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Corporate Governance in Hungary in a comparative perspective

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1. Introduction

The present Thesis work essentially focuses on the Hungarian Corporate Governance system. Today’s Hungarian Corporate Governance theory was influenced by historical, economical, legal and political factors.

Throughout my Thesis I will show the fundamental historical assumptions and driving forces behind corporate governance theories. I will focus on the historical connections and the constantly changing character of what is considered an adequate and efficient corporate governance system by also pointing out the relevance of the shareholder and stakeholder theories as driving forces behind corporate governance models. In my paper I will concentrate on the various corporate governance systems of the different countries and compare them in light of the established Hungarian corporate governance model. I will evaluate how both the Continental model, -especially the German one - and the Anglo-American model are related to each other, and how they have influenced the elaboration of the Hungarian corporate governance system.

After discussing the main models of corporate governance theories I will focus on the regulatory background of the Hungarian corporate governance in a comparative perspective. I will present a brief overview on the main economic and legal factors influencing the establishment of the Hungarian corporate governance in its present form.

I will compare the Hungarian corporate governance theory with real life practice through the discussion of the MOL-OMV struggle. I will also compare the controlling power of the shareholders over the management of the Hungarian stock corporations to the practices of the Western listed-public companies. This comparison mainly intends to draw general conclusions on important topics of whether ‘soft’ (non-mandatory) or ‘hard’ (mandatory) law should regulate the relations between the members of the Board of Directors and the shareholders in Hungary and internationally; or how effectively internal and external monitoring tools are used.
In the last chapters I analyze the situation of the corporate governance system in the Central-Eastern European region. I also make numerous practical suggestions on how - according to my point of view- corporate governance models and best practices should be internationally integrated, and why legal and economic education should further in Central and Eastern Europe the corporate governance theory.
2. Early Corporate Governance Theory in the USA: the birth of Corporate Governance

As Adolf A. Berle and Gardiner C. Means note in their book *The Modern Corporation and Private Property*: “like the industrial revolution, which established the factory as a predominant form of production and separated worker from control over the instruments of production, the corporate revolution separating ownership from control over instruments of production (…)”¹ According to Berle & Means, the corporate revolution gave rise to the gradual occurrence of today’s large corporations which created a translation of approximately two thirds of the industrial wealth of the United States from individual ownership to ownership by these powerful corporations (also called by Berle & Means as *quasi-public corporation*) changing vitally the lives of property owners and workers and the methods of property tenure. Although the American law makes no distinction between the private and the quasi-public corporation, from an economic perspective the two are radically different.

Owing to the corporate revolution the quasi-public corporation gained such a relevant status in modern economy that an individual can hardly avoid constantly coming into contact with them, as he or she may be accepting their services (for example, from the huge corporations providing gas, or electricity), may be employed by them or have other own interest (for example, by purchasing stocks) in one of them. The above described modern corporate structure not only affects the laymen’s everyday life in a manner that resembles to fulfill state tasks and involves a certain social significance and responsibility of these corporations, but put the property content in a whole new dimension.

(The book could be characterized as the alpha of not just company/corporate and securities law and regulation but as well as of the emerging discipline of corporate governance which is why I am going to refer to it in several occasions in the Introduction part. Although the first edition of the book was published in 1932, many of its findings are key for understanding modern times).
This radical transformation was pointed out by Berle & Means in the example of the owner of a horse, who is responsible because if the horse lives, he must feed it, if it dies he must bury it. This ‘old type of physical property’ capable of being shaped by its owner worked as an extension of the owner’s own personality, and was completely overruled by the corporate revolution (a direct consequence of the industrial revolution), as the above mentioned elemental responsibility does not at all attach to a share of stock for example. Essentially this means that with the emergence of the corporation, the institution of the ‘old’ private property has been fundamentally changed bringing forth the surrender of the control over the wealth of individuals and in case of these huge quasi-public corporations also resulting in a concentration into huge aggregates, where the old property relationships lost their notions.

This significant transformation in the ownership structure of the actors of the market undoubtedly contributed to a major economic development during the last several hundred years and it certainly had a major impact on the economy and society. The changed rules of the game in the economy, society and the legal regulations gave birth to the -now well known- enormous, private corporations at the end of the 19th century. These corporations, especially flourishing in the USA, were owned by private actors: shareholders. The totally new corporate structure also raised the issue of how these companies should be managed in order to function the most efficiently and make the biggest profit. According to the above reasoning one can certainly conclude that the very first theories of Corporate Governance were published in the USA. One of these early works from 1932, Berle & Means, The Modern Corporation and Private Property already describes the main characteristics of the corporate governance, and not only does it put emphasis on questions of principal-agent problems but also it discusses in detail the questions of the quality of corporate governance which certainly has a major impact on the profitability of the corporation. Naturally I do

