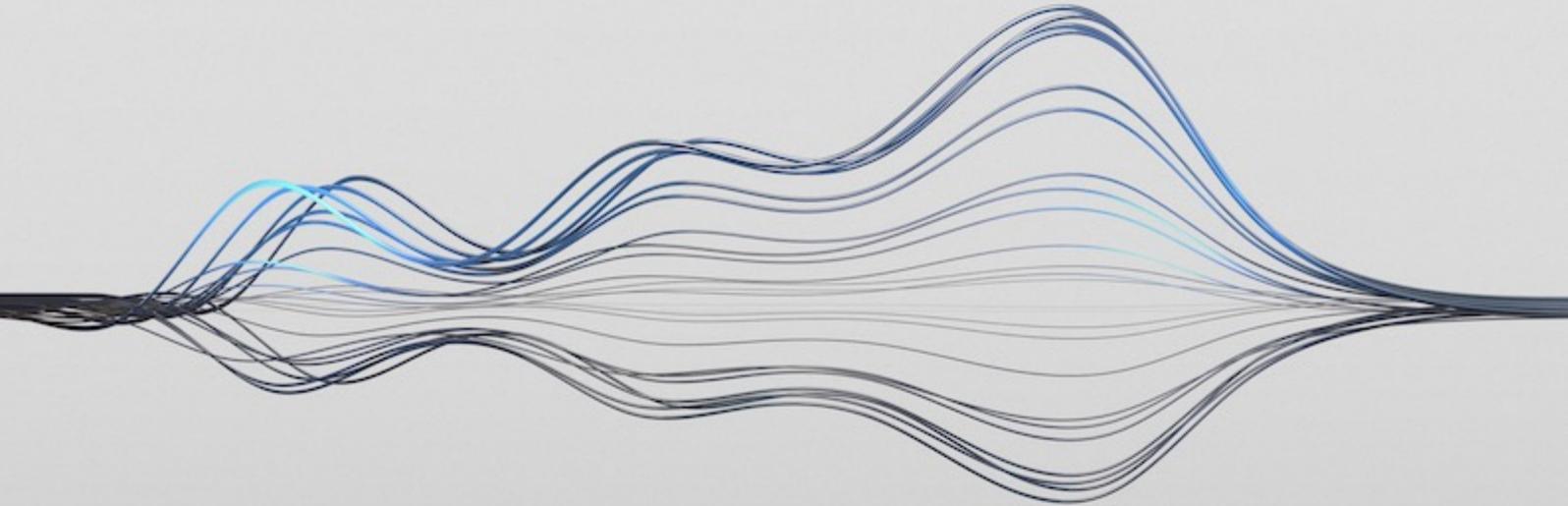


HUNGARY

Global Guide to Directors' Duties





Hungary

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Corporate entities

What type of company is typically used in group structures?

The most common (more than 99%) types of company used in group structures are:

- Limited liability companies (*korlátolt felelősség társaság or kft.*).
- Private companies limited by shares (*zártkörűen működő részvénytársaság or zrt.*).

The key difference between these two company forms is that in the case of companies limited by shares, the owners' equity interest is embodied in shares (printed or electronic share certificates) while in the case of limited liability companies the owners' interest is only a notional share in the company's equity (*üzletrész*), shares cannot/must not be issued.

This guide focuses on the management of these two company forms. In general, the directors' duties are the same in both types of companies.

Types of director

What is a "director"?

Under Hungarian law in *kfts.* and *zrts.*, the strategic management of the company is carried out by either one or more individual "executive officers" (*vezető tisztségviselő*), or by a body consisting of "executive officers" (board of directors). For the purpose of this guide we will use the term "director" for the executive officers.

The directors must be registered in the Hungarian companies register and such record must be kept up to date. Accordingly, the identity of the directors of any *kfts* and *zrts* is available to the public at any time.

What are the different types of director?

