

**EMPLOYEE REPRESENTATION AT BOARD-LEVEL - THE  
HUNGARIAN REGULATION IN A COMPARATIVE CORPORATE  
GOVERNANCE ASPECT**

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## Abstract

The aim of the current thesis is to show the weak points of the Hungarian regulation on employee representation at board level and to recommend possible solutions. The research focuses on the present law from a corporate governance perspective. The underlying hypothesis of this thesis is that although the Hungarian Business Association Act obliges all companies above a certain size to provide seats in the supervisory board for employee representatives, in practice the institution of EBLR is rather weak. The analysis shows that it is mainly for two reasons. First, the role of the Hungarian supervisory board is not strong enough. Second, the enforcement of the rules on EBLR is insufficient, because the legislator has provided too many and (vague) possibilities for opting out. Through a comparative analysis of the Hungarian and German system this paper concludes that in order to attain better corporate governance the monitoring system of the corporation shall be strengthened as a whole in Hungary.

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# Introduction

In the age of technology skills are becoming an increasingly dominant factor in the success of the company. As corporations cannot prevail without highly committed workforce, it has been recognized that the influence of labor on strategic decisions has to be strengthened. At the same time, empirical data suggests that corporate governance plays an important role in investment decisions.<sup>1</sup> As Pistor points out, both corporate governance and employee board-level representation (EBLR) has the same goal: “to control economic power associated with large corporate enterprises.”<sup>2</sup>

In the present thesis I will examine the issue of employee representation at board level in Hungary. Through my research I will map out the weak points of Hungarian company law regarding EBLR and recommend possible solutions based on a comparative analysis with the German system of co-determination. During my research I am focusing on the effectiveness of the present law from a corporate governance perspective.

At international level the issue of employee board-level representation has been highly debated in the corporate governance literature. During my research I will mainly rely on the analyses of Katharina Pistor, Klaus Hopt and Christine Windbichler. Recent studies evaluating the new German Corporate Governance Code and the Societas Europaea (SE) Regulation are also taken into account. Although outstanding Hungarian scholars of company law like Kisfaludi and Sárközy have addressed the question of EBLR in Hungary, they focused on the interpretation of the legal text and thus took a classic, formalistic approach. The effectiveness of the current

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<sup>1</sup> BAKER & MCKENZIE. *Corporate Governance. A European Perspective*. 2007. p. 1.

<sup>2</sup> PISTOR, K. Codetermination: A sociopolitical Model with Governance Externalities. *Employees and Corporate Governance*, Washington D.C.: Brookings Institution Press, 1999, p. 163.

regulation in Hungary has been examined so far only from a labor point of view<sup>3</sup>. The authors of the Friedrich Ebert Foundation has identified many fatal flaws in the Hungarian arrangement that I will refer to throughout my analysis, however, they mainly put emphasis on the trade unions' interests and did not take into account the requirements of good corporate governance.

Notwithstanding the fact that the Budapest Stock Exchange has already published three Corporate Governance Codes, in Hungary corporate governance literature is rare in general. As scholars usually take a managerial approach, the following thesis aims to fill in this gap by mapping out the deficiencies of the current regulation in a comparative corporate governance aspect. The basic assumption behind the legal approach that I will follow during my research is that corporate laws are subject to development. The underlying hypothesis of this thesis is that although the Hungarian Business Association Act obliges all companies above a certain size to provide seats in the supervisory board for employee representatives, in practice the institution of EBLR is rather weak.

As the German system of co-determination that I am taking as a model is unique and not immune from criticism, first of all I will analyze the underlying theories of corporate governance in a nutshell in order to show why labor should be involved in the decision-making process. The next chapter compares the advantages and disadvantages of employee representation on the board. Although in the framework of this thesis is impossible to show all aspects of EBLR, I will sum up the main arguments on the subject matter. With reference to recent studies, I will point out that the most important benefit from a corporate governance aspect is that employee representatives on the supervisory board foster the flow of information. Since the Hungarian regulation can not be analyzed without having a look at the current European trends, in Chapter 2, I will give a snapshot on the recent developments at European-level. In the light of the

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<sup>3</sup> GRÓF, Gabriella, KISGYÖRGY, Sándor, LÉNÁRT, Szilvia. *Dolgozói Képviselek a Gazdasági Társaságok Felügyelőbizottságaiban*. Budapest: Friedrich Ebert Foundation, 2007.

European development I am taking the position that in order to prevent the deterioration of EBLR the regulation in the Member States should be enhanced.

Keeping in mind the lessons of the first chapters, I will not only examine the role and the position of the employee representatives, but also consider the role and composition of the German and Hungarian supervisory boards. While identifying the main shortcomings of the Hungarian regulation I will also observe that that the enforcement of EBLR is not effective because the legislator has provided too many and (vague) possibilities for opting out. I will suggest that the monitoring body of the corporation shall be strengthened as a whole in order to attain better corporate governance in Hungarian Public Stock Corporations.

# 1. Theoretical Principles of Employee Representation

## 1.1. Shareholder versus Stakeholder Theory

As the Introductory chapter indicated, when scrutinizing the Hungarian regulation on EBLR I will take a corporate governance approach. Since this perspective is a focal point in my research I cannot avoid identifying what this aspect means. This is of crucial importance as there is no uniform and generally accepted definition of corporate governance.<sup>7</sup> According to the most paraphrased definition of the Cadbury Report, corporate governance is „the system by which companies are directed and controlled”.<sup>8</sup> The definition used by the OECD Principles of Corporate Governance is also widely accepted:

Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.<sup>9</sup>

As to a definition used in the Hungarian literature, Miklós Dobák identifies corporate governance as the

(...) structuring of the control mechanisms, monitoring, and organization of a company or a group of companies in a manner that satisfies owners’ objectives and the interest of other stakeholders as well.<sup>10</sup>

Although the beginning of the corporate governance debate points back to 1932 when the key work of Berle and Means had been published, it is naivety to think that it has been settled by now. To the contrary: as a consequence of the corporate scandals in the 1990s, the questions just became even more complex.

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<sup>7</sup> DU PLESSIS, Jean Jacques [et al.]. *Principles of Contemporary Corporate Governance 1*. Cambridge University Press, 2005, p. 4.

<sup>8</sup> Report of the Committee on the Financial Aspects of Corporate Governance. London: Gee and Co, 1992, 2.5.

<sup>9</sup> OECD Principles of Corporate Governance (2004) p. 11.

<sup>10</sup> DOBÁK, Miklós. Corporate governance in Central and Eastern Europe. *Society and Economy*, Vol. 28. Issue 1., 2006. p. 27.

Basically, corporate governance models may be divided into two groups. At one extreme, the shareholder theory suggests that the main goal of the enterprise is to maximize the profit of its shareholders.<sup>11</sup> This perspective is founded on a property-based argument but also prevails in the contractual theory of the firm. The shareholder model focuses primarily on the agent-principal problem, arguing that directors owe fiduciary duties solely to the shareholders of the company.<sup>12</sup>

At another extreme, commentators suggest that corporations should be managed in a way that the interest of the stakeholders is also considered. The so-called stakeholder perspective had been first suggested by Freeman in 1984. The success of this concept is proven by the OECD Principles of Corporate Governance setting forth that:

The corporate governance framework should recognize the right of stakeholders as established by law and encourage active co-optation between corporations and stakeholders in creating wealth and the sustainability of financially sound enterprises.<sup>13</sup>

According to Freeman's definition "stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the activities of an organization."<sup>14</sup> He classifies not only owners, managers, employees as stakeholders but governments and local communities, too. There are several other definitions specifying the stakeholders of the corporation.<sup>15</sup> Nonetheless, there is one thing in common of those concepts: all of them acknowledge employees as stakeholders.<sup>16</sup>

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<sup>11</sup> FRIEDMAN, Milton. *Capitalism and freedom*. Chicago: University of Chicago Press, 1962. According to Friedman „there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game (...)"

<sup>12</sup> See e.g. JENSEN, Michael C. *A theory of the firm: governance, residual claims, and organizational forms*. Cambridge, MA: Harvard University Press, 2003.

<sup>13</sup> OECD Principles of Corporate Governance (2004) p. 21.

<sup>14</sup> FREEMAN, R. Edward. *Strategic Management. A Stakeholder Approach*. Boston: Pitman, 1984. p. 46.

<sup>15</sup> Friedman and Miles enumerate fifty-five different definitions. See FRIEDMAN, Andrew L., MILES, Samantha. *Stakeholders: theory and practice*. Oxford, New York: Oxford University Press, 2006.

<sup>16</sup> JOHNSTON, Andrew. *EC regulation of corporate governance*. Cambridge: Cambridge University Press, 2009. p. 61.



It would be pointless to restate all the theories that support the participation of labor in corporate governance. However, it must be emphasized that employees are required to be stakeholders for various reasons. In general, commentators argue that employees are affected by the business conduct of the corporation not only because the firm provides their wages or salaries. Employees are also interested in the success of the firm in the long run, because their jobs and usually also their future pensions depend on the prosperity of the company. Additionally, stocks of the company are often allotted to the employees as allowance.

Blair suggests that in the 21<sup>st</sup> century companies are organized in a way that they particularly rely on the qualifications and skills of the employees.<sup>17</sup> Since employees are required to invest in special skills that are not compensated directly by the enterprise, she takes the position that “the problem raised by investments in firm-specific human capital is analogous to the principal-agent problem.”<sup>18</sup> It has been pointed out that the relationship between the employees and the corporation is asymmetric. Therefore, employees are more at the mercy of the firm than other stakeholder groups. Shareholders may have stocks in different corporations as suppliers and consumers may rely on several companies. In contrast, the resources supplied by the labor cannot be diversified. Hence, as Greenfield stresses out, the firm-specific investment of the labor is illiquid.<sup>19</sup>

There are several acknowledged methods of employee participation. The most usual forms are work councils, participation in the management of the company, stock ownership plans and other profit sharing mechanisms. Employee representation on boards belongs to the latter group. More precisely, according to Bainbridge’s differentiation, it is a form of strategic participation: He

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<sup>17</sup> BLAIR, M. Margaret. *Ownership and Control*. Washington D.C.: The Brookings Institution, 1995. p. 233-234.

<sup>18</sup> BLAIR, M. Firm-Specific Human Capital and Theories of the Firm. *Employees and Corporate Governance*, Washington D.C.: Brookings Institution Press, 1999. p. 71

<sup>19</sup> GREENFIELD, Kent. *The failure of corporate law : fundamental flaws and progressive possibilities*. Chicago : University of Chicago Press, 2006. p. 52.

defines strategic participation as “(...) programs in which employees participate in major policy decisions, such as those traditionally viewed as falling within the realm of corporate governance.”<sup>20</sup>

Most commentators agree that corporate governance has to be interpreted in the context of the regulatory framework of the country.<sup>21</sup> Hodge considers both Germany and Hungary as systems “which provide a corporate governance structure that affords employees strong rights as stakeholders”.<sup>22</sup> EBLR exists in several European countries, however, as I will outline in a subsequent chapter the solutions are very diverse.

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<sup>20</sup> BAINBRIDGE, Stephen M. *Corporate Decision-Making and the Moral Rights of employees* p. 742. cited by DU PLESSIS, *supra* ft. 7. p. 22.

<sup>21</sup> OECD Principles p. 12.