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3 principle-agent problem or agency problem according to bussinessdictionary.com: “Conflict arising when people (the agents) entrusted to look after the interests of others (the principals) use the authority or power (given to them, directly or indirectly, by the principals) for their own benefit instead. It is a pervasive problem and exists in practically every organization whether a business, church, club, or government. Organizations try to solve it by instituting measures such as tough screening processes, incentives for good behavior and punishments for bad behavior, watchdog bodies, and so on but no organization can remedy it 100 percent because the costs of doing so sooner or later outweigh the worth of the results.”

not want to create the impression that only the above discussed big corporations have corporate governance issues, as it is evident that every organization has a governance system: “governance concerns the distribution of power and responsibilities and, consequently, accountability for the organization’s performance”.\textsuperscript{4} This certainly applies to small associations with few members as well as to a sovereign state. However in my thesis I will elaborate the corporate governance theories concerning large stock market-listed corporations in Hungary mainly by comparing the Hungarian corporate governance system to others, as CG theories differ from country to country depending on economic and historical developments of the given country.

In order to revert back to the US evaluation of the ownership transformation due to the emergence of the large corporations the above discussed development of loosing the old notion of property relations, the established new situation divides the ‘real’ ownership into ‘nominal ownership’ and the power formerly attached to it. This happens through the transfer of the control of physical assets from the individual owners to those who direct the corporations. In the above used sense from principal to agent. This means an almost complete surrender of the former total power over the physical assets (meaning a complete right to the use, to the fruits and to the proceeds of the asset) retaining only an interest in their product and increase.

The consequence of all is not only the emergence of a nominal ownership of the individual, but also the loss of the very basic assumption of the so-far existing economic order whereby the best guarantee for economic efficiency rested upon the self interest of the individual by using his or her wealth in order to gain as much profit as possible. With the total disperse of the ownership in these quasi-public corporations\textsuperscript{5} this basic economic

\textsuperscript{4} Ulrich Steger and Wolfgang Amann (2008): Corporate Governance, How to add value. pg 3., John Wiley & Sons Ltd, The Atrium, Southern Gate, Chicester, West Sussex, England

\textsuperscript{5} by the term ‘quasi public corporation’ of the end of the 19\textsuperscript{th}. century I refer to the predecessors of today’s large corporations at the time already listed on the stock exchange. According to http://www.investorwords.com/4005/quasi_public_corporation.html “Quasi public corporation: Privately operated corporation with some sort of government backing, and specifically mandated responsibilities that are stated in the corporation’s legal charter. Examples include Fannie Mae and Sallie Mae. Though quasi-public corporations can usually issue stocks publicly, their primary responsibility is always to carry out their designated mandates, and creating shareholder value is a secondary objective.”
rule has been totally eliminated creating a new type of owner: the shareholder who only
possesses an insignificant fraction of the company’s stock thereby having no or only very
little direct control over the company, and no personal contribution to the efficient use of its
property. The only interest that individuals have is the long term increase and stability of
their stocks losing all direct control over their property. On the other hand, the managers
obtaining the actual control over the corporation are in the position of having legal and
economic powers over it.

This can also be described as the birth of two new groups created out of a former
single one “the owners without appreciable control and the control without appreciable
ownership”\textsuperscript{6} This raises another important question, whether the control operates in the
interests of the owners or we are to assume that the desire for personal profit is the prime
force motivating the control.

This tension between the control and the owners and their different interests grew
with the years through the weakening of the shareholders’ control over the direction of the
enterprise. The changes did obviously not come about overnight but gradually with major
steps showing how the shareholders’ rights over the control faded. Some of these steps are
for instance the right to vote by proxy, with the disappearance of the principle that
shareholders had the right to remove directors at will, or the simple fact that any striking
change to reach in the kind of business for which the corporation was organized became
impossible without unanimous consent. To demonstrate how the control gained more and
more independence, another good example is the evolution of the elimination of the state
supervision over contributions of capital. It is important to note that corporate management
is an institution created by law, (although the rules of the corporate game are certainly not
only set by law). The managers practicing control over the owners, the shareholders are
given legal legitimacy by the law itself since powers of control and management were
created by law, this important factor appeared to legalize the diversion of profit into the
hands of the controlling group.

\textsuperscript{6} Pg.113 Adolf A. Berle and Gardiner C. Means: (2009) The Modern Corporation and Private Property,
chapter Implications of the Corporate Revolution in Economic Theory, page 113. Transaction Publisher, New
Brunswick, New Jersey, tenth Printing.
3. Shareholder versus Stakeholder Theory as driving force behind corporate governance?