In general, Hungarian law has a single class of directors, who are responsible for the strategic management of their company. The only distinction in this regard is that in the case of public companies limited by shares (i.e. listed companies) operating a unitary management system (i.e. having only a single committee of directors that unite both management and supervisory duties, without a separate board of directors and a separate supervisory board), the Hungarian Civil Code requires that the majority of the directors must be independent. The definition of independence is set out in the Hungarian Civil Code – in this regard directors can therefore be independent or non-independent. Further, sectoral rules may also require that the board of directors includes "inside" directors, i.e. directors who are executive employees of the company – this applies e.g. to banks.

For completeness, two additional types of corporate officers are mentioned who are sometimes referred to as some form of "director" but who are in fact not directors:

- Company secretaries (*cégvezet*): these officers are appointed by the general meeting to assist the directors. Company secretaries are always employees of their company who must comply with the directors' instructions.
- Supervisory directors: this term is sometimes used for members of the supervisory board – under Hungarian law the supervisory board is usually a monitoring body ensuring shareholder supervision (similar to the widely used audit committees) and it usually does not have a strategic/operative management function; referring to the supervisory board members as “directors” is, therefore, misleading.

Eligibility

Who can be a director?

Directors must meet the following criteria:

- They must be of legal age and have full legal capacity.
- They must not be prohibited from practicing their profession by a final judgment; any person who has been prohibited by a final judgment from practicing a specific profession cannot serve as a director of a company that is engaged in the activity indicated in the judgment.
- They must not be subject to a disqualification order.

Any person who has been sentenced to imprisonment by a final judgment for committing a crime cannot be a director until released from the consequences of having a criminal record.

If the director is a legal person (e.g. a company), it must designate a natural person (individual) to perform the director's functions in its name and on its behalf. The rules applicable to directors shall also apply to this designated person.

In general, Hungarian law does not prescribe nationality or residency requirements for directors in a Hungarian company. However, sectoral legislation may set specific requirements (e.g. the board of directors of Hungarian banks must include at least two directors who are Hungarian residents for foreign exchange purposes).

Minimum / maximum number of directors

- In the case of limited liability companies (kfts) it is possible:
 - To set up a board of directors (Board): neither minimum nor maximum number is set by law.
 - Instead of a Board, to appoint one or more individual directors: such individual officers do not form a board; they can be appointed with sole or joint signatory rights (the latter will force the directors to coordinate their actions).
- In the case of private companies limited by shares (zrts), the shareholder(s) may:
 - Set up a Board (with a minimum of three members; no limit on the maximum number).
 - Appoint a single executive officer (*vezérigazgató*) who exercises the rights of a Board.

Appointment and removal

How are directors appointed?

- The first directors are designated in the articles of association of the company when the company is formed.
- As a general rule, after the incorporation of the company, directors are elected and removed by the general meeting. In a wholly-owned company, the sole shareholder resolves on election and removal (this must be in writing).
- Diverging from the above general rule, kfts and zrts may issue a preference business quota (kft) / share (zrt) that entitles its holder to appoint/remove one or more director(s) without the need for any action by the general meeting. No such preference share may be issued if a private company limited by shares is managed by a sole director (*in lieu of a Board*).

- Appointment takes effect when the appointment is accepted by the person appointed and in accordance with the effective date set out in corporate resolution on the appointment. Accordingly, when the appointment is subsequently registered in the Hungarian companies register, the register will record the aforementioned date as the effective date of the appointment.
- The directors must be registered in the companies register.

How are directors removed?

- The general meeting may remove a director at any time, without having to give any reason. In a wholly-owned company, the sole shareholder resolves on the removal (this must be in writing).
- If the company has issued a preference business quota (kft) / share (zrt) that entitles its holder to appoint/remove director(s), the removal will be decided upon by the holder(s) of such preference business quota (kft) / share (zrt), there is no need for any action by the general meeting. For the decision to take effect, the holder must notify the company of its decision (removal).
- A director may also resign at any time (without having to give reasons) by notice to the company delivered to the other director(s) of the company or its decision-making body. By force of law, if continuity of the operation of the company requires, the resignation will take effect only upon the appointment of the new director/ successor but in any case, 60 days after the resignation (so e.g. a director may not "jump ship" immediately if he is the only director in a company and his successor has not been elected yet).
- Removal of/resignation by a director must be registered in the Hungarian companies register. The effective date of the removal /resignation will be the date determined as such in the relevant resolution/resignation – the Hungarian companies register will record such date as the effective date of the change.