<sup>22</sup> See HODGE, Tom. The Treatment of Employees as Stakeholders in the European Union: Current and Future Trends. *Syracuse Journal of International Law and Commerce*, 2010, Fall.

## 1.2. Advantages and Disadvantages

The current chapter elaborates the possible positive and negative “side-effects” of EBLR. Although in the framework of this thesis is impossible to show all the considerations, I will sum up the main arguments concerning the pros and cons of labor representation on the board. Note that most of the evaluations came to light with regard to the German system of codetermination.

The institution of EBLR may be examined at least in three aspects. First, in the field of economics numerous publications attempted to show positive or negative correlation between EBLR and firm performance. Some scholars have suggested that labor representation may further the firm to be more risk averse.<sup>23</sup> There have been also various researches implying that EBLR deters foreign investment or reduces stock prices<sup>24</sup>. The outcomes of those papers are extremely diversified.<sup>25</sup> Because of the inconsistency of the results it is very tempting to agree with Kludge and Wilke who are at the opinion that employee representation has not been proven to be disadvantageous.<sup>26</sup> On the other hand we have to keep in mind that it is very difficult to make an entirely faithful comparison between corporations because hardly all German companies are obligated to give board seats to employee representatives.<sup>27</sup>

Furthermore, it is articulated that EBLR is such a complex issue that can not be viewed from a purely economic perspective. Authors suggest that its social and political functions should be

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<sup>23</sup> *Idem* p. 19.

<sup>24</sup> See e.g. GORTON, Gary, SCHMID, Frank. Capital, Labor, and the Firm: A Study of German Codetermination, *Journal of the European Economic Association*, 2004, pp. 863-905

<sup>25</sup> Compare e.g. the summary of HODGE, supra ft. 22.

<sup>26</sup> KLUGE, Norbert, WILKE, Peter. Board-level participation and workers' financial participation in Europe. State of the art and development trends, *ETUI-REHS Research department Report No. 102*, 2007. available at: <http://www.etui.org/fr/Publications2/Rapports/Board-level-participation-and-workers-financial-participation-in-Europe> (26.03.2012.) p. 11.

<sup>27</sup> LIEDER, Jan. The German Supervisory Board on its way to Professionalism. *German Law Journal*, 2010, Vol. 11, No. 115, p. 16.

considered as key factors.<sup>28</sup> Kludge and Wilke refers to the institution as an “important connecting link between the enterprise and society”<sup>29</sup>. Basically, it is undisputed that strikes are rare in Germany and that “social peace” is the beneficial consequence of co-determination.<sup>30</sup> As Windbichler suggests, EBLR creates a “consensual corporate culture” for the management and workers are required to reach compromises during everyday business.<sup>31</sup>

Criticism from corporate governance literature came relatively late in time. Legislative history suggests that in 1976 corporate governance did not play the principal role during the implementation of codetermination in Germany.<sup>32</sup> Later on, corporate governance scholars pointed at co-determination as the reason why German supervisory boards had been so weak.<sup>33</sup> Pistor express that co-determination slows-down decision-making in the supervisory board. She also blames the rules of co-determination for the ineffectively big size of the controlling body.<sup>34</sup> It has been argued that labor representatives having a seat on the board undermine effective monitoring: Anecdotic evidence suggested that since the supervisory board is divided into two groups, the control over management might become less effective. Roe observed that because shareholders are reluctant to share information with employees, the “net beneficiaries are those who ought to be controlled: the company’s management”<sup>35</sup>.

On the other hand Greenfield emphasizes the advantages of diversified boards. One of his main arguments is that since workers are interested in the long-time success of the company<sup>36</sup> it is

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<sup>28</sup> HOPT K. Labor representation on corporate boards: Impacts and problems for corporate governance and economic integration in Europe. *International Review of Law and Economics*, 1994, Vol. 14, No. 2, p. 7.

<sup>29</sup> KLUDGE and WILKE p. 23, supra ft. 26.

<sup>30</sup> PISTOR p. 165, supra ft. 2.

<sup>31</sup> WINDBICHLER C. Cheers and Boos for Employee Involvement: Co-Determination as Corporate Governance Conundrum. *European Business Organization Law Review*, 2005, Vol. 6, No. 4, p. 6.

<sup>32</sup> PISTOR p. 164, supra ft. 2.

<sup>33</sup> See e. g. ROE, Mark J. Codetermination and German Securities Market. *Employees and Corporate Governance, Washington D.C.: Brookings Institution Press, 1999*; PISTOR, supra ft. 2. stating that co-determination “certainly reinforced (...) and added to the lack of control over management that already existed”, see also HOPT, supra ft. 28.

<sup>34</sup> PISTOR p. 190, supra ft. 2.

<sup>35</sup> ROE p., supra ft. 33.

<sup>36</sup> HODGE, supra ft 23, p. 21. referring to Greenfield

beneficial to let them to have a say in strategic decisions from the beginning of the negotiations. Most commentators agree that employee representatives are likely to bring a different viewpoint to the decision-making process.<sup>37</sup> It is also unquestioned that information is a crucial factor in effective monitoring. In general, shareholders' representatives are dependent upon managerial information, because they contact with the management infrequently. The problems that may arise from the lack of information may be circumvented by the participation of employees because they may call the attention of the shareholders' representatives to issues that otherwise would be hidden from them.

Hertig stresses that codetermination as an "information channel" is especially important in bank-oriented financial systems (such as Germany and Hungary).<sup>38</sup> L. Fauver and M.E. Fuerst describe three positive effects of EBLR. First, they suggest that the data supported by the labor may help the board to understand the rationale behind managerial decisions. Second, minority shareholders may also profit from the information gained from the delegates.<sup>39</sup> At the same time, employee representatives partaking in strategic decisions also help the labor side to get information about the long-term strategy of the corporation.<sup>40</sup> Kludge and Waddington refers to German surveys evidencing that EBLR makes the decision-making process more transparent.<sup>41</sup> Williamson also acknowledges the benefits of EBLR regarding the exchange of information. However, he puts emphasis on that it is the only advantage that may justify the institution. Furthermore, he restricts this finding to corporations whose employees have to develop firm-specific skills.<sup>42</sup>

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<sup>37</sup> HOPT, *supra* ft. 28.

<sup>38</sup> HERTIG, Gerard. Codetermination as a (partial) substitute for mandatory disclosure? *European Business Organization Law Review*, 2006, Vol. 7, No. 1, p. 4.

<sup>39</sup> L. FAUVER and M.E. FUERST. Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards. *Journal of Financial Economics*, 2006, Vol. 82, No. 3, p. 31.

<sup>40</sup> *Idem* p. 5.

<sup>41</sup> KLUGE, Norbert, WADDINGTON, Jeremy. Corporate governance and the voice of labour: Issues and debates. Paths to progress. Paths to progress. Mapping innovation on information, consultation and participation for employee involvement in corporate governance, Brussels: SDA, pp. 56-79. Available at: <http://www.sda-asbl.org>. Accessed March 27, 2012, p. 60.

<sup>42</sup> WILLIAMSON, O. Corporate Governance. *Yale Law Journal*, 1984, Vol. 93, No. 1197. paraphrased by JOHNSTON, *supra* ft. 16, p. 98-99.

Another positive effect usually mentioned about EBLR in a corporate governance aspect that it is a useful tool against hostile takeovers in Germany. While the underlying debate whether takeovers could be hostile at all is far from settled, it is clear that the fact that the bidder must obtain support from the side of labor renders his position to be more difficult.<sup>43</sup>

With regard to the Hungarian experience, Gróf, Kisgyörgy and Lénárt express that experience from the last ten years has evidenced that instead of jeopardizing the control over the corporation employee representatives enhances the continuous functioning of the supervisory board. They stress out that the supervisory boards of companies owned by foreign investors mainly consist of foreigners. Thus labor representatives support the monitoring body with essential local knowledge.<sup>44</sup>

In summary, most of the authors agree that EBLR not only enables the employees to be informed about the future of the corporation, but the delegates of the employees may also advance the monitoring ability of the board. In the next chapters I will focus on whether the Hungarian regulation fosters enough this information channel.

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<sup>43</sup> See: KOMO, Daniel, VILLIERS, Charlotte. Are trends in European company law threatening industrial democracy? *European Law Review*, 2009, Vol. 34, No. 2, p. 14; DU PLESSIS J,J, GROBFELD B., LUTTERMANN C., SAENGER I., SANDROC O. : German Corporate Governance in International and European Context, Berlin: Springer, 2007.: du Plessis and Sandrock refer to the regulation on co-determination as a “poison pill”

<sup>44</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 7.

## 2. The European approach to Employee Representation at Board-level

Corporate governance scholars claim that in the field of employee participation the European approach is not “fully integrated”<sup>45</sup>. While the slogan of “unity in diversity” is very high sounding, in fact the European legislator can not find the right balance of these two policy goals.<sup>46</sup> The approaches towards employee participation at board-level in the Member States are so diversified, that the issue had not only been an obstacle to the harmonization of European company laws, but also one of the key factors that held up the SE Regulation.<sup>47</sup>

Unfortunately, this thesis cannot cover the European legislation in details. Nevertheless, in order to be able to place the German and the Hungarian regulations it worth giving a snapshot about the different approaches in the Member States. The present chapter will show that EBLR is a “by and large accepted policy goal in the European Union”<sup>48</sup>.

In accordance with the most plausible compartmentalization<sup>49</sup> there are three main groups of countries in the EU with regard to EBLR. The largest group consists of Member States where EBLR is mandatory. Legislations belonging to this group mandate EBLR for every company - irrespective of the nature of ownership -, usually over a certain size. Nevertheless, there are big differences among these rules concerning the number (ratio) of the employee representatives, the threshold, the selection and appointment criteria.<sup>50</sup>

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<sup>45</sup> WINDBICHLER p.7, *supra* ft. 31.

<sup>46</sup> KOMO, VILLIERS, *supra* ft. 43. p. 17

<sup>47</sup> HOPT, *supra* ft. 28, p. 1.

<sup>48</sup> WINDBICHLER *supra* ft. 31, p 1.

<sup>49</sup> See. KLUGE, Norbert, STOLLT Michael (ed). *The European Company- Prospects for Worker Board-level Participation in the Enlarged EU*. Brussels: SDA and ETUI-REHS, 2006.

<sup>50</sup> Paths to progress, *supra* ft. 41.

At one extreme, Germany is said to have the “most formal and advanced system”.<sup>51</sup> As I will express in the forthcoming chapter, in some companies half of the supervisory board shall be appointed by workers. Scandinavian countries such as Sweden and Finland are also outstanding, since their system of ERBL entitles workers to be represented even in the board of directors. Sweden must be also mentioned for having the lowest threshold among the Member States: The Board Representation Act provides that in every company employing more than twenty-five workers two or three seats are taken by the employee representatives on the board.<sup>52</sup> To compare, in Austrian joint stock companies and limited liability companies one-third of the supervisory board is delegated by employees provided that the company has more than 300 workers.<sup>53</sup> Under Netherlands’ unique system called “co-optation”, as the board members are obligated to act in the best interest of the company the delegates are rather neutral directors than direct “representatives” of the workforce.<sup>54</sup>

In the first group there are also several Central and Eastern European countries. Contrary to the old Member States, where EBLR has been long-term tradition, in new Member States, like Czech Republic, Hungary, Slovak Republic and Slovenia, codification took place only around 1990.<sup>55</sup> As Kludge rightly points out, “the main motive behind adopting the German model was the idea of involving employees in the ‘painful’ privatization process”.<sup>56</sup> While the regulation in Slovakia and Czech Republic obliges state-owned companies and joint stock companies with more than fifty workers, in Slovenia worker representatives shall have seats in every joint stock company with a supervisory board. Hungary also belongs to this group of countries where the participation rights of the employees are said to be the “strongest”. However, it would be shortsighted to think that

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<sup>51</sup> The European Company, *supra* ft. 49.

