–kft.) during codification failed. In effect, however, the third ABA advanced distinctly towards permissive regulation.

and ltd.s, respectively, show more correlation, but the rapprochement eventuated basically owing to the regulation of companies limited by shares (e.g., preference shares that secure the right of pre-emption).

- b) It needs to be prospectively prevented that large-scale associations in Hungary relinquish the rule of domestic law and opt for Community law. Consequently, the third ABA, in an unprecedented manner in Hungarian company law, permits that the entities forming public corporations opt for the board system according to the model of Anglo-American integrate management in lieu of the German model of shared management. That integrate managing organ is designated as board of directors, which is distinguished from general management under the third ABA. That solution obviously benefits investors from the US, Britain and the Far-East, however, permission of the establishment of boards of directors for ltd.s and close companies limited by shares would have been an evident excess.
- c) In accordance with the development of information technology, the third ABA allows to some extent both the exercise of members' rights and the operation of association organs, i.e., general meeting, management, supervisory boards via means of information technology, although, we must acknowledge that access to these facilities is not immediate reality for Hungarian entrepreneurs. The basic rules are stipulated under Article 20, nevertheless, the chapters on ltd.s, and particularly, on companies limited by shares prescribe several special rules that govern, e.g., holding general meetings via video-conferences. Simultaneously, the use of these modern facilities is safeguarded by the rule that it may not infringe either members' rights to equal protection of the law or equal opportunity for participation in business matters.
- d) With respect to the purpose of modernisation, it was not only Anglo-Saxon/Anglo-American solutions that we took into consideration. In my view, a momentous according step consists in the co-optation under Chapter 5 of the regulation pertaining to trusts already well-established in the Hungarian business world, and consequently, to the acquisition agreement from German law.<sup>8</sup> The acquisition agreement is obviously not a typical element under civil law, its introduction was challenged both theoretically and functionally. Nevertheless, due to the institution of the acquisition agreement, the implementation of a uniform economic policy

<sup>8</sup> See Mielicke, J.: Konzern durch Beherrschungs und Ergebnisübernahmeverträge (Trusts via Acquisitions and Take-Over Agreements), *Zeitschrift für das gesamte Handels und Wirtschaftsrecht (ZHR)*, no. 4/2001.

will be considerably more refined, relations within the trust will become more perspicuous, the reasonable interests of the shareholders, creditors and the management of subsidiaries will be more defensible. As a matter of course, voluntary registration by trusts may not be immediately expected, therefore, the ABA can prove to be a progressive and programmatic statute, furthermore, the provisions of Article 64 of ABA governing effective trusts also admit the judicial enforcement of registration.

- e) The consistent effectuation of the purpose of modernisation was not feasible for an economic and a legal reason in one area, that is, the distinction of corporations in terms of forms of operation. Firstly, economic policy-makers did not concur with the solution customary in Western Europe (which had not been included in the conception of the ABA, either), namely, that public limited companies would be peremptorily classified as companies quoted at the Stock Exchange. Scilicet, in this case, a corporation not quoted at the Stock Exchange would be automatically classified as a close company limited by shares. On condition that the public limited company is concurrently quoted, market self-adjustment could supersede a substantial range of legal regulations. Therefore, the regulation of corporate governance would not have been incorporated into the Section of the ABA pertaining to public limited companies, but, in concert with the German model, the issuance of an ethical code on corporate governance would have sufficed.<sup>9</sup> Secondly, as regards the legal reason, pursuant to the amendment of the ACM approximately one year before the adoption of the third ABA, the distinction of close and public corporations had been established in company law and in the Hungarian business world also to be denoted in the designation of corporations as abbreviations Zrt. and Nyrt., which is unfamiliar in Western-Europe and non-transplantable into English or German. This solution should have been interfered with under the third ABA within one year, which would have been evidently arguable from the point of view of legal policy.
- f) The prima facie dogmatic solution of the separate designations of Zrt. and Nyrt. is based on the assumption that, if the scope of public limited companies does not coincide with the scope of quoted companies, EU directives concerning public limited companies will either govern all Hungarian corporations, or close companies limited by shares will have