Board / management structure

Typical management structure

- **Strategic management: Board or individual directors.** As noted above, in the case of limited liability companies (kfts) strategic management is in the hands of either a Board or one or more (individual) directors. In the case of private companies limited by shares (zrts), shareholders usually set up a Board; however, sometimes they appoint a single director (*vezérigazgató*) instead of a Board.
- **Supervisory Board:**
 - **With monitoring functions.** The primary function of this body is to monitor/oversee the directors on behalf of the shareholders; formation of this body is mandatory in certain limited cases (e.g. if the average annual number of full time employees exceeds 200; state owned companies) and optional in most cases.
 - **With decision-making powers.** To provide flexibility, Hungarian law allows the shareholders to subject certain decisions of the Board/directors to the consent of the supervisory board or to allocate certain decisions altogether to the supervisory board (instead of the Board) creating thereby a divided decision-making system; the foregoing flexibility is sometimes used of as a compromise governance system where one shareholder (group) controls the Board, the other shareholder group controls the Supervisory Board.

How are decisions made by directors?

- In the case of Boards (both in kfts and zrts) the decisions of the Board take the form of board resolutions. Such corporate resolutions are usually passed by voting at Board meetings. The majority requirement for passing a resolution (simple or qualified majority) must be set out in the Board's rules of procedure. Alternatively, board resolutions may also be passed by circulation (i.e. without holding a meeting). In such cases Board members indicate their support for/objection to the proposed action by a written statement (vote).
- In the case of limited liability companies with one or more directors and in the case of private companies limited by shares with a single director: given that these officers are individual officers and not a collegiate body (board), there is no need to pass a resolution. Instead, they simply perform the acts in accordance with their decisions (e.g. they sign a contract).
- In the case of kfts having more than one director with independent signatory rights, the directors are entitled to act independently, however they are each entitled to raise objection against the actions of the other director(s). In that case the objection shall be decided by the general meeting and the planned action cannot be carried out pending such decision.

- In the case of zrts weighted voting may also be applied in decision-making, in which case, for example, the vote of the chairman of the Board may be decisive in case of a tie in votes. Further, it is also possible to grant multiple voting rights to certain members of the Board.

Authority and powers

- **Powers (competence).** Under Hungarian law, the powers of the Board/directors are residual, meaning that *all* decisions that are not expressly reserved for the general meeting shall fall within the competence of the Board/directors. Certain key decisions are reserved for the general meeting by law (e.g. approval of annual accounts, decrease of share capital, winding up of the company, appointment and dismissal of directors, auditors supervisory board members). Further, the shareholders may reserve additional decisions for the general meeting through the articles of association. Decisions that are not reserved for the general meeting by law and the articles of association shall fall within the competence of the Board/director(s). The foregoing issue concerns the allocation of decision making powers within the company and as such this is a corporate governance / internal issue.
- **Authority.** The directors are the legal representatives of the company vis-à-vis third parties. The representation rights of the individual directors (including the signing rights) can be sole or joint. In the latter case, the relevant legal document will only bind the company (as a general rule) if two directors sign it. The companies register must reflect whether or not a director's signatory right is sole or joint. Apart from the joint/sole signatory right, no other internal limitation on the directors' authority shall be effective vi-a-vis third parties. For example, if the articles of association subject the signing of a contract above a given value to the prior approval of the general meeting and the directors sign such a contract without the approval of the general meeting, the contract shall still be binding and effective on the company. Non-compliance with such internal limitations will trigger the directors' liability towards the company for beach of their duties but will not impact the validity/effectiveness of the directors' act vis-a-vis third parties.