<sup>52</sup> *Idem* p. 79.

<sup>53</sup> ETUI-REHS, Hans Böckler Foundation (eds.) *Workers’ participation at board-level in the EU-15 countries. Reports on the national systems and practices*. Brussels: ETUI-REHS 2004. p. 6-13.

<sup>54</sup> The European Company p. 76; See also HODGE, *supra* ft 21, p. 30.

<sup>55</sup> *Idem* p. 88.

<sup>56</sup> JAGODZINSKI, R., KLUGE, N. and STOLLT M. Worker interest representation in Europe: Towards a better understanding of the pieces of a still unfinished jigsaw. Paper presented at *8th IIRA European Congress*, 3-6 September 2007, Manchester, p. 8.



the current legislation is appropriate or better than in many other western European countries only because it EBRL is compulsory. Even before analyzing the Hungarian regulation, I suggest to consider “the gap between legislation and social reality” because, as Kludge rightly points out, “the existence of basic legal provisions does not automatically imply that the laws are being actively implemented”.<sup>57</sup>

The second group of Member States can be characterized as legislations where EBLR is recognized, but usually compulsory only for state-owned companies. For instance, in France, a delegate of the labor shall sit among the board of directors in state-owned companies, whereas it is only optional for joint-stock companies in the private sector. The participation rights of workers on the board are limited as the number of their representatives is maximized at one-third. In addition, shareholders may withdraw from such arrangements easily, as EBRL is “just a possibility and not an obligation for them”.<sup>59</sup> The biggest problem with the arrangements introduced in this group (eg. in Greece, Spain) is that the on-going privatization process lessens the participation rights of workers. One exception is Poland, where EBLR rules were designated especially for privatized companies. Until the state owns shares in the company, employees have the right to be take two-fifth of the supervisory board.<sup>60</sup>

Finally, there are ten member states<sup>61</sup> where EBLR is only exceptional. For instance, EBLR is only a voluntary institution in Italy even though employees have the right to take part in “the management of enterprises with the resources and within the limits laid down by the law”<sup>62</sup> pursuant to the Constitution of 1949. In UK, it was the so-called Bullock Committee that had proposed in the 1970s to introduce an arrangement in companies having more than 2000

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<sup>57</sup> The European Company, *supra* ft., p. 90.

<sup>59</sup> Workers’ participation at board-level in the EU-15 countries, *supra* ft. , p. 34.

<sup>60</sup> The European Company, *supra* ft. p. 89.

<sup>61</sup> <http://www.worker-participation.eu/National-Industrial-Relations/Across-Europe/Board-level-Representation2>

<sup>62</sup> The European Company, *supra* ft. , p. 75.

employees whereby independent directors would have been elected by a governing board consisting of an equal number of employee and shareholder representatives.<sup>63</sup> However, the proposal did not succeed and currently there is only one provision in the Company Act requiring the management to “have regard to the interest of the company’s employees” that indicates employees as stakeholders of the company.<sup>64</sup>

The examples above illustrate the reason why national level regulations on EBLR could not be harmonized at European-level. Currently, the European Union promotes employee involvement on the one hand and strengthens shareholder protection on the other.<sup>65</sup> According to the Commission’s Communication on “Modernizing Company Law and Enhancing Corporate Governance in the European Union” instead of total harmonization “a common approach should be adopted at EU level with respect to a few essential rules and adequate coordination of corporate governance codes should be ensured” (emphasis in original).<sup>66</sup>

Because of the lack of coherent European legislation the existing models of EBLR face challenges in the age of globalization. Furthermore, pursuant to the freedom of establishment and the state of incorporation doctrine that prevail in the decisions of the European Court of Justice, companies are free to choose the corporate law as they think fit. It is not difficult to see why lawyers predicted that ECJ decisions will lead toward a so-called Delaware effect.<sup>67</sup> Nowadays even if some member states require EBLR, these jurisdictions face the risk that corporations may easily escape such compulsory regulations by reincorporating elsewhere.<sup>68</sup>

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<sup>63</sup> Workers’ participation at board-level in the EU-15 countries, *supra* ft. , p. 130.

<sup>64</sup> Section 172(1)(b) of the U.K. Companies Act 2006 cited by HODGE, *supra* ft 21. p. 35.

<sup>65</sup> WINDBICHLER p.7, *supra* ft. 31.

<sup>66</sup> COM (2003) 284 final. *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*. Brussels, 21.5.2003. 3.1. p. 12.

<sup>67</sup> COMO, VILLIERS, *supra* ft. 43, p.11, see also WINDBICHLER *supra* ft. 31, p. 9. For a summary of the relevant cases see e.g. DU PLESSIS J.J. [et al.] *German Corporate Governance in International and European Context*. Springer, 2007, p. 146-158.

<sup>68</sup> DAMMANN, Jens. The future of codetermination after Centros: Will German corporate law move closer to the U.S. model? *Fordham Journal of Corporate and Financial Law*, 2003, Vol. 8, p. 649. Although Damman’s analysis of the

While empirical data shows that the judgments of the ECJ induced in particular smaller private limited companies to incorporate outside of stricter company laws, large public corporations have rather transformed into a European Company (SE).<sup>69</sup> Recent studies summarizing the motives behind the formation of an SE emphasize that the specific motivation of German companies had been the aim to circumvent the heavy duty of co-determination.<sup>70</sup> The SE Regulation trying to balance between the Anglo-American and the German model takes a contractual approach referring the question to the 2001 Directive on Worker Involvement. The Directive expressly states that setting up a single European model of employee involvement applicable to the SE would be “inadvisable” because of “the great diversity of rules and practices existing in the Member States as regards the manner in which employees' representatives are involved in decision-making within companies”.<sup>71</sup> Thus, employee involvement in the SE is subject to negotiations between the management and a so-called Special Negotiating Body that shall be comprised according to the Directive. Since the Directive takes a so-called “before and after” approach, if the parties fail to reach an agreement the applicable default rules provide the pre-existing levels of participation.<sup>72</sup>

In summary, it seems to be obvious that a single, unified system of co-determination can not be implemented at European-level. However, with regards to the level of the member states, it can not be emphasized enough that if the legislator decides to implement EBLR, it must provide a sufficient solution that enables stakeholders to participate in strategic decisions.

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Centros-case leads him to the conclusion that under the imperative requirements doctrine “could probably extend” the requirement toward “pseudo-foreign” companies, without violating the freedom of establishment, Villiers call our attention to the fact that such question has not been examined by the Court yet.

<sup>69</sup> KOMO, VILLIERS p. 18, *supra* ft. 39. Sandrock and du Plessis estimate thirty thousand English limited companies to have been incorporated by German citizens: German Corporate Governance in International and European Context, *supra* ft. , p. 157.

<sup>70</sup> See e.g. EIDENMÜLLER, Horst, HORNUF, Lars, and REPS, Marcus. Contracting Employee Involvement: An Analysis of Bargaining over Employee Involvement Rules for Societas Europaea. *Eggi WorkingPaper no. 185/2012*. available at: <http://ssrn.com>; REICHERT, Jochem. Experience with the SE in Germany. *Utrecht Law Review* 2008, Vol. 4, No. 1, available at: <http://ssrn.com/abstract=1114782>

<sup>71</sup> Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European Company with regard to the involvement of employees

<sup>72</sup> Eidenmüller observes that the percentage of employee representatives had not been reduced in any of the companies where employee participation existed before. To compare: REICHERT, *supra* ft. 70.

### 3. The Role of the Supervisory Board in German and Hungarian Stock Corporations

Since the evaluation of EBLR cannot be divided from the roles and responsibilities of the body to where the employee representatives are delegated<sup>73</sup> first of all I will examine the functions and the composition of the supervisory board in general.

As it is well known (and harshly debated) every German stock corporation shall have a two-tier board. According to this model, control and management is divided irrespective of the size of the corporation. The Hungarian regulation took the same path,<sup>74</sup> however, in order to comply with the SE Regulation nowadays public corporations may also opt for a single board.

The supervisory board in a German stock corporation has multiple roles and responsibilities that are well defined by the Stock Corporations Act. It not only supervises the management but also appoints and removes its members. Besides that, some transactions may be subject to the supervisory board's approval. However, the Act expressly forbids transferring managerial power to the board.<sup>75</sup> The supervisory board is vested with the right to bring actions against the management if the management does not act in accordance with the law or with the articles of incorporation.<sup>76</sup>

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<sup>73</sup> KLUDGE and WILKE, *supra* ft. 26, p. 11.

<sup>74</sup> While setting up of the controlling body is optional, the Statute describes cases where it is mandatory. Establishment of a supervisory board is mandatory for public corporations, except for any public or private limited company that is controlled by the one-tier system.

<sup>75</sup> Stock Corporation Act 1965 § 111(4)

<sup>76</sup> *Idem* §112

In addition, as Hopt notes, the “soft functions” of the supervisory board, such as balancing the interests between the different stakeholder groups, are essential and distinctive features.<sup>77</sup> § 126 of the Stock Corporation Act obligates the supervisory board to be involved in decisions that are of fundamental importance to the company. Pursuant to the German Corporate Governance Code (GCGC)<sup>78</sup> the management board and the supervisory board shall cooperate closely. Jan Lieder points out that the supervisory board became a powerful institution that monitors efficiently and also has a say in strategic decisions.<sup>79</sup>

According to the Hungarian Business Associations Act, the supervisory board is the main supervising body of the company in Hungary as well.<sup>80</sup> As the Hungarian law does not provide a detailed list of its functions, we can say that its main role is to control the operation of the company’s management in general. Presumably, the Hungarian Corporate Governance Code has recognized the vagueness of the Company Act and that is why it recommends that the supervisory board should provide a detailed list of its functions and roles in its rules of procedure.<sup>81</sup>

Even though the Hungarian legislator took German law as a model, the rights of the Hungarian supervisory boards are very limited. For instance, § 35(3) prescribes that without the written report of the supervisory board the shareholders’ meeting cannot adopt the annual accounting report. However, commentators agree that it is irrelevant what position the supervisory board take concerning the accounting report. As opposed to German law, the Hungarian Act does not

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<sup>77</sup> HOPT K., LEYENS P. Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy. *European Company and Financial Law Review*, 2004, Vol. 1. No. 2. p. 141.

<sup>78</sup> German Corporate Governance Code (as amended on May 26, 2010) available at: <http://www.corporate-governance-code.de>

<sup>79</sup> LIEDER, *supra* ft. 27. at p. 2.

<sup>80</sup> Act IV of 2006 on Business Associations (the „Company Act”) § 33. During my analysis I am relying on the Official Translation of the Act. However, in order to use a unified terminology I am following the terminology applied by the German Stock Corporations Act.