<sup>9</sup> Ringleb, H. H.–Kremer, T.–Lutter, M.–Werder, A.: *Kommentar zum Deutschen Corporate Governance Kodex* (Commentary on the German Corporate Governance Code). Munich, 2005. 18–21.

to be distinctly differentiated from public limited companies. In an effort to effectuate the latter alternative, the law-maker stipulated under Para. (3) of Article 171 of ACM that close and public operation shall be denoted in the designation of the company. This solution, however, is obviously defective in my judgement, because, on the one hand, it would have sufficed to denote the form of operation in line with the designation, not in the designation of the company. Namely, in re the obligation set forth under Para. (1) of Article 4 of ABA, according to which the non-profit character of corporations shall be indicated in the designation of the company, the abbreviation of non-profit close corporations will be NpZrt. On the other hand, even if we intend to denote the form of operation in the designation, it would have amply sufficed to prescribe the denotation of Nyrt. for at most 100 corporations that operate publicly out of the approx. 4,000 corporations, since all other corporations would have been necessarily classified as close corporations. Whereas, in this status quo, we have imposed substantial costs and administrative burden on our corporations (e.g., new firm stamps, bank-papers, exchange of shares, etc.), which contradicts the basic objectives of legal regulation.

- g) The indefinite differentiation of close companies limited by shares from public limited companies incurred a structural problem in law-making, viz., the structure of Chapter 10 of ABA on Corporations is excessively complicated. It is introduced by a General Section encompassing Articles 172–183, which is followed by detailed regulation that constitutes the principal rules under Articles 184–284 pertaining to close companies limited by shares, subsequently, the auxiliary and departing rules governing public limited companies are specified under Articles 285–315, and finally, corporate governance recommendations of the Budapest Stock Exchange concerning quoted public limited companies conclude Chapter 10. Obviously, the identification of the scope of quoted public limited companies with that of public limited companies would have eventuated considerably more undemanding and easily applicable regulation.
- h) With respect to Union law, we may eventually establish that law-making in Hungary should not verbatim adopt EU directives (which equals mere adaptation by “translation”), but the recognition of the purpose of legal policy is imperative, which may facilitate its implementation by legal instruments inherent in the Hungarian legal system. Therefore, for instance, the unreasonable adaptation of EU directives governing public limited companies to unions of entities is inappropriate, however, that practice has prevailed in re, e.g., the invalidity of deeds association since

1991, that is, the effect of Directive no. 1 of 1968 on Harmonisation of Safeguards for Business Associations has been extended to irrelevant areas not designed by law-makers of the EU. Furthermore, the adoption of still non-effective EU norms as a manifestation of “pushing forward” is also deemed inappropriate, which, nevertheless, had ensued in terms of the limitation of one-entity associations under the second ABA, nullified under Para. (4) of Article 5 of the third ABA. Nonetheless, in the course of codification of the third ABA, the adoption of the more rigorous, currently drafted EU regulation pertaining to auditors was propounded (e.g., of the provision that auditors’ contracts of agency shall not be renewed), however, we defied and the contingent later settlement has been referred to the competence of accountancy law.

#### **4. A Pro-Entrepreneur Approach**

The third ABA is marked by an approach that emphatically favours entrepreneurs with the exception of the elements specified under Point e) of Section 3 above. According to the standpoint of the Codification Committee,

- a)* if the interests of entrepreneurs, public administration, the Court of Registration or attorneys (notaries public) conflict, entrepreneurial interests shall be promoted,
- b)* the facilitation of more expeditious, inexpensive and simple formation of enterprises and of their operation shall be necessary.
- c)* For the purpose of the accomplishment of the objectives above, the third ABA substantially deregulates, i.e., crucially diminishes the administrative burden imposed on associated parties and extends the scope of permissive regulation via basic reinforcement of the autonomy of associated parties and the specification of a broad set of applicable options for organisation and operation. The third ABA is based on the assumption that nearly 18 years after the restitution of company law in Hungary, both company law and business culture are adequately refined to admit such “liberal” regulation and its flexible implementation.

