



**Employee board representation
in Hungary's new company law**

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Following lengthy preparations involving social dialogue and specialist debates, the Parliament passed Act IV of 2006 on Business Associations on 19 December 2005. It came into force on 1 July 2006, replacing Act CXLIV of 1997. The new legislation brought about several minor changes reducing the red tape involved in setting up and running various forms of association characteristic of small and medium-sized companies, such as limited partnerships ('betéti társaság' or Bt.) and private limited liability companies ('korlátolt felelősségű társaság' or 'Kft.'). For instance, these companies may now be established more easily by using a standard form of 'articles of association', provided by Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings, a law passed in tandem with the new company law. The new company law amended numerous regulations in the following areas: equity capital contribution for the foundation of a business association; legal position of executives; minority shareholders' rights; filing appeals to courts concerning decisions of shareholders' meetings; protection of creditors, and so on. The following review is limited to presenting the changes affecting employee's representation.

Introduction of the one-tier system

As far as share companies ('részvénytársaság' or Rt.) are concerned, Section 172 of the new act distinguishes between two forms: 'public limited company' ('nyilvánosan működő részvénytársaság' or 'Nyrt.') and 'private limited company' ('zártkörűen működő részvénytársaság' or 'Zrt.'). The former means that the company's shares (all or some) are traded publicly in compliance with the Securities Act, while in the latter case the shares are not offered to the public or have been removed from trading on regulated markets.

By default, the law prescribes a two-tier corporate governance system with a separate board of executive officers and a supervisory board. Section 21, however, contains the option of the one-tier corporate governance system: the articles of association of a public limited company (the company charter) may contain provisions to combine management and supervisory functions in a single board of directors. The new law does not allow Hungarian private limited companies to opt for a one-tier corporate governance system. (Please note that the English translation of the law is somewhat misleading on this point.) In the monistic system there is no supervisory board, and the law requires the members of the (single) board of directors to be regarded as executive officers.

The legal regulation of board-level representation in the monistic system is limited to Paragraph 2, Section 38, prescribing that ‘in the case of public limited companies under the one-tier system, the procedures for exercising the rights of employees to supervise the company's management shall be laid down in an agreement between the board of directors and the works council, in accordance with the articles of association.’ This legal text, however, invites three comments: first, there is no minimum legal standard for employee representation in the one-tier corporate governance system; second, it is not clear what sorts of conditions the articles of association may include to modify or perhaps reduce the scope of the agreement to be concluded between the board of directors and the works council; third, this wording also suggests that the parties may conclude an agreement which altogether excludes the board-level representation of employees. Given that in line with the relevant EU directive the Hungarian legislation produced a fairly specific and detailed regulation concerning employee representation in the European Company (SE), the summary language of the Hungarian company law is surprisingly inadequate.

Another novelty of the law is the introduction of so-called ‘Recognized Groups of Companies’: holding companies (required by the Accounting Act to file ‘consolidated annual reports’) and their subsidiary companies may decide to enter into a ‘control contract’ and continue operating in the form of a recognized group. ‘Employees’ interest representation organs’ at the companies affected have to be informed and consulted prior to the decision on the formation of a recognized group. The law, however, does not specify whether employees’ interest representation organs shall be trade unions or works councils, or both.

Changing regulations on employee representation on the Supervisory Board

In the two-tier system, it is not compulsory for private limited companies to set up a Supervisory Board, if they meet certain criteria. At present, in line with the deregulatory endeavours of law-makers, a limited liability company or a private limited company has to set up a Supervisory Board only if the law specifically requires it in order to protect the public interest, or the company otherwise is obliged to establish employee representation in the Supervisory Board. Furthermore, in a private limited company a Supervisory Board must be established if 5 per cent of the shareholders wish to do so. According to the old law, a Supervisory Board was not compulsory for a limited liability company, provided that its equity capital was less than HUF 50 million (EUR 200,000). This stipulation suggests that legislators intended to give SMEs – typically choosing limited liability as their business form – a waiver from establishing Supervisory Boards. Nonetheless, the new legislation has extended the use of such a ‘simplified’ corporate governance system without setting a specific limit on equity capital.

The new law has not changed the main features of board-level representation of employees. At companies with 200 full-time employees or more, one-third of the Supervisory Board must consist of employee representatives. If one-third of the number of board seats is a fraction, rounding-up must be in favour of employee delegates. Such board-level representation is obligatory in both state-owned and private companies, regardless of whether the business operates as a public or private limited company (Nyrt. and Zrt. in the common Hungarian abbreviation) or as a limited liability company (Kft.).

Section 38 of the new law, however, contains the following strange wording: 'If the annual average number of full-time employees employed by the business association is over two hundred, the employees shall have the right to partake in the supervision of the company, unless there is an agreement between the works council and the management of the business association to the contrary.' In fact, this passage amounts to nothing less than allowing works councils to waive the employees' right to board-level representation.