<sup>81</sup> Corporate Governance Recommendations of the Budapest Stock Exchange (March 11, 2008) 2.2.1. p. 12.

empower supervisory boards with preemptory rights. In the case of limited liability companies and non-listed corporations the articles of association may authorize the monitoring body with the right of the appointment and removal of management board members and also with certain appraisal rights. However, Hungarian corporations that are listed on the stock-exchange may not establish a so-called “preemptory supervisory board”. In other words, supervisory boards in public corporations do not have the power to make decisions in order to cure disorders. Gróf, Kisgyörgy and Lénárt argue that the main deficiency in practice is that Hungarian supervisory boards tend to analyze the work of the management instead of advising it.<sup>82</sup> Court decisions also support such practices: The Supreme Court confirmed that the supervisory board is obliged to sort out behaviors that might be detrimental to the company. However, it does not owe the duty to prevent damages. The judgment confirmed that the supervisory board fulfills its obligation by noticing and signaling detrimental conducts to the shareholders’ meeting.<sup>83</sup>

Most importantly, the board has the right and duty to call an extraordinary meeting of the shareholders any time it finds the activity of the management to be contrary to the law, to the articles of association or to the resolutions of the shareholders’ meeting. The supervisory board shall also notify the shareholders’ meeting if the management’s conduct “otherwise infringes the interests of the corporation or its shareholders”. What marks out from the Hungarian legal text is that that the supervisory board functions not only in order to provide that the company operates according to the law but the interest of the shareholders is also stressed. The Official Reasoning also indicates that the main idea behind the establishment of the supervisory board has been the aim to enforce the shareholders’ interest. In my opinion it is unfortunate that the Hungarian legislator has not emphasized more the rationales behind EBLR. To compare, it is widely accepted in German literature that the supervisory board must “safeguard” principally the company’s interest, “which may be different from the interest of the stockholders or the

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<sup>82</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 19.

<sup>83</sup> BH. 2009.367.

employees”.<sup>84</sup> Furthermore, the GCGC expressly states that all supervisory board members must act in the best interest of the company.<sup>85</sup> I believe that the legislator should clarify that the interest of the company is not always the same as the interest of the shareholders. Therefore, I think that the Corporate Governance Recommendations in Hungary also should contain a provision that is similar to the cited stipulation of the German Corporate Governance Code.

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<sup>84</sup> See e. g. RÜSTER, Bernd (ed.) *Business Transactions in Germany*. New York: Looseleaf. Matthew Bender, New York, 1983. 24-86; Being a board member in Germany p. 142.

<sup>85</sup> German Corporate Governance Code, *supra* ft. 81, 5.5.1

## 4. The Composition of Supervisory Boards in Germany and Hungary

German supervisory boards are usually bigger than the Hungarian ones: The Hungarian Company Act stipulates that supervisory boards shall comprise of not more than fifteen members. The monitoring body of German stock corporations consists of minimum three and maximum twenty-one members. With the exception of co-determined boards, the Stock Corporations Act requires that the number of the supervisory board's members shall be divisible by three.<sup>86</sup>

The Hungarian Business Associations Act stipulates that representatives of the employees shall comprise one-third of the members of the supervisory board provided that the business association employs more than two hundred employees.<sup>87</sup> The legislator advances EBLR by ordering that the number of supervisory board members shall be determined in favor of the employees if one-third of the number of members is a fraction.<sup>88</sup> This is the obligation of every business association irrespective of its form.

As Kisfaludi and Szabó point out, EBLR cannot be exercised in smaller companies on a voluntary basis<sup>89</sup> because § 36(2) expressly forbids the appointment of employees to the supervisory board except from the above mentioned cases. Sárközy, who took a principal role during the codification of the Business Associations Act, argues that EBLR is an institution that characterizes large enterprises; hence the threshold has been set up according to the statistical data concerning the minimum number of workers employed by such companies in Hungary.<sup>90</sup>

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<sup>86</sup> Compare: Company Act § 34(1) and Stock Corporation Act § 95

<sup>87</sup> Company Act § 38 (1)

<sup>88</sup> Company Act § 38

<sup>89</sup> KISFALUDI, András, SZABÓ, Marianna (ed). *A gazdasági társaságok nagy kézikönyve*. Budapest: CompLex, 2008. p.449.

<sup>90</sup> SÁRKÖZY, Tamás. *Gazdasági társaságok vezetési rendszere: vezető tisztségviselői státusz és felelősség a gazdasági társaságokban*. Budapest: Kompkonzult, 2010. p. 72.



Concerning the composition of the supervisory board the German law provides at least five different regimes depending upon the amount of share capital and on the number of employees. A supervising body that consists solely of members who have been appointed by the shareholders is exceptional among stock corporations. As a general rule, every listed stock corporation having more than 500 but less than 2000 employees is required to set up a supervisory board where labor has the right to delegate one-third of the members. There are only few corporations that are exempted from this rule, like companies having political, religious, charitable, educational, artistic, or similar purpose. Corporations falling within the Scope of the Coal, Iron and Steel Industry Codetermination Act are required to set up a supervisory board with eleven members. With regard to iron and steel holding companies the law sets forth that the supervisory boards of such companies should be designed as both the shareholders and the employees are represented by seven-seven representatives. In addition, a neutral person shall also be elected by the supervisory board.<sup>91</sup>

Joint stock companies, partnerships limited by shares, limited liability partnerships, trade and industrial cooperatives employing more than 2000 employees are subject to the Co-determination Act. Under the Act the supervisory board has to be formed according to the following charter:<sup>92</sup>

Number of employees employed by the company	Number of Supervisory Board Members	Number of shareholders representatives	Number of employee representatives	Number of trade union representatives
2000-10 000	12	6	4	2
10001-20 000	16	8	6	2
20 001-	20	10	7	3

With regard to the ratio of employee representatives it must be emphasized that even those authors who conclude that employee board representation has a positive impact on firm value

<sup>91</sup> See Coal and Steel Co-determination Act of May 21, 1951

<sup>92</sup> See Co-determination Act §1 and §7

suggest that the optimal ratio of workers in the board should be below 50%.<sup>93</sup> Since legal scholars usually find the one-third ratio of employee representatives to be preferable it would be pointless to suggest an amendment in order to reach the Co-Determination Act. However, as this “quasi-parity” system of co-determination is the most scrutinized model in the next subchapters will compare the Hungarian regulation with the 1976 Act on Co-determination.

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<sup>93</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 31.

## 4.1. Enforcement of Mandatory EBLR

Although § 38 of the Hungarian Business Associations Act seems to prescribe a quite straightforward obligation, I have to mention three things here: First, the participation can be avoided if works council and the management concludes an agreement. Second, as Chapter 4.3. will show, the regulation regarding public corporations governed in a one-tier system is rather controversial. Third, the enforcement of the obligation is dubious. As I will deal with the first two issues in the next chapter in details, it is only the latter question that will be examined here.

Neumann observed that although the Act obligates companies to set up a supervisory board where employees are represented, in practice neither labor inspection nor the courts of registration are authorized to monitor company practices regarding EBLR.<sup>94</sup> It could be argued that according to the Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings, judicial oversight proceedings may be launched in order to enforce the lawful operation of the companies.<sup>95</sup> Among others, such proceedings shall be conducted if the company fails comply with legal regulations or with the provisions of the articles of association concerning the company's structure and operation. Since the motion for a judicial oversight proceeding is given to any person who has legitimate interest, in practice labor unions have the right to launch a claim if the company fails to elect employee representatives in the supervisory board. Hungarian courts took the position that the supervisory board as a body may not ask for the supervision of the registry court but the sole members are authorized to do so.<sup>96</sup>

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<sup>94</sup> ETUI-REHS, SDA (eds.) *Worker Board-Level Representation in the New EU Member States: Country Reports on the National Systems and Practices*. Brussels: ETUI-REHS-SDA, 2005. p. 14.

<sup>95</sup> Act V of 2006 on Public Company Information, Company Registration and Windingup Proceedings § 72(1)

<sup>96</sup> BH 2002.367.

However, the court in its judicial supervisory competence may notify the company affected, impose a fine of between 100,000 and 10 million forints on the company or on the executive officer. In addition, it may convene the shareholders' meeting or appoint a supervising commissioner.<sup>97</sup>

§ 34 (5) of the Business Associations Act requires the management of the corporation to convene the shareholders' meeting if the number of supervisory board members falls below the number prescribed by the articles of incorporation or there is no person to convene the meeting of the supervisory board. However, the management is not obliged to call upon the shareholders' meeting if the monitoring body is composed unlawfully.

In contrast, German law requires the management board to make an announcement in the company's designated journals if it finds that the supervisory board has not been composed in accordance with the applicable statutory provisions. The Stock Corporation Act also sets forth that a new supervisory board shall be established that must be lawfully composed.<sup>98</sup> In case of dispute about the governing law, the Court regional court in whose district the company has its registered office has the competence to decide the issue.

In addition, the AG regulates the case when the statute of the company is against the rules of co-determination. § 97(2) stipulates that such provisions cease to exist. In addition, the supervisory board mandated by such unlawful provisions terminates. As a result of the decision of the Court, the supervisory board shall be set up within six months. Furthermore, the Court is authorized to appoint members to the supervisory board if the supervisory board does not have the requisite number of members to constitute a quorum or consists of fewer members than

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<sup>97</sup> Act V of 2006 on Public Company Information, Company Registration and Windingup Proceedings § 81

<sup>98</sup> Stock Corporation Act § 97

stipulated by the law for a three-month period.<sup>99</sup> The Act enhances that in case of codetermination, the “court shall appoint members in such a manner that the numerical ratio required for the composition of the supervisory board is maintained or re-established”. The Court must also consider the nominations of the work council (or the trade union) if the member to be replaced is an employee representative “unless appointment of the nominated person would contravene overriding interests of the company or the general public”.<sup>100</sup>

While the management is obliged to file such application, the law guarantees the right to bring action to the court not only to the shareholders and the governing bodies of the company but also to the central spokespersons, the work council and the trade unions which would have the right to nominate member. What is more, also the employees themselves are entitled to launch a claim.<sup>101</sup>

To summarize, German courts have quite strong competences concerning co-determination. At the same time, Hungarian courts are not authorized to appoint the members of the supervisory board. In my opinion the Hungarian legislator should consider to empower the registry court with more rights in respect of EBLR, especially with the right to appoint members to the supervisory board. In the light of the German regulation, I think that it would be also desirable to impose some duty on the management in order to enforce the obligation of EBLR.

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<sup>99</sup> *Idem* § 104(1)-(2)

<sup>100</sup> *Idem* § 104 (4)

<sup>101</sup> *Idem* § 98 (2)

## 4.2. Opting out by agreement

As I have pointed out in the previous chapter, the German rules on the composition of the supervisory board are very rigid. Although both lawyers and economist would welcome the possibility of negotiated, thus flexible solutions, nowadays the only way to escape from mandatory codetermination is to incorporate outside of Germany.<sup>102</sup>

Since 2006, Hungarian business associations having a two-tier board may be exempted from compulsory EBLR by an agreement with the work council. Theoretically, such solution should be endorsed. As Reichert points out with regard to the SE Regulation, negotiable arrangements on employee involvement enable the company to choose a solution that specially fits its needs and structure.<sup>103</sup> However, the Hungarian regulation is very vague in fact.