In the following passages, we’ll expose some instances of such pro-entrepreneur approach:

- a)* As to my point of view, the deregulation of the sphere of operation of business associations is particularly important. The third ABA sets forth the principle of the permission of all sorts of activities that are not prohibited or limited by law, even if the respective activity is not itemised in the sphere of activities. The business association shall be obligated to

indicate only one main activity in its sphere of activities, whereas, all other activities shall be included in the trade register at the specific according request of the association. This new regulation will basically change the proceedings of the tax authority.

- b) Upon the advent of political transformation, it was justifiable to administratively limit the terms of the mandates of executive officials and the number of assumable executive positions, the limitation of which, however, is no longer required. Therefore, the limiting rule prescribing that one entity may concurrently fulfil executive positions at maximum three different associations was repealed under the third ABA. Whilst, the principal rule stipulating that appointments shall be valid for a definite, but at most for a five-year period was maintained as a permissive regulation. Therefore, deeds of association may permit that executive officials will be appointed for an indefinite period, in the case of which, mandates for indefinite periods may be conferred on supervisory board members, as well. At the same time and after much delay, the third ABA finally institutes the maxim of distinction between the legal relations of executive officials under company law (substantiated by the rules of contracts of agency under the Civil Code, albeit, such legal relations shall not be established by contracts of agency) and other potential employment of the concerned executive officials by the respective association. By the generalisation of the rule formerly pertaining merely to corporations, Para. (2) of Article 22 of ABA stipulates that the mandates of executive officials shall not be assumed in employment. Therefore, the legal consequences of mandates of executive officials governed by company law (the fulfilment of which may be either gratuitous or subject to consideration) shall be consistently differentiated from those of the potential employment of executive officials in other positions (e.g., in the director's position) at the specific association, which shall be unequivocally grounded on the Labour Code. Therefore, the general manager of a limited liability company may exclusively fulfil the position of managing director concurrently, on condition that the appointments are established on grounds of two separate scopes of legal relations. However, in view of the fact that the majority of ltd.s in Hungary have accommodated interwoven legal relations under company and labour law, this subtle regulation will merely govern legal relations established subsequently to 1st July, 2006. Whereas, the parties concerned shall be guaranteed a reasonable provisory period for the settlement of prevailing legal relations, since the legal relations of executive officials instituted

preceding 1st July, 2006 may be eventually upheld for a further period of five years.

- c) Under the third ABA, the significant reinforcement of permissive regulation extends the scope of entrepreneurial liberties. Although, for technical reasons of drafting, the cogency of its rules was maintained by virtue of Para. (1) of Article 9, owing to the General Section and to the rules governing specific forms of business associations, the freedom of parties to depart from the majority of the rules of the ABA was considerably expanded. The last phrase of Para. (1) of Article 9 stipulates with general effect that, if the departure from the ABA consists in the co-optation of a solution not recognised under the ABA, it will be regarded permissible (which formerly in most cases had been reversely adjudicated by the Court of Registration), with the exception (a safeguarding general clause is inserted), if the respective solution contradicts a) the general purpose of company law, or, b) the objectives of the regulation pertaining to the respective form of association, or, c) infringes the basic principle of bona fide exercise of rights pursuant to the Civil Code. In re the specific forms of association, due to the formulation of rules per se, approx. 95 p.c. of the regulation concerning unlimited and limited partnerships (kkt.–bt.) is currently de facto permissive, whereas, more than 50 p.c. of the regulation of ltd.s (kft.) and nearly 50 p.c. of the regulation of close companies limited by shares are also permissive in my judgement. In this scope, the substantial enhancement of the permissiveness of the regulation of close corporations is peculiarly emphatic, considering that the form of operation of the overwhelming majority of corporations in Hungary is close. Accordingly, it is unprecedented in the regulation of corporations in Hungary that the optional establishment of the supervisory board is permitted [dependent on the respective claim of fifty per cent of the shareholders (nominal value rate) of the close corporation]. As to ltd.s, the establishment of supervisory boards is completely discretionary, in addition, the regulation of the institution of employee participation is permissive, as well. The rule that in case of associations with more than 200 full-time employees on an annual average, one-third the supervisory board members shall be appointed by the general/members' meeting upon the nomination of the works council was maintained, but the management of the association and the works council may conclude a deviating agreement. Which implies that in return for, e.g., pay-rise or the provision of social, etc. surplus services, the community of employees may renounce due participation rights. This may exclusively eventuate on a voluntary basis and in compensation,