The rest of the regulations have remained basically unchanged. The law contains a detailed procedure for the delegation of employee representatives: they are nominated by the company's works council from among the employees, but prior to nomination the works council is required 'to listen to the opinions' of company trade unions. This regulation basically fits Hungary's 'dual-channel' workplace representation system. If an employee representative is nominated, the shareholders' meeting is obliged to appoint the nominee of the works council if he/she meets the legal criteria defined by the law. Supervisory Board members' term of office is not limited by the law, but the shareholders' meeting may decide on the length of their term. Only the nominating works council is in a position to propose the recall and replacement of a current employee representative by another person. A new nomination of the works council is necessary if the representative's employment relationship is terminated for any reason. An addition in the new law is that the company's articles of association are supposed to set a deadline for such a procedure. The rights and duties of employee delegates are basically the same as those of non-employee Supervisory Board members elected by the shareholders. There is only one extra entitlement of employee representatives: should the Supervisory Board fail to reach a consensus, the shareholders' meeting must be informed about the minority position of the workers' representatives. In turn, the employee representatives' duty is to inform the 'community of employees' through the works council about all issues, with the exception of those restricted by business confidentiality.

The only regulation in the new law that definitely aims to strengthen the position of employee representatives is Paragraph 4, Section 39. It reads that 'employees'

representatives shall be entitled to the same protection as members of the works council in accordance with the Labour Code'. At the same time, another paragraph weakens the rights of both employee representatives and non-employee members of the Supervisory Board: the provision of the old law that any Supervisory Board member is entitled to request an extraordinary board meeting by specifying its purpose is missing from the new law. While the old law provided a detailed regulation, currently the Supervisory Board is authorised to establish its own rule, to be approved by the shareholders' meeting.

Furthermore, the new company law introduces the option of a German-style Supervisory Board with strong decision-making powers. Section 37 stipulates that 'the articles of association of private limited companies or the memorandum of association of private limited liability companies may contain provisions on assigning the right of appointment and recall of management board members and of managing directors, as well as of establishing their remuneration to the supervisory board, and on rendering the passing of certain peremptory resolutions subject to the prior consent of the Supervisory Board (Peremptory Supervisory Board). In this case members of the Supervisory Board shall also be considered as executive officers as regards the functions of management'. In fact, with the exception of the last sentence and the name 'Peremptory Supervisory Board' ('ügydöntő felügyelőbizottság') the old company law included the same rights and criteria. Another widely publicised novelty of the regulation on the Supervisory Board is that it allows the use of ICT, such as videoconferencing, with no need to be present in person.

Social dialogue on the bill

Prior to the Parliamentary debate, the bill was on the agenda of the 21 October 2005 plenary session of the National Interest Reconciliation Council (Országos Érdekegyeztető Tanács, OÉT), the highest-level tripartite consultative forum. At the meeting trade unions opposed the permissive rule in Section 38 which allows the works council and the management to conclude an agreement on employee representation in the Supervisory Board deviating from mandatory rules. As far as the delegation of employee representatives is concerned, trade unions proposed that, in case neither a trade union nor a works council exists at the given company, at least 50% of the employees should elect their representatives directly. At the plenary session of the OÉT, government representatives accepted the trade unions' proposal concerning Section 38, but insisted that the issue of direct elections needed further consultation and finally could be settled in a separate law. (In contrast to the consensus on Section 38, this passage remained unchanged in the law passed by the Parliament.)

Given that the bill ensured only information rights for employee representatives in the decision-making process on forming recognised groups of companies, the trade unions demanded consultation rights too. The government representatives accepted this proposal and the law includes both information and consultation rights.

It is worth noting that at the plenary session neither the trade unions nor the employers' associations provided any input on the stipulations concerning the one-tier system and employee representation in the monistic corporate governance structure.

Commentary

Contrary to its previous drafts, the law ultimately did not make board representation voluntary and the major regulations on employee representation remained intact. However, a sort of deregulation is emerging both in the one-tier system and in mandatory board-level representation. Instead of prescribing detailed procedures, the general trend for legislation seems to be to refer to the 'articles of association'; in other words, the shareholders' meeting, the supreme body of the company, is increasingly in a position to establish (or, in the case of a Supervisory Board, approve) rules, deadlines and ways of implementing the law. Another sign of deregulation is that, instead of laying down concrete regulations, the law relies on agreements in which – as in the case of the Supervisory Board – employee representatives may voluntarily waive their mandatory rights. Trade unions were too weak to successfully fight the above-mentioned amendments of the company law, and apparently were not aware of the problems regarding the regulation of employee representation in the one-tier system at all.