§ 38(2) prescribes that the opting-out agreement shall be concluded between the work council and the management.<sup>104</sup> As Kisfaludi contends, this arrangement is defective for two reasons. First, the management is in lack of legal capacity. Additionally, it is the controlled body that is entitled to negotiate about the composition of the supervising body. He suggests that the conclusion of the agreement should be in the power of the shareholders' meeting since it is a strategic decision that is fundamental for the company.<sup>105</sup>

Furthermore, the legal qualification of the contract is unclear. Both Sárközy and Kisfaludi raise the question whether it shall be governed by general contract law or by the stricter provisions of labor law. The issue of the consideration is not less controversial. Sárközy suggest that financial

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<sup>102</sup> ROTH, Markus, Employee Participation, Corporate Governance and the Firm: A Transatlantic View Focused on Occupational Pensions and Co-Determination. *European Business Organization Law Review*, 2010, Vol 11, <http://ssrn.com>, p. 24. See also: WINDBICHLER p.7, *supra* ft. 31. and HOPT, *supra* ft. 28.

<sup>103</sup> REICHERT, *supra* ft. 70, p. 27.

<sup>104</sup> Company Act § 38 (1)

<sup>105</sup> KISFALUDI, András. *Társasági jog*. Budapest: Complex, 2007. p. 193.

compensation such as increased salaries or social institutions (for example nursery schools or sport centers) could be adequate consideration.<sup>106</sup> On the other hand, Gróf, Kisgyörgy and Lénárt argue that such arrangement would result in that the workers lose an invaluable information channel that can not be supplemented in any way.<sup>107</sup> Therefore, they rather at the option that the agreement should provide more participation rights for the work councils in exchange. For instance they suggest bargaining for appraisal rights in the appointment of an equivalent of the German labor director. The rights to attend the most important sessions of the supervisory board could also be considered as a condition of the agreement. Combination of those solutions also has been also proposed by the above mentioned authors.

The law is also silent about the duration of the negotiated arrangements. It is ambiguous under which circumstances may the parties terminate the contract. Kisfaludi argues that the practice that enables the employees to cancel the agreement at any time is just as inconvenient as to force them to withdraw from EBLR for eternity.<sup>108</sup> Commentators suggest that these questions should be decided by the courts, however, to my best knowledge no cases has reached the courts concerning the issue so far.

As a result of the dubious adjudication of the courts, contract based participation is not likely to be practiced in Hungary. During my research I found only one public corporation, namely the Zwack Public Corporation that explicitly states on its web page that employee representatives are not seated on its board for the management of the company has concluded an agreement with the work council.<sup>109</sup> In addition, even if the parties conclude such agreements they are strictly confidential. As a consequence, instead of creating “an evolutionary process” that Windbichler visualizes at the European level, the concluded contracts rather belong to “the grey area of

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<sup>106</sup> Compare SÁRKÖZY, *supra* ft. 90, p. 72. and KISFALUDI, *supra* ft. 105, p. 193.

<sup>107</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 11.

<sup>108</sup> KISFALUDI, *supra* ft. 105, p. 193.

<sup>109</sup> [www.zwack.hu](http://www.zwack.hu) Accessed on: 2010.03.20.

law”.<sup>110</sup> The lawyer who has the task to draft an agreement does not have any rules to rely on. As Kisfaludi suggests to turn to the general principles of contract law, such as the requirement of good faith and commercial reasonableness.<sup>111</sup>

It is also highly recommended to examine existing arrangements in foreign companies. A recent research upon agreements concluded in SEs provides some valuable ideas. For example, Eidenmüller’s research mentions a case where EBLR „was traded for a social fund” set up with 1 million euros in order to promote the interests of the employees.<sup>112</sup> With regard to the problem concerning the duration of the contract, empirical data shows that 80% of the analyzed contracts have contained a provision stipulating that „structural changes” triggers renegotiations.<sup>113</sup>

Both national and international lawyers agree that although default rules should give space for bargaining, the minimum requirements of “opting-out” agreements should be regulated by the legislator.<sup>114</sup> The authors of Friedrich Ebert Foundation also suppose that the labor side’s position would be very weak through the bargaining process.<sup>115</sup> In line with that, Eidenmüller suggests that the bargaining process should also be well regulated. The legislator should provide not only that the employees are represented by trained delegates but also that the labor side would be able to make decisions on a well-informed basis.<sup>116</sup>

However, there are not so many examples that might be scrutinized as a model. As Eidenmüller observes the possibility to „choose applicable governance rules on employee involvement by negotiating an individual agreement [within the SE - added] is so far a unique experiment in the

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<sup>110</sup> See WNDICLER, *supra* ft. 31.

<sup>111</sup> KISFALUDI, *supra* ft. 105, p. 193.

<sup>112</sup> EIDENMÜLLER, HORNUF and REPS, *supra* ft. 70, p. 18.

<sup>113</sup> *Idem* p. 17.

<sup>114</sup> KISFALUDI, SZABÓ (ed), *supra* ft. 90, p. 452, WNDICLER, *supra* ft. 31, p. 9.

<sup>115</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 11.

<sup>116</sup> EIDENMÜLLER, HORNUF and REPS, *supra* ft. 70, p. 22.



he realm of corporate law”.<sup>117</sup> Since the Directive provides detailed rules on the negotiations and on the minimum standards of the agreements like the scope, date of entry, duration and circumstances that trigger renegotiations<sup>118</sup> I think that the SE Regulation could be a compass for the Hungarian legislator.

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<sup>117</sup> EIDENMÜLLER, HORNUF and REPS, *supra* ft. 70, p. 2.

<sup>118</sup> *Idem* p. 5.

### 4.3. One-tier Boards

One of the stated aims of the Business Association Act enacted in 2006 was to enhance the contracting freedom of the companies' shareholders. As a result, the Hungarian legislator created the conditions for a one-tier board in public corporations.<sup>119</sup> With regards to labor participation §38(2) stipulates that (...) "the procedures for exercising the right of employees - according to the articles of association - in supervising the company's management shall be laid down in agreement between the board of directors and the works council".<sup>120</sup>

Throughout the debates on the SE Regulation many authors observed that codetermination is connected to the two-tier structure. The German Corporate Governance Code has been widely criticized<sup>121</sup> because implementation of the one-tier system not on its agenda at all. Some authors took the position that "transforming a precise equivalent of quasi-parity co-determined supervisory boards into a one-tier board is difficult and arguably impossible task."<sup>122</sup> In fact, it is not without example, to have employee representatives in companies controlled in a one-tier system. For instance, Swedish company law stipulates that companies shall have employee representatives on a one-tier board.<sup>123</sup>

The Company Act does not specify what kind of rights could be conferred upon the employees, but it expressly refers to the possibility when employee representatives have seats on the board of directors. § 309(1) states that the maximum number of the Board of Directors may be exceeded as a result of employee participation.<sup>124</sup> The law reform triggered different reactions from foreign

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<sup>119</sup> Company Act § 308(1)

<sup>120</sup> Company Act § 38(2)

<sup>121</sup> See e.g. LEIDER, *supra* ft. 27.

<sup>122</sup> ROTH, *supra* ft. 101, p. 26.

<sup>123</sup> HABBARD P. *Corporate Governance in Sweden – An International Trade Union Perspective, report to the Hans Böckler Foundation*. 2008. p. 25-28.

<sup>124</sup> Company Act § 309(1)

commentators. While Roth promotes the flexibility of the Hungarian regime Vliegenhart argued that the amendment has “undermined effective employee representation (...)”.<sup>125</sup>

This controversy results from the adverse circumstance that there are two conflicting interpretations of the legal text: According to the first interpretation, the law enables employee representation among the board of directors, however, it is subject to two conditions: Besides the articles of incorporation, an agreement between the board of directors and the works council shall also be concluded. Assuming that the legal text refers the question of EBLR to the articles of incorporation, thus into the discretion of the shareholders, it is easy to recognize the drawback of the regulation. Presumably shareholders will be reluctant to conclude such agreements because having employee representatives among the board of directors would mean that the delegates of the labor take part in daily management. Therefore, by choosing the one-tier system, companies automatically would deny EBLR.

On the other hand, some authors believe that the employees have the right to participate in the supervision of the management whenever the number of the employees exceeds the threshold. They argue that the provision in question is under a subsection of the rule that stipulates that EBLR is mandatory if the company has more than 200 employees. Their argument is also underlined by the Official Reasoning. Consequently, they suggest that the articles of association may only determine the content of the participation rights and the management shall conclude an agreement with the work council about the procedures by which such rights are to be exercised.<sup>126</sup>

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<sup>125</sup> Compare: ROTH, *supra* ft. 101. and Vliegenthart, A. Regulating employee representation in post-socialist supervisory boards. *South-East Europe Review*, 2007, Vol. 10, No. 4.

<sup>126</sup> KISFALUDI, SZABÓ (ed), *supra* ft. 89, p. 453.

Kisfaludi expressed hope that the latter interpretation will prevail. As a matter of fact, in the light of my examination regarding the available corporate governance documents of the Hungarian publicly-held corporations whose stocks are introduced to the Budapest Stock Exchange, I have to conclude that employee representation on one-tier boards is illusionary in Hungary.

#### 4.4. The problem of Corporate Groups

In the 21<sup>st</sup> century, the group of companies that serves as an economical unit while consists of several separate legal entities from a formalistic point of view has become the „normal form of organization”<sup>132</sup>. Tom Hadden refers to the corporate group as a “significant institutional phenomenon in its own right”.<sup>133</sup> The legal community acknowledges flexibility as its main advantage. However, it is also a common-knowledge that it jeopardizes the legitimate interest of different stakeholder groups because it enables a sophisticated way to circumvent regulations.<sup>134</sup>

The Hungarian legislator had recognized the need of special regulation and in 2006 introduced differentiated rules regarding the relationship between holding companies and subsidiaries. The act expressly permits the creation of corporate groups by a control contract, if according to the Accounting Act the controlling business association required to draw up consolidated annual reports effectively exercises a dominant influence over the controlled company.<sup>135</sup> In practice companies may join forces in pursuing their common business interests in the lack of a control contract, too. The Act takes a functional approach and expands the rules to *de facto* groups of companies who, based on the collaboration of the controlling and controlled company (companies), operate under a common business strategy and demonstrate a conduct for at least three consecutive years that ensures the predictability and balanced allocation of the advantages and disadvantages stemming from operating in the form of a group.<sup>136</sup>

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<sup>132</sup> WINDBICHLER p. 5, *supra* ft. 29.

<sup>133</sup> HADDEN, Tom. Regulation Corporate Groups: An International Perspective. *Corporate Control and Accountability: changing structures and the dynamics of regulation*. Oxford: Clarendon Press, 2002. p. 343.

<sup>134</sup> *Idem* p. 344.