since the enforcement of employer over-representation shall be expressly deemed *ex parte* abuse of rights and sanctioned.

- d)* The range of eligible management options for associated parties was considerably extended, which is most conspicuously instantiated under the rules governing corporations. As to close corporations, the application of the option of the German *drei Ecken* (triangular) system, which constitutes the principal rule, is an alternative to the jointly applicable institutions of one-entity management as per Article 247 and of the executive supervisory board, the power of which was expanded as per Article 37. As to public corporations, the German management system established in Hungary is simultaneously instituted with the optional Anglo-American integrate management system, furthermore, new organs, such as the auditing board are also introduced. The establishment of optional organs, such as advisory bodies and boards modelled on the German *Beirat* is admissible with general effect as per Para. (6) of Article 19.
- e)* The procedural auxiliary of the enhancement of permissiveness in substantive law consists in guaranteeing broader access to institutional and *ad hoc* arbitration courts in lieu of administrative courts for intent parties. Pursuant to Article 10 of ABA, the range of options for recourse to arbitration courts is extended in two respects. On the one hand, recourse to arbitration courts abroad is also secured for associations with exclusively Hungarian members, on the other hand, it is merely in *re legal* disputes between the association and the members that guaranteeing the opportunity for recourse to arbitration courts and the specification of one arbitration court in deeds of association shall be mandatory, whereas, irrespective of the before-mentioned criterion, for the settlement of disputes among members concerning the operation of the association, the members may resort to arbitration courts as well as may institute various arbitration courts.

## **5. Conflicts of Interests**

Besides the protection of reasonable entrepreneurial interests, the third ABA purports to safeguard other interests, as well. Albeit, the business association is possessed primarily by its members, the proprietors, the enforcement of the interests of other parties must also be protected by law. To that effect, protection of the interests of the management is guaranteed by, e.g., the institution of exoneration pursuant to Para. (5) of Article 30. Furthermore, the former 10 p.c.

limit of the admission of collective minority protection was decreased to 5 p.c. pursuant to Para. (1) of Article 49, finally, the instruments of creditor protection were elucidated and circumscribed, for instance, *in re* the so-called company vacation, the scope of protection was extended to limited partners of limited partnerships (bt.) pursuant to Para. (3) of Article 50.

As a matter of course, protected interests may conflict. Consequently, in my judgement, Para. (3) of Article 30 adopted during parliamentary debate upon the motion of an MP is defective, since it makes an exception to the principal rule as per Para. (2) of Article 30, according to which executive officials of the association shall proceed with regard to the primacy of the interests of the association, by the prescription of the obligation of executive officials to observe the primacy of creditors' interests "subsequently to the supervision of the minatory situation of insolvency of the association". Scilicet, executive officials constitute an organ of the association and shall proceed upon the trust of the general/members' meeting, therefore, they shall promote members' interests. Whereas, creditors' interests are basically protected under the ABP and other law along with the ABA, which shall be obviously observed by executive officials. Apart from the bona fide adherence to legal regulations, which explicitly precludes resort to irresponsible hazardous solutions, whatsoever, executive officials may not further creditors' interests as opposed to the interests of the association. Furthermore, on condition that the association declares insolvency and the executive officials do not proceed with regard to the primacy of creditors' interests, Para. (3) of Article 30 also stipulates that separate law will lay down the liability of executive officials for creditors' interests. However, as to the regulation of limited liability companies, even the establishment of the secondary liability of members shall be exceptional, therefore, the specification that non-member officials shall accept responsibility *in lieu of* the association and the members is an overtly excessive rule in my view, an instance of the overreach of wrongful trading. The according law founding such responsibility was adopted pursuant to Article 33/A of Act VI of 2006 amending the ABP, which circumscribes the supervision of the minatory situation of insolvency, grounds for the presumption of the infringement of creditors' interests, classifies liabilities for damages as debts to creditors and defines the imputation of executive officials, etc. According to my view, that qualifies as an overbreadth of law-making. In this context, we must also refer to Article 50 of ABA, in terms of which the court may transfer liability to the members of the ltd. or the corporation, the scope of which, nevertheless, is inordinately extended both under the Company Act and the amendment of the ABP, whereas, the admission of the transfer of responsibility is extremely exceptional in international legal practice. Notwithstanding, the provisions