Delegation

- As a general rule, under Hungarian law, directors must perform their duties personally. This means that e.g. at Board meetings directors cannot be substituted by a proxy/agent, decisions of the Board must be based on the Board members' votes cast directly. Notwithstanding the foregoing, the company's articles of association and/or its internal organisational rules (which are usually approved by the general meeting or the board) may allocate responsibilities for implementing the decisions of the Board /directors to the various levels of the company's organisations and to make decisions in their own right in this connection.
- As regards the right to act on behalf of the company vis-à-vis third parties, the directors may grant authority to the employees of the company to act on behalf of the company in the scope specified in the power of attorney on a permanent basis. Such authority can also be granted via the internal organisational rules of the company (e.g. giving authority to the CFO in office at any time to sign certain documents in the name of the company). It is, however, not permitted to give authority to an employee covering the full scope of the directors' duties. For ad hoc/specific cases, power of attorney may also be issued to third parties (non-employees) empowering such persons to act on behalf of the company vis-à-vis third parties.

Duties and obligations of directors

What are the key general duties of directors?

- To make all decisions related to the governance / strategic management of the company that are outside the powers of the general meeting.
- In performing their role, directors must always act in the interest of the company, and in line with the articles of association and the resolutions of the general meeting.
- To keep the shareholders informed in relation to the company and provide access to shareholders to the company's documents, records and registers (subject to confidentiality obligations).

What are directors' other key obligations?

The director(s) must, among other things:

- File the annual accounts (financial statements) of the company with the relevant authority (following the approval of such accounts by the general meeting).
- Ensure that the data indicated in the company register is up to date (e.g. signatories, company address, registered share capital).
- Convene the general meeting if they become aware that:
 - The company's shareholders equity fell below half (kft)/ two-thirds (zrt) of the registered share capital due to losses (sectoral legislation may set higher limits).
 - The company is threatened by insolvency or has stopped making payments or its assets do not cover its liabilities.

Directors must not acquire any shareholding in a business association -except for listed companies- and must not be directors in a business association whose main activity is the same as that of the company in which they are a director; however, the foregoing are default rules of the Hungarian Civil Code, so the articles of association may diverge from these. Further, within fifteen days of accepting their appointment, directors must notify any other company in which they are a director or a supervisory board member of such appointment.

Directors also must not enter into any transactions in their own name and/or on their own behalf falling within the main activity of the company except for usual transactions in the scope of everyday dealings (corporate opportunities); the foregoing are default rules of the Civil Code, so the articles of association may diverge from these.

Transactions with the company

In the case of kfts (limited liability companies), approval of entering into a contract between the company and a director (or his relatives) falls within the exclusive competence of the general meeting.

There is no corresponding mandatory rule for zrts (companies limited by shares) by default. However, the articles of association often contain such requirement or if the decision belongs to the board, the affected board members are usually disenfranchised (by the board rules) when voting on the approval of such contracts.

Liabilities of directors

Breach of general duties

For damages caused by the directors in the performance of their duties:

- **Vis-à-vis their own company.** As a general rule, the directors have unlimited liability towards their company for damages caused by the breach of their duties; commencement of an action against the directors for breach of their duties falls within the power of the general meeting; however, if the general meeting decides not to pursue such action, shareholders with at least 5% of the votes (or 1% in the case of public companies) have the right to litigate against the director on behalf of the company (derivative suit).
- **Vis-à-vis third parties.** As a general rule, it is the company who will be liable towards third parties for the actions of their directors (i.e. such third parties can sue the company, not the individual directors); however, if the director causes damages deliberately to third parties, the director will be liable jointly with the company vis-à-vis the third party.