3.1 Freeman versus Friedman: Shareholder versus Stakeholder theory

In the previous chapter I have discussed the birth of corporate governance by pointing out some historical facts about the US type of corporate governance which I certainly consider the very source of all other corporate governance theories. Before going into the comparative analysis of the different types of corporate governance I would like to devote this chapter to comparing the very basic theories about the role of companies and the essence of their governance reflecting two radically different approaches. Both the shareholder and the stakeholder theories are considered normative theories of corporate social responsibility. These theories are not directly regulated by company or business laws in most countries however in light of the scandals at Enron, Global Crossing, and the Mannesmann Incident they became more and more hot topics in the last two decades.

According to the shareholder theory the only task of a company is to make as much profit for its owners, the shareholders as possible. The business entity has the binding fiduciary duty to put the interest of the shareholders in the first place and increase value for them at any cost. As I will evaluate in the upcoming chapters, the shareholder concept is the main theory recognized in business law of the different corporate governance models in different countries. The economic literature in general considers R. Milton Friedman as the promoter of the shareholder theory which is clearly undermined by his opinion: “there is one and only one social responsibility of business—to use its resources and engage in

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7 In order to point out the differences between the two theories I have relied on the books: Milton Friedman (1962) Capitalism and Freedom, with the assistance of Rose D. Friedman, The university of Chicago Press, Chicago and R. Edward Freeman (2007) Managing for shareholders, The Darden School University of Virginia, Virginia.


activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud”

The stakeholder theory in contrast deals not only with the question of ‘who is affecting the company’s life’ but also with the one of ‘who is affected by the activity of the company.’ According to the stakeholder theory shareholders and managers are not the only (although admittedly primary) actors affected positively or negatively by the company’s achievement, there are additional players who have a stake in the company’s actions: the stakeholders. According to Post, Preston and Sachs, “the stakeholders in a corporation are individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and/or risk bearers.”

From another point of view one can conclude that the stakeholder theory is not the total negation of the shareholder theory but rather an application for the changed conditions after the beginning of the 1970’s, or that the shareholder theory is an extreme –single stakeholder- version of the stakeholder theory. The relationship between political and economic freedom is complex and by no means unilateral as noted by Friedman in his book, Capitalism and Freedom. After the end of the Second World War this complex system of the concept of maximizing the profit of the shareholders many times to the injury of basic human values undoubtedly led to social injustice, environmental pollution and poverty for some parts of the world and a never experienced riches for those who benefit from this asymmetric interdependence of the present global economic order. The fall of the Soviet Union has shown that the free market economy serving the individuals own purposes and counter-balancing the political power is the way determined for human to follow for greater prosperity. Economic freedom is a necessary condition for political freedom and vica-versa. There are basically two ways of coordinating the economic


activities of millions: totalitarian state and the technique of market place. As proven by history the free market gives a ground for the co-operation of millions of individuals which can be achieved without coercion. To leave individuals this freedom is the corner point of future development. The collapse of the Communist/Nazi totalitarian state model shows that great, five-year and ten-year obligatory, macroeconomic state plans can not in the long run offset the basic human claim of individuals to be free and able to do business for their own benefit and not for an ideology imposed upon them. Professor Hoós puts this in the following way: “Government through its governance activities -in the institutional framework of a national state- can be a stabilizer of the economy and can permit the highest level of individual freedom without anarchy.”

As long as the freedom of exchange is maintained the central feature of market organization of the economic activity is that it prevents one person from interfering with another in respect of most of its activities, says Friedman and gives the example that in the liberal free market system the consumer is protected from a coercion by the seller due to the presence of other sellers with similar goods who he or she can do business with. One can rightfully conclude that through the liberty of the individuals, the market can reach the maximum profit possible without coercion and harm done to other individuals. More than eighty years after its birth the shareholder theory proved not to be completely true and this is why the stakeholder management theory could emerge. It certainly suits the present situation of the global comprehension of the world’s present state better.

In his book Friedman points out that the existence of free market is highly interrelated with the need for government, serving as a forum for determining the rules of the game of the market and as an umpire to interpret and enforce the rules to be decided on. However, shareholder theory which also supports the idea that the wider the range of activities covered by the market, the fewer the issues on which governmental decisions and regulations are required has been proven to be wrong in the last decades. The widespread above liberal approach supported the belief that in case governments left ultimate decision

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15 Milton Friedman (1962) Capitalism and Freedom, with the assistance of Rose D. Friedman, The university of Chicago Press, Chicago,
to the market it could function by itself. This “laissez faire” approach has certainly contributed to the present worldwide economic crises. Adam Smith’s idea of the ‘invisible hand’, whereby each business actor pursues his or her own self interest and thus the greatest good of all emerges, proved to be true with reservations in the world of Multinational Corporations and Foreign Direct investments moving greater capitals in relatively short time than the annual budget of some small countries.