under Paras. (2)–(3) of Article 63 of ABP and Paras. (1)–(2) of Article 93 of Company Act unreasonably extend the scope of the transfer of responsibility. En passant, the Company Act is not assigned to supplement the substantive rules of the ABA, such as the prescription of a separate rule of the transfer of responsibility, provided that the remaining total debt of the terminated association exceeds 50 p.c. of its equity capital.

In view of the fact that the entrepreneur jeopardises its private property, the liberalisation of the regulation in this scope is justifiable. However, the case of *business associations operating with public funds* is assessed differently. The rigour of requirements *in re* associations operating with state (local government) participation with majority interest as well as *in re* public corporations operating with significant investment by natural entities must obviously not be mitigated, but affirmed as opposed to the general tendency of liberalisation. Additional requirements concerning associations operating in the public sector must be formulated fundamentally under the Act on the State Budget in a similar manner to the amendment of the before-mentioned law by the so-called Transparency Act of 2003. Undoubtedly, the requirements concerning the corporate governance of associations in public property will have to be radically emended under a new Act on the State Budget.

## **6. Streamlining and Economising Firmregistration Procedures – Functional Changes Concerning the Court of Registration**

The necessary implications of the enforcement of a pro-entrepreneurial approach consist in the freedoms of *streamlined and economical formation* of business associations, *effectuation of required changes* in deeds of association and in the forms of association, contingent *termination* of associations without the violation of public interest, such as authoritativeness of the trade register, creditors' interests, etc.

As a matter of fact, streamlining the procedure of company registration and the introduction of electronic company procedures supervened before drafting the third ABA, wherefore, of course, the pertinent regulation was further amended. In this respect, the new rules pursuant to Para. (6) of Article 46 and Article 47 of Firmregistration Act are of fundamental importance, since the formerly differentiated registration of associations with investments by legal and non-legal entities was superseded, the term of registration was determined in a maximum of 15 working days as of submission of the respective claim and safeguards for the potential omission of the deadline were specified. As elements of basic streamlining, patterns of legal deeds of association were introduced

pursuant to Articles 48–49 of Firmregistration Act [four patterns, one for unlimited, one for limited partnerships and two patterns for (one-entity, multi-entity) ltd.s], in case of the application of which, the term of registration shall be restricted to 8 working days for submission of claims on paper and to 2 working days for electronic submission.

The specification of the freedom of expressly voluntary application of the patterns of legal deeds of association is notably unprecedented in domestic business law, therefore, it has been contested by several legal theorists, attorneys and registry judges. In my judgement, the application of the pattern is expedient for the simplest forms of association, since it crucially effects streamlining and no complex contractual procedure is required *in re* small-scale enterprises. Consequently, those who agree to the application of the simple patterns without changes will be facilitated to establish associations more expeditiously. Whereas, those who intend to establish more complex associations (e.g., with several managers and supervisory boards at ltd.s) will conclude deviating and individual deeds of association.