Liabilities on insolvency

Focusing on officer liability in the context of bankruptcy and liquidation proceedings, Hungarian law prohibits "wrongful trading" by directors. This involves two stages as follows:

- **Establishment of liability.** Any creditor or - in the debtor's name - the liquidator may bring an action during the insolvent liquidation procedure of a company to establish that a person who had been a director of the company within the three year period prior to the opening of liquidation procedure failed to exercise his duties in the interest of the creditors after the threat of insolvency of the company had arisen and as a result of such failure the company's assets have diminished or satisfaction of the creditors' claims have been frustrated for other reasons. For the purpose of the foregoing, amongst others, non-compliance with the rules on the protection of the environment is also considered as a failure to take into account the creditors' interest. The court may not establish the director's

liability if he can prove that following when the threat of insolvency of the company had arisen he did not take any business risks that could be considered unreasonable in the light of the company's financial position and that he took all steps that can be reasonably expected from a director to mitigate the losses of creditors, including by the initiating the actions of the general meeting.

- **Claim for unsatisfied losses.** Following the publication of the court's resolution on the conclusion of insolvent liquidation of the company in the Company Gazette, any creditor may bring an action for ordering the (former) directors of the liquidated company whose liability was established in the course of the insolvency procedure (as set out above), for satisfying its claim registered in the liquidation proceedings that has remained unsatisfied (up to the loss resulting from the wrongful trading).

The above rules also apply if the court of registration strikes off a company from the company register in any involuntary deregistration procedure (*kényszertörési eljárás*), i.e. not in an insolvent liquidation procedure. An involuntary deregistration procedure (*kényszertörési eljárás*) is pursued by the court of registration if the company's operation is not in compliance with the applicable laws and such compliance is not remedied despite the measures of the court of registrations imposed on the company.

Other key risks

The Bankruptcy Act imposes several obligations on the directors of companies under insolvent liquidation or bankruptcy procedures (aiming at the orderly and transparent management of such distress situations, particularly the handover of the management and documentation of the insolvent company to the liquidator). Failure to observe these obligations may give rise to penalties imposed personally on the directors.

The direct, personal exposure of the directors to fines or liability may also arise in several other specific cases under applicable laws, including tax and environmental laws. For example, sectorial environment legislations (Section 102(5) of Act LIII of 1995 on the protection of the environment) sets out that directors who have supported a resolution (measure), in respect of which they knew, or should have known given reasonable care that such resolution (measure), if carried out, will cause environmental damage, shall bear unlimited and joint and several liability in the event of the termination of the business association or sole proprietorship for the company's ensuing liability for remediation and compensation for damages, which the company did not satisfy.

Criminal liability of the directors may also be relevant in extreme cases (embezzlement, fraud, serious breach of financial reporting obligations etc.).

Protection against liability

How can directors be protected from liability?

There are three main methods that may be used to protect the directors from liability *to some extent*:

- **Contractual limitation of liability.** The director's liability towards his company may be limited in his service agreement with the company (or the articles of association) – in these agreements, indemnity protection can also be agreed for the directors; liability for deliberate breaches of the directors' duties cannot be lawfully limited; contractual limitation of the directors' liability is not used widely in practice.
- **Hold-harmless/release certificate (*felmentvény*).** This is issued by the general meeting of the company: in connection with the approval of the annual financial accounts or when removed from office (in between the approval of the annual financial statements), the general meeting may pass a resolution confirming that the director duly performed his duties in the previous financial year. If such certificate is issued, then the company may only make a claim against the director for breach of his duties if it proves that the certificate was issued on the basis of incomplete or false information.
- **Directors' liability insurance.**

What practical steps can directors take to avoid liability?

Directors should:

- Keep in mind that they are always expected to act in the interest of the company and in line with the articles of association and the resolutions of the general meeting.
- Keep in mind that they are expected to act independently/autonomously, i.e. except for sole shareholder companies, no shareholders (including majority shareholders) have the right to instruct the directors.

- Avoid conflict of interest situations and if this is not possible, act transparently in that regard (e.g. by informing the general meeting).
- If the financial position of the company becomes fragile, particularly if the company is threatened by insolvency, take legal advice in order to avoid liability for wrongful trading (as detailed in the point concerning Liabilities on insolvency).
- Treat the shareholders equally, in a non-discriminatory manner, including if they request information on the operation of the company.

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