<sup>135</sup> Company Act § 55

<sup>136</sup> Company Act § 64

Although the law stipulates that the creditors and the minority shareholders shall be protected by the provisions of the controlling contract<sup>137</sup>, nothing in the Act enhances the participation rights of the employees of the controlled company. Unfortunately, with regards to EBLR, the current Hungarian regulation focuses on the formal corporate organization of holding companies and subsidiaries. Since the most important decisions concerning the operation of the controlled companies are decided at the level of the holding company, the employees will be unable to enforce their interests.<sup>138</sup> As Tom Hadden points out, it would be “essential for employee representatives to be located in the managerial or supervisory structure at the point where decisions are actually made.”<sup>139</sup>

In German law, § 5 of the Co-Determination Act specifies the obligations of group of companies with regard to co-determination. Unlike the Hungarian regulation, the Co-Determination Act stipulates that “the employees of the companies within the group are deemed to be employees of the controlling company”.<sup>140</sup> According to of the Stock Corporation Act, enterprises incorporated in Germany shall constitute a group if one or more controlled enterprises are subject to the common management of the controlling enterprise.<sup>141</sup> Not surprisingly, even German law is lack of protective provisions imposing mandatory rules on foreign subsidiaries. As we have seen in the previous chapters, the problem of international groups can not be solved by any state alone.<sup>142</sup>

In the meanwhile, as Windbichler highlights the European Company is a form of corporation that has been designated to be a member of group of companies.<sup>143</sup> In line with that, empirical evidence suggests that the current SE Regulation works out quite well in practice. The most often

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<sup>137</sup> Company Act § 55(2)

<sup>138</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 14.

<sup>139</sup> HADDEN, *supra* ft. 133, p. 365.

<sup>140</sup> Co-determination Act § 5

<sup>141</sup> Stock Corporation Act § 18

<sup>142</sup> WINDBICHLER, *supra* ft. 31, p. 8.

<sup>143</sup> KOMO, VILLIERS, *supra* ft. 43, p. 19.

cited examples are the supervisory boards of Allianz and MAN Diesel SE. Authors call our attention to their “truly international board composition”.<sup>144</sup> The Supervisory Board of Allianz consists not only of German but also English and French workers delegate members to the board. It is of extreme importance because their home countries do not impose mandatory regulation regarding EBLR.<sup>145</sup>

Although there are only several SEs that are incorporated in Hungary, the holding companies are very usual especially in the energy sector. My research has showed that out of fifteen examined companies whose stocks are traded in “Class A” on the Budapest Stock-Exchange there are four holding companies. Regarding national group of companies I believe that the German Co-determination Act provides a viable solution for the shortcomings of the current regulation. Therefore, in agreement with the authors of the Friedrich Ebert Foundation, I think that the above described technique of the Co-determination Act should be considered by the Hungarian legislator.

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<sup>144</sup> JAGODZINSKI, R., KLUGE, N. and STOLLT M. Worker interest representation in Europe: Towards a better understanding of the pieces of a still unfinished jigsaw, *supra* ft. 56, p. 10.

<sup>145</sup> *Idem*

## 5. The appointment and revocation of Employee Representatives

As a general rule, the Hungarian Company Law Act sets forth that the members of the supervisory board shall be elected by the shareholders' meeting. There are two exceptions from this rule: First, identically to the German regulation, shareholders of stock corporations may be entitled by the articles of incorporation to delegate a member to the supervisory board. Second, the nomination of employee representatives is in the competence of the work council.<sup>146</sup>

While the Hungarian law provides that “employee representatives are elected as members of the supervisory board by the general meeting”,<sup>147</sup> it must be emphasized that shareholders do not have much power concerning the decision. The shareholders' meeting is obligated to elect the nominees, unless statutory grounds for disqualification exist in respect of them. In this case, a new nomination shall be requested.<sup>148</sup> In the light of this, I have to agree with Kisfaludi on that the election is rather formal, and “it is aimed to preserve the illusion that the members of the organs of the corporate are elected by the decision-making body of the company and not by third parties”.<sup>149</sup>

Sárközy mentions that the idea to empower the trade unions with the right of nomination had also been considered during the legislative process. He explains as in most Hungarian corporations there are either no trade unions at all or too many, the initiative was abandoned.<sup>150</sup> Similarly, Gróf, Kisgyörgy and Lénárt mention that there had been fears that EBLR would

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<sup>146</sup> Compare Companies Act 231(1) d); § 288(3) and § 39 (1)

<sup>147</sup> *Idem* § 39(2)

<sup>148</sup> *Idem* § 39(2)

<sup>149</sup> KISFALUDI, *supra* ft. 104 at p. 195.

<sup>150</sup> SÁRKÖZY, *supra* ft. 90, referring to § 39(1) of Company Act



become “a battlefield of trade unions”.<sup>151</sup> As a consequence, trade unions operating at the business association are only entitled to set forth their opinion concerning the elections.

Pursuant to the Co-determination Act of 1976, employee representatives shall be elected by the employees of the corporation directly or by delegates. The regulation is very flexible since the employees having a right to vote may decide to opt for either of these arrangements. As a general rule, the Act differentiates between the ways of elections according to the size of the company: In companies having more than 8000 employees the election is to be held through delegates, and by direct election if the enterprise employs less than 8000 employees.<sup>152</sup>

Taking the German solution as a model, all the other CEEC countries where codetermination is mandatory implemented the system of direct election.<sup>153</sup> The authors of Friedrich Ebert Foundation justify the divergence of Hungary by explaining that successful cooperation between the different branches of worker involvement requires employee representative to be subordinated to the will of the work council.<sup>154</sup> As a consequence of the nomination right of the works council, the current situation in Hungary well fits Kluge’s metaphor that describes labor relations in Europe as „an unfinished jigsaw”.<sup>155</sup>

However, the present regulation is very controversial because of a flaw in Hungarian Labor Law. Since the Labor Code states that a work council shall be elected at every employer who employs more than fifty workers<sup>157</sup>, it seems to be straightforward that there is a work council at all companies with more than two hundred employees. As a matter of fact, commentators pointed out that the cited section of the Labor Code is a *lex imperfecta*. The law entitles the workers to elect

<sup>151</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 7.

<sup>152</sup> Co-Determination Act § 9

<sup>153</sup> The European Company p. 90.

<sup>154</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 10.

<sup>155</sup> See JAGODZINSKI, R., KLUGE, N. and STOLLT M. Worker interest representation in Europe: Towards a better understanding of the pieces of a still unfinished jigsaw

<sup>157</sup> Act XXII of 1992 on the Labor Code § 42(3)

a work council, whereas it does not regulate the case when such rights are not exercised. As a consequence, if the workers do not elect a work council, their participation right on the board will be lost.<sup>158</sup> Therefore, when evaluating the rule from a corporate governance perspective, I accept Kiss's opinion that "[I]t is no exaggeration to say that the legal consequences (of the regulation on Hungarian workers' councils) are simply inapplicable according to both labor law, civil law and company law."<sup>159</sup>

Obviously, it is the task of labor law to cure the deficiencies of the regulation on work councils. Nevertheless, a court decision dealing with a case where the unlawful composition of the board was due to the fact that the works council was not able to nominate an employee representative indicates another shortcoming of the work council's nomination right. The Supreme Court stressed out in its judgment that the shareholders' meeting is not obligated to call upon the work council by a resolution since the shareholders' meeting does not have such competence. Although the Court held that the conduct of the shareholders' meeting has to be examined during the judicial oversight proceedings, it pointed out that the shareholders' meeting has no duty to elect employee representatives if there has been no nomination by the work council. It is not difficult to note the insufficiency of the current arrangement from the vagueness of the decision. Therefore, I have to agree with the authors of Friedrich Ebert Foundation who argue that the Company Act should enable their direct participation at least as a default rule.

The complex rules of elections in the Co-Determination Act provide that beside the salaried and waged employees the executives will also have representatives. The delegates of the employees must be employed by the company for at least one year already. Additionally, as it has been indicated in Chapter 4 the trade unions represented in the company also delegates labor representatives. This latter group has been blamed a lot because of representing union policies

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<sup>158</sup> KISS, György. *Munkajog*. Budapest: Osiris, 2005. p. 457.

<sup>159</sup> *Idem* p. 485.

instead of the interest of the company.<sup>160</sup> The Hungarian regulation takes the position that no “external” members can be involved in the supervision of the company: The work council can only nominate a representative who is an employee of the corporation. Similarly, upon the termination of employment, the employees' representative also loses his membership on the supervisory board. This solution is in line with the suggestions of international corporate governance literature. Nevertheless, it has to be mentioned that in practice there is a “personal overlap” between trade union leaders, the chairpersons of the work councils and board members. Thus, as Neumann observes the general opinion is that “EBLR is nothing more than an opportunity to provide local union leaders and works councilors with extra income”.<sup>161</sup> It is due to the fact that in opposition to the German regulation that prescribes the procedure of elections in details, the Hungarian legislator left these questions to be subject of self-regulation. As a consequence, the work councils are free to approve any kind of set of rules they think fit.

The above elaborated problems concerning the appointment and the election of the employee representatives drive me to the conclusion that the Hungarian regulation should endorse direct elections. I suggest the Hungarian legislator to take the German law as a model and to create complex rules. On the other hand, I think that the regulation should also be as flexible as the German one and let the employees of the company to choose between the different set of rules.

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<sup>160</sup> PISTOR, *supra* ft 2, p. 190.

<sup>161</sup> ETUI-REHS, SDA (eds.) *Worker Board-Level Representation in the New EU Member States: Country Reports on the National Systems and Practices*, p. 14.

## 6. The Role of the Employee Representatives

### 6.1. Rights and Obligations

In this chapter I will enumerate the rights and duties of the Hungarian and German employee representatives. Both the German and the Hungarian law lay down that employee representatives have the same rights and obligations as every other members of the supervisory board. Most importantly, such rights comprise of the right to participate, right to vote and the right to be informed. Equality also prevails regarding the remuneration of supervisory board members. (However, since the latter topic is not subject to legal research it is out of the scope of the current thesis.) At the same time, every board member is bound by the duty of confidentiality and the duty of loyalty.

Concerning the rights of the German supervisory board members, commentaries stress out the right and duty to participate. On the one hand, employee representatives are entitled to enforce their participation rights. They have the right to commence an action against the company if they are barred of partaking in a meeting.<sup>163</sup> I believe that this right has special importance, since in theory both under the Co-determination and the Company Act the supervisory board might have a quorum without the delegates of the labor side. On the other hand, C. Von Dryander argues that the members are not only obliged to attend the meetings regularly, but they are also bound to cooperate with their colleagues.<sup>164</sup>

Although the German Stock Corporation Act sets forth that certain issues may be decided only by the entire supervisory board, among large corporations there is a tendency to establish supervisory board committees. This practice principally aims to overcome the problem of the excessively big size of co-determined boards. The GCGC also recommends the setting up of

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<sup>163</sup> VON DRYANDER, Christof, RIEHMER, *supra* ft. 84, p. 149.

<sup>164</sup> *Idem* p. 143.

committees, with emphasis on that their formation enables the supervisory board to monitor more effectively. In this context it is important to emphasize that when filing committee seats supervisory board decisions cannot discriminate against employee representatives.<sup>165</sup>

Although the Hungarian Code does not state expressly such rights, we can confer it from the legal text. The Hungarian Code neither regulates who is entitled to call for a meeting of the supervisory board. The prevailing opinion is that it is subject to the rules of procedures of the supervisory board. Theoretically, it is possible to let every member to call for a meeting. At the same time, in Germany every board member has the statutory right to call for a meeting.<sup>166</sup>

Anecdotal evidence shows that in Hungary supervisory boards do not have more than one scheduled meeting per year. The German Act stipulates that the supervisory board of non-listed corporations shall have at least two meetings in a year. In public corporations the board members are required to assemble minimum twice per half-year.<sup>167</sup> The Hungarian CGC recommends that the supervisory board should meet “regularly”.<sup>168</sup> While it would be high-sounding to suggest that the Hungarian Act should impose some requirements regarding the frequency of board meetings, I rather agree with Lieder who argues that as long as the board does not have the sufficient powers to monitor, it is useless to set up such obligations.<sup>169</sup>

As a result of the one-third ratio of employee representatives in Hungary, it is obvious that they will be in minority on the board. Since the decision-making on the monitoring body requires majority decisions,<sup>170</sup> the delegates of the employees can be voted down easily. Furthermore, the Act does not provide any veto rights for them. § 39 (3) states that if the opinion of employee

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<sup>165</sup> *Idem* p. 142. See also: German Corporate Governance Code

<sup>166</sup> Stock Corporation Act § 110(2)

<sup>167</sup> *Idem* § 110(3)

<sup>168</sup> Corporate Governance Recommendations of the Budapest Stock Exchange, 2.3.1. at p. 12.