In my view, the patterns will also promote the economisation of the formation of small-scale enterprises in the long run, therefore, it is inappropriate to regard them as “awkward procedures”. As a *modus vivendi*, mandatory endorsement by attorneys, which is unknown in Western Europe, was upheld, however, in the future, that requirement may be naturally cancelled *in re* deeds of association concluded according to patterns, and with the expansion of the market, attorneys’ fees will evidently decrease, as well. Since the scale of contribution by the Court of Registration to the formation of associations on grounds of patterns is negligible, the respective fees will be soon and necessarily reduced by the Ministry of Finance. Furthermore, upon the following revision of the institutions of the ABA, the publication of the formation of these simple associations will be obviously deemed unnecessary, whence, the related costs may also be released. Eventually, the facilitation of the formation of associations is also furthered by the procedure of the reservation of the name of the company under Article 6 of Firmregistration Act, which specifies the freedom to reserve the name opted for by the associated parties for a period of 60 days.

Nevertheless, other company procedures have also been consequentially streamlined. In this context, we must refer to the simplification of the conclusion of deeds of association under Article 18 of ABA, which, e.g., authorises the management to effect minimal changes in deeds of association. Furthermore, by the definition of reorganisation as a change in the form of the association, the elements of the three-pillared structure of reorganisation, association and dissolution were more unequivocally distinguished under Article 67 of ABA. Again, the process of reorganisation was momentarily streamlined under

Articles 71-72 of ABA, wherefore, in a basic case, a session of the chief organ may effectuate reorganisation as well as the scope of the obligation to draft a reorganisation plan was restricted, etc. In order to resolve former uncertainties, it is expressly stipulated that co-ordinate unions of legal entities may also reorganise as business associations, and, vice versa, then again, the dissolution agreement shall be concluded by members (not by the association) under Para. (3) of Article 84 of ABA.

In the scope of the regulation of the termination of business associations without legal successors, the procedural rules of final settlement were revoked under the ABP and introduced into the Firmregistration Act, which marks remarkable progress. Scilicet, final settlement is a procedure related to the termination of associations not substantiated by insolvency. Therefore, enactment of such separate regulation of final settlement will probably impel law-making to eventually frame up-to-date law pertaining to insolvency equivalent to the pertinent EU regulation, so that it can supersede the effective obsolete regulation of bankruptcy and liquidation proceedings. (Pursuant to Act VI of 2006, only a minor amendment of ABP was adopted.) In effect, final settlement was momentarily differentiated under the new Firmregistration Act, wherefore, coerced and voluntary final settlements were distinguished and the scope of streamlined final settlement was extended.

Within the purview of the new Firmregistration Act, the procedures purporting to implement the termination of business associations are regulated (to some extent with reproachable “overindulgence”) in a considerably more refined manner, than before. Accordingly, associations shall be formed by *ex nunc* registration with constitutive effect and cancelled in a similar manner from the trade register. The Court of Registration shall terminate, that is, dissolve business associations *ex officio*, a) if the association was finally liquidated by court, b) in proceedings directed at the termination of phony companies with headquarters at unknown addresses as per Articles 89–93 of Firmregistration Act, c) on account of repeated, gross misdemeanors on the part of the association as per Article 84 of Firmregistration Act.

As the two latter-mentioned proceedings demonstrate, with the lapse of the boom of the formation of business associations and the establishment of the material and incorporate criteria of lawful and expeditious company procedures, the sphere of the activity of the Court of Registration has focused on the *legality supervision* of business associations, which is only partially designed to sanction, since it increasingly assumes *functions of advocacy and assistance*. The regulation of the procedure of legality supervision is more elaborate under Chapter 6 of Firmregistration Act, since it specifies new instruments of legality supervision, e.g., in parallel with by-law, the designation of supervisory trustees

*ex officio* is admissible as per Articles 82–83 of Firmregistration Act. Several peculiar procedures of legality supervision are further regulated under the Firmregistration Act, such as the appointment of an official receiver as per Article 85 as well as the enforcement of the deposition or publication of company reports as per Article 87. The settlement of the equivocal financial situation following the termination of the business association is promoted by the procedure of financial settlement introduced formerly and regulated as per Chapter 9 of Firmregistration Act.