<sup>169</sup> LIEDER, *supra* ft. 27, at p. 4.

<sup>170</sup> The statutory provision is cogent: Nor the articles of incorporation neither the rules of procedure of the supervisory board may deviate from the majority rule. See KISFALUDI, SZABÓ (eds), *supra* ft. 89, p. 462.

representatives unanimously differs from the majority standpoint of the supervisory board, they are entitled to state their viewpoint at the shareholders' meeting. Nothing in the law provides that the opinion of the workers will prevail. Consequently, authors enhances that the Company Act does not empowers the labor-force with a decisive influence.<sup>171</sup>

In the so-called “quasi-parity” system under the Co-determination Act decisions are also usually taken by majority. To prevent that the voting results in tie, the chairman shall have two votes.<sup>172</sup> As a result of the chairperson's casting vote, who is almost always elected by the shareholders' members of the supervisory board, the power is slightly shifted to the shareholders. Nevertheless, Hopt draw attention to the fact that “this vote is hardly ever used, since the probable moral and long-term costs usually far outweigh the victory in the concrete case.”<sup>173</sup> On the other hand, the members of the managing board shall be appointed by a majority of two-thirds.<sup>174</sup> Jean du Plessis and Otto Sandrock argue that this arrangement is a “general flaw” in German codetermination, because the “(...) members of the management have to seek the goodwill of the employee delegates (...)” not only before their appointment but also during their mandate.<sup>175</sup>

Despite of this argument, authors of Friedrich Ebert Foundation suggest that the same two-third majority rule should be applied in Hungary.<sup>176</sup> In the light of the German scholars' argument their recommendation seems to be disadvantageous with regard to the requirements of good corporate governance. In Chapter 1.2. I have expressed that the main goal of EBLR is to let the shareholders to be informed. In my opinion the present regulation fulfils this task, because it enables the employees of the company to add new perspectives into the decision-making process.

Therefore, I have to disagree with this initiative.

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<sup>171</sup> KISFALUDI, *supra* ft. 105, p. 197.

<sup>172</sup> Co-determination Act §27-28

<sup>173</sup> HOPT, *supra* ft. 28, p. 4.

<sup>174</sup> Co-determination Act § 31(2)

<sup>175</sup> German Corporate Governance in International and European Context, *supra* ft. 43, p. 129.

<sup>176</sup> Sec. GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3.

It is a common-knowledge that relevant information is fundamental for successful monitoring. I have also pointed out in Chapter 1.2. that commentators almost unanimously agree that the informational benefits of codetermination are essential from a corporate governance point of view. In the 1990s, Pistor and Roe argued that the ineffectiveness of German supervisory boards originates from the institution of co-determination. They explained that the monitoring body was in lack of information because the management and shareholders were unwilling to share confidential data with the workers.<sup>177</sup> However, in the last ten years the flow of information from the management board to the supervisory board has been strengthened by several amendments in the German Stock Corporation Act.

Since 1998, Section 90(1) obliges the management to disclose information about the “intended business policy and other fundamental matters regarding the company’s prospective business policy”. § 90(3) provides that not only the supervisory board, but also its members may require at any time a report from the management board on the affairs of the company, on the company’s legal and business relationships with affiliated enterprises, and on the circumstances concerning the business of such enterprises that may have a material impact upon the condition of the company. In addition, the auditor’s report shall be handed over to the supervisory board pursuant to Sec 321(5). If the supervisory board decides so the report shall only be submitted to the audit committee instead to every member.<sup>178</sup> According to Jan Lieder this stipulation has been enacted because companies might be reluctant to share such confidential information with the employee representatives.<sup>179</sup>

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<sup>177</sup> See PISTOR, K. Codetermination: A sociopolitical Model with Governance Externalities and ROE, Mark J. Codetermination and German Securities Market. *Employees and Corporate Governance, Washington D.C.: Brookings Institution Press, 1999.*

<sup>178</sup> See Stock Corporation Act § 90, §170 (3) and § 321.

<sup>179</sup> LIEDER, *supra* ft. 24, p. 5.

Identically to the German Stock Corporation Act, the Hungarian Code basically sets forth rights belonging to the supervisory board as a body. Section 34 states that the board may request information from the executive officers and employees and inspect the books and documents of the business association. The board may also require the help of experts when deemed necessary. However, the board may entrust any of its members to fulfill certain supervisory tasks, or may divide supervisory duties among its members on a permanent basis. Members of the supervisory board are also authorized to attend sessions of the shareholders' meeting in an advisory capacity.<sup>181</sup>

The Company Act forbids the management to hold back information because of trade secrecy. In the case of public corporations, the management's duty to disclose information is even more specified: According to § 244 (2) the management is obliged to inform the board at least once every three months about the financial situation and the business policy of the company. Pursuant to the Act, it is the supervisory board as a whole that is entitled to information. Contrary to the stipulations of the Company Act, the current practice in Hungary is that the management delivers the reports only to the chairman of the supervisory board. As a matter of fact, it is also usual that the members get information at the very last moment.<sup>182</sup>

By contrast, Jan Lieder observes that as a consequence of the appraisal rights of the German supervisory boards, nowadays the management provide the supervisory board "with all information necessary to decide on fundamental decisions on a well-informed basis" in Germany.<sup>183</sup> His argument induces me to think that the monitoring ability of the Hungarian boards could be more efficient if the law required the managing and the supervising body to cooperate more closely. As I have explained in Chapter ... supervisory boards in Hungarian

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<sup>181</sup> See Companies Act § 34(3), §35(1)-(2)

<sup>182</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 27.

<sup>183</sup> LIEDER, *supra* ft. 27, p. 7.



public corporations may not have preemptory rights. In summary, I think that if the Hungarian regulation empowered the supervisory board of public corporations with the right to be involved in strategic decisions, it would also enhance the flow of information between the governing bodies of the company.

However, the *janus faced* position of the employee representatives raises difficult questions regarding the right to information. Hopt argues that in this aspect equality among the supervisory board members is only illusionary. He explains that the interest represented by the employee delegates may conflict the interests of the company. His argument based on several German scandals where confidential information about important decisions had been disclosed to the public by the employee representatives.<sup>184</sup>

As a result, the Stock Corporation Act has been amended and nowadays a provision in the Act expressly prohibits the disclosure of “any confidential information or any trade and business secrets of the company”.<sup>185</sup> According to commentators “all information that is unknown to outsiders and that the company intends to remain to be unknown is a business secret”. In case of group of companies, this rule also applies to information concerning the subsidiaries.<sup>186</sup> Furthermore, the German CGC emphasizes that “[t]he comprehensive observance of confidentiality is of paramount importance” because good corporate governance requires an open discussion among the bodies of the company.<sup>187</sup> The duty of confidentiality covers not only confidential reports received but consultations, positions and statements, too.<sup>188</sup> If a board

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<sup>184</sup> HOPT, *supra* ft. 28, p. 3.

<sup>185</sup> Stock Corporation Act § 93

<sup>186</sup> Being a board member in Germany, *supra* ft. 84., p. 166.

<sup>187</sup> German Corporate Governance Code 3.5.

<sup>188</sup> Being a board member in Germany, *supra* ft. 84., p. 144.

member violates his duty, he might not only be liable for damages, but his behavior is also subject to criminal law.<sup>189</sup>

Like in Germany, § 27(1) of the Hungarian Company Law stipulates that employee representatives as executive officers of the company are obligated to keep all business secrets strictly confidential.<sup>190</sup> Business secrets are defined by the Civil Code as “all of the facts, information, conclusions or data pertaining to economic activities that, if published or released to or used by unauthorized persons, are likely to jeopardize the rightful financial, economic or market interest of the owner of such secrets, provided the owner has taken all of the necessary steps to keep such information confidential”.<sup>191</sup> This obligation of the board members does not end upon the termination of their office.

Despite of the recent modifications and the express requirement of duty of secrecy in the German Stock Corporation Act, Lieder suggest that employee representatives “(...) still occasionally believe that they are authorized to forward confidential information from the boardroom to the workforce, even if they thereby infringe their legal obligation of secrecy under § 116.”<sup>192</sup> This is especially true in Hungary where the law expressly obligates the employee representatives to inform the company's employees about the activities of the supervisory board.

It is a common practice in the Hungary to submit information in the very last moment to employee representatives or to the supervisory board as a whole.<sup>193</sup> Commentators argue that since every supervisory board member have the same rights the operation of the board should guarantee that the employee representatives get the same amount of information as the other

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<sup>189</sup> Stock Corporation Act § 404

<sup>190</sup> Company Act § 27(1)

<sup>191</sup> Act V of 1959 on the Civil Code § 81(2)

<sup>192</sup> LIEDER, *supra* ft. 26, p. 5.

<sup>193</sup> See GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3; ETUI-REHS, SDA (eds.) *Worker Board-Level Representation in the New EU Member States: Country Reports on the National Systems and Practices*.

members do.<sup>194</sup> On the other hand, if adequate information is handed over to the employee representatives, the delegates are usually required to sign a Declaration of Secrecy that prohibits disclosing any information which has become known to the members as a result of their service on the supervisory board. Friedrich rightly points out that such total ban results that the employee representative will not consult the workers and as a consequence they will represent “no one else, but themselves”.<sup>195</sup>

According to their suggestion, the problem could be resolved by preparing a detailed Declaration of Secrecy that regulates the conditions of disclosure. In my point of view, besides self-regulation the Hungarian Corporate Governance Code should contain a similar provision to the GCGC in order to promote that the exchange of information is quintessential for the efficient supervision of the company.

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<sup>194</sup> GRÓF, KISGYÖRGY and LÉNÁRT, *supra* ft. 3, p. 26.

<sup>195</sup> *Idem* p. 26.

## 6.2. Independence

The independence of employee representatives may be examined from two different aspects. First, it is of paramount importance to protect the delegates in order provide that they perform control effectively, in the best interest of the company. On the other hand, corporate governance literature implies that corporate abuses could be prevented if the members monitoring the management board have no personal or business relations with the company or its management. From this perspective EBLR has been strongly criticized, therefore the latter issue will be also addressed in the present subchapter.

As a general rule, the German Stock Corporation Act requires the members of the supervisory board to act in the best interest of the company. This is to mean that they cannot be influenced in their decision-making and voting on the supervisory board. It is also forbidden for them to benefit a particular shareholder groups.<sup>196</sup> The Hungarian Act guarantees the position of the supervisory board members by setting forth that they cannot be instructed in this capacity by the shareholders or by the employer.<sup>197</sup> This latter restriction is of special importance as to the employee representatives. In addition, § 39 (5) provides that they may be removed only upon the recommendation of the works council or if the representative is disqualified. Provided that the shareholders' meeting and the work council cannot agree on the question of disqualification, the regional court is authorized to decide the issue in its supervisory competence.<sup>198</sup>

Both the German and the Hungarian regulation adequately protect the delegates of the employees. § 26 of Co Determination Act forbids the discrimination of the labor representatives on the basis of their activities on the supervisory board. The cited Section also states that they

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<sup>196</sup> Being a board member in Germany, *supra* ft. 84. p. 143.

<sup>197</sup> Companies Act § 34(3)

<sup>198</sup> KISFALUDI, *supra* ft. 105, p. 195.

shall not be hindered or disturbed in the exercise of their activities.<sup>199</sup> Pursuant to § 39 (4) of the Hungarian Company Act, employee representatives are entitled to the same protection as the members of the works council under the Labor Code. According to the provisions of labor law, employee representatives may not be transferred, neither their employment may be terminated by the employer without the consent of the works council. This protection is due during their membership on the board and for one year following the expiration of such term, provided that the official held the office for at least six months.<sup>200</sup>

As to the independence of the supervisory board members in general, commentators argued that “[E]mployee-elected board members get in the way of this vision of an effective board.”<sup>201</sup> Lieder refers to the modification of the GCGC in 2005 concerning the requirement of “an adequate number of independent members” on the supervisory board as a “milestone” in German corporate governance. However, he also criticizes the Code because it did not specify the definition of independence.<sup>202</sup>

With regard to the supervisory board of Hungarian public corporations the Company Act requires the majority of the board of directors to be independent persons, unless the articles of incorporation prescribes a higher percentage. According to Section 309(3) independent members shall not be in any other legal relationship with the company. Therefore, an employee of the company will never count as an independent member of the board. Furthermore, employee representatives cannot be members of the audit committee as only independent members can be delegated to the body that’s establishment is mandatory pursuant to § 311.<sup>203</sup>

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<sup>199</sup> Co-Determination Act § 26

<sup>200</sup> Labor Code § 62(3) and § 28

<sup>201</sup> WINDBICHLER *supra* ft. 31, p6

<sup>202</sup> Compare: LIEDER, *supra* ft. 26. and HIRT, Hans-Christoph. Germany: the German corporate governance code: co-determination and corporate governance reform. *Company Lawyer*, 23(11), 2002, p. 9.

<sup>203</sup> See Companies Act § 309-311.

Lieder thinks that corporate governance regimes with a two-tier system should lay down that the majority of the board members shall be independent. On the other hand, the argument that implies that the institutionalized representation of different groups in the supervisory board is one of the main strengths of the German corporate governance system seems to be convincing.<sup>204</sup>

Due to the fact that – theoretically - Hungarian Stock corporations may also opt for a corporate governance structure where employee representatives take a seat on the board of directors, the subject matter has become even more controversial in Hungary. The regulation fulfils the requirements with regard to the notion of independence by expressly stating that the majority of the board of directors shall be comprised of independent persons. However, in the light of the quoted provision it seems to be less likely that shareholders will let employees to partake in this arrangement.

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<sup>204</sup> HIRT, *supra* ft. 205. referring to Davies, p. 10.

### 6.3. Liability

I will devote the last subchapter to the issue of liability. Although this issue could be a subject of separate research in itself as I am taking the position that the efficiency of monitoring “can and have to” be cured by amendments of company law,<sup>205</sup> the question cannot be evaded.

Under German law, supervisory board members are subject to the same the duty of care and responsibility as the members of the management board. The Stock Corporation Act requires every board member to act with “the care of a diligent and conscientious manager”. Each member has the duty to actively and diligently participate in supervisory board matters, and to act in the best interest of the company. If the members of the supervisory board violate such duties, pursuant to § 93(2) they are jointly and severally liable to the company for any resulting damage. The Act specially lists the behaviors of the management that may be a basis of action. However, as the supervisory board is the controlling body of the company its main duties are different. The Stock Corporation Act enhances that they are in particular liable for damages if they determine unreasonable remuneration.<sup>206</sup>

Pursuant to German Court decisions, the standard of monitoring is the same with regard to every supervisory board member. Although some scholars argued that the delegates of the labor side can not fulfill the standard of a prudent board member because of they are in lack of sufficient grounding<sup>207</sup>, the German Federal Court of Justice held that “every board member must at a minimum have the ability to understand and evaluate correctly the business operations that are subject to the board’s supervision”.<sup>208</sup>

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<sup>205</sup> THEISEN, M. R. Empirical Evidence and Economic Comments on Board Structure in Germany. *Comparative corporate governance : the state of the art and emerging research*. Oxford: Oxford University Press, 1998, p. 265.

<sup>206</sup> Stock Corporation Act § 93 and § 87

<sup>207</sup> HOPT, *supra* ft. 28, p. 3.

<sup>208</sup> Business Transactions in Germany, *supra* ft., 24-111

Some commentaries took the position that in order to escape liability, a member who thinks that the conduct of the management board is against law must “do whatever is needed” with a view to enforce the legality of the operations of the executive bodies of the company. Arguably, commentators expressed concern that „if these efforts provide to be unsuccessful, he must resign from a board if continued membership would constitute participation in or promotion of illegal acts”.<sup>209</sup>

Lieder emphasize that the recent amendments of German company law raised the requirements towards the representatives’ conduct.<sup>210</sup> Most importantly, the enhanced informational rights expressed in the former chapter, eliminated the possibility to claim the lack of information in order to be excused from responsibility.<sup>211</sup> Although it seems that the supervisory board members are subject to very strict liability rules, there have been only a few cases so far where court have declared their responsibility. As a matter of fact, as Semler notes, in practice inadequate behavior on the board results in losing membership on the board instead of judicial proceedings.<sup>212</sup> Critics argue that this practice is due to the fact that the right to sue lies with the stock corporation that must be represented by the management. Furthermore, with regard to the management’s liability, courts held that the decrease in the value of shares is only an indirect harm, not a direct damage, therefore shareholders are barred of initiating a suit. Thesien observes that in practice only liquidators sue.<sup>213</sup> However, as Baums points out the preventive function of the liability rules is crucial. He express that German supervisory board members are aware of their responsibility.<sup>214</sup>

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<sup>209</sup> Business Transactions in Germany 24-112

<sup>210</sup> LIEDER, *supra* ft. 26. at p. 18

<sup>211</sup> *Idem* p. 7.

<sup>212</sup> SEMLER, J. The practice of the German Aufsichtsrat. *Comparative corporate governance: the state of the art and emerging research*. Oxford: Oxford University Press, 1998. p. 279.

<sup>213</sup> THEISEN, *supra* ft. 208, p. 264.

<sup>214</sup> See BAUMS, Theodor. Personal liabilities of company directors in German law. *Speech at the Stratford-upon-Avon Conference of the British-German Jurist Association*, April 21, 1996.



Neither can shareholders commence a suit in Hungary. According to the Supreme Court, the right to claim belongs to the company itself, and derivative suits by shareholders are not permitted under the Hungarian Company law.<sup>215</sup> However, analogously to German law, minority shareholders of the company who owns at least five per cent of the votes may enforce rights on behalf of the company.<sup>216</sup>

§ 36(4) of the Hungarian Business Associations Act sets forth that “[s]upervisory board members shall bear unlimited, joint and several liability according to the provisions of the Civil Code pertaining to joint negligence for damages caused to the business association through the violation of their supervisory obligation”.<sup>217</sup> According to the commentators, supervisory board members will be held liable if they caused damages to the company by breaching their duty to monitor. Kisfaludi notes that as the supervisory board does not have decisive power, it is always the management whose conduct may cause damages in fact. Hence, wrongful behavior of the management is a prerequisite for resulting damages. Hungarian courts will consider whether damages could have been prevented had the supervisory board member performed their duty to supervise. Concerning the standard of monitoring Courts examine whether the board members acted according to the objective category of a prudent business men.<sup>218</sup>

The lack of court decisions indicates that in practice it is very difficult to prove the responsibility of the monitoring body in causing damages. On the other hand, the law stipulates that members are subject to joint and several liability. Pursuant to the Official Reasoning it cannot serve as a basis for exemption if the individual members prove that they have voted against a resolution.

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<sup>215</sup> BH 1997.329.

<sup>216</sup> Company Act § 49(5) There is no clearcut provision in the Company Act that authorizes the general meeting to enforce the rights of the company against the supervisory board members, however, as Kisfaludi claims, we can conclude it from the cited Section.

<sup>217</sup> Company Act § 36(4)

<sup>218</sup> KISFALUDI, SZABÓ (ed), *supra* ft. 89, p. 464.

With regard to the German regime Theisen observes that the liability of the board members is very extensive, however, the right to claim is very restricted. The analysis of the Hungarian regulation on the liability of supervisory board members drives me to the conclusion that this statement is also true in Hungary. With reference to Baums' argument I am on the opinion that the scope of the supervisory board members' liability should be emphasized more. I think that it is especially important to inform the employee representatives that supervisory board members have not only rights but also bear heavy responsibility.

## Conclusion

This thesis has scrutinized the Hungarian regulation on board-level employee representation by a comparative analysis with the German system of quasi-parity co-determination. The underlying assumption of my research has been that employees as stakeholders of the company should be involved in the corporate governance system of the company. With regard to the advantages and disadvantages of EBLR I have enhanced that it supports transparency and control because the information gained from employee representatives may advance the monitoring ability of the board. I have also pointed out that as a result of recent trends within the European Union, the institution of EBLR may only survive if the Member States themselves implement protective measures.

Throughout my analysis I have pointed out that the Hungarian Business Association Act obliges all companies above a certain size to provide seats in the supervisory board for employee representatives. However, there are several loopholes in the law that make mandatory EBLR illusionary. In agreement with Windbichler, I have taken the position that if the legislator implements the institution of EBLR, the regulation must provide that employees are equally represented irrespective of whether the corporation is a subsidiary or a holding company. Neither should it make difference whether the corporation is governed a one-tier or two-tier board. Therefore, in the light of the German regulation on group of companies, I have suggested that the Company Law should be amended in order to provide the participation rights of the employees without differentiating between the arrangements of stock corporations.

As EBLR depends on the establishment of work council at the company, in the lack of such institution employees automatically lose their participation rights on the board, too. Therefore, I have suggested the Hungarian legislator to take the German law as a model and to create

complex rules that endorse direct elections. Further research would be needed in order to evaluate EBLR in the light of other collective labor relations. This topic could be especially interesting for the new Hungarian Labor Code will enter into force on the 1<sup>st</sup> May 2012.

In my opinion the main shortcomings of the Hungarian regulation on EBLR are rooted in the absence of implementing the underlying principles of employee representation at board-level. I suggest that the Corporate Governance Code of Hungary should explicitly acknowledge that the supervisory board members should act in the best interest of the corporation.

Considering the question of effective monitoring, my research has showed that the supervisory board of Hungarian stock corporations has much less power than its German predecessor. I think that if the Hungarian regulation empowered the supervisory board of public corporations with the right to be involved in strategic decisions, it would also enhance the flow of information between the governing bodies of the company. Therefore, in order to fulfill the requirements of modern corporate governance, the supervisory board should be strengthened as a whole.

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