Corporations following the rule of gaining the highest possible profit for the shareholder and supported by the highly liberalized global market have many times disregarded issues like social justice, labor norms, environmental issues, local communities and this contributed to a change in the attitude of the last fifty years which can clearly be reflected in Freeman’s stakeholder theory. The stakeholder management theory focuses on the need for ethics behind business activity. The ethical and responsible way of doing business which pays attention to all the stakeholders, (basically employees, customers, suppliers, local communities) beyond concentrating only on profit maximalization of the shareholders, is the response of the liberal market economy theory of Mr. Friedman originating in the 1960’s. With the collapse of the Bretton Woods international monetary and fiscal system the market became liberalized in a global sense. This multiplied the effect of the laissez faire policy and made the emergence of large firms possible thereby helping individuals to gain unseen wealth. It has also deepened the asymmetrical international interdependence between developing and developed nations. The above described events could not have been foreseen in the 1960’s and no-one could have imagined such a radical economic growth explosion due to the enormous development in information technologies, communication, (i.e: internet), infrastructure and transportation.

The Stakeholder management theory considers corporations and big firms as human institutions populated by real and live complex beings. Based on the lessons learned from the economic crises, environmental pollution and human rights concerns caused by the MNCs in the last decades, the stakeholder management theory’s main assumption is that business decisions and ethical decisions can not be separated and that business and ethics have to be integrated in a complex set of stakeholder relationships rather than treating
ethics as a side constraint on making profit. Freeman also highlights\(^{16}\) that the narrow self-interest is limiting, and can also be self-reinforcing if people do business only to gain the highest possible profit. In contrary to the shareholder theory the stakeholder theory fosters that the acts of a corporation have to be viewed as a complex activity and the main goal is to endeavor the best consequences for all parties, i.e. stakeholders.

Due to the stakeholder management theory there has to be a change of attitude from the so far dominant focus on the process of shareholders’ profit maximalization to the process of value creation where all actors (whether employee, manager, member of the local community or shareholder) i.e. stakeholders are inherently connected to each other. It is the primary responsibility of the executive to create as much value for stakeholders as possible. Thereby the central question of the management is transformed from the ‘how do we make the maximal profit possible’ to ‘how do we create value for the shareholder’ and thereby to ‘how do we create and sustain the creation of value for stakeholders’\(^{17}\). In order to achieve this we must finally refuse the theories of business relying on the separation of business decisions from ethical decisions and the two have to be integrated.

Another important consideration for the stakeholder concept is that the company has to take not only legal but also moral responsibility for its business decisions\(^{18}\). According to the stakeholder theory this results in a totally new interpretation of business that is about how customers, suppliers, employees, local communities and managers interact and create value. This idea according to Freeman leads to the best consequences for all. Freeman argues that Adam Smith’s idea of the invisible hand creating the greatest good only worked


\(^{17}\) This argumentation is called by Freeman as „The Open Question Argument” R. Edward Freeman (2007) *Managing for shareholders*, The Darden School University of Virginia, Virginia. Pgs 9. and 23.

\(^{18}\) According to FOCUS Group: Success Factors - Monitoring and Evaluation: “management should acknowledge the potential conflicts between (a) their own role as corporate stakeholders, and (b) their legal and moral responsibilities for the interests of stakeholders, and should address such conflicts through open communication, appropriate reporting and incentive systems and, where necessary, third party review”. Webpage: [http://www.focus-project.eu/focus_targetgroups.html](http://www.focus-project.eu/focus_targetgroups.html) accessed 15\(^{th}\) October 2010.
in special circumstances and proved to be improper in light of the recent scandals of large corporations or in light of the economic crises\textsuperscript{19}.

3.2 Concluding Remarks to Chapter 2 and 3

In chapters 2 and 3, I showed the fundamental historical and theoretical assumptions and driving forces behind corporate governance theories. In the second chapter I focused on the historical connections, how the corporate governance theory came into existence. In this chapter I intended to show the basic assumptions and constantly changing character of what is considered as good and efficient corporate governance theory based on the shareholder and stakeholder theories as driving forces behind corporate governance aspects. In the following chapters I will concentrate on certain main corporate governance practices of the different countries.

4. Definition and models of Corporate Governance established in different countries

4.1 Definition of Corporate governance

There is no unique definition of corporate governance, and definitions cannot be either right or good as they represent different historical, economical and legal backgrounds reflecting the various ideas of the authors. In the following I will present some of the different definitions of corporate governance:

“Corporate governance is only part of the large economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in production and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success.”  


“Corporate governance (…) is the structuring of the control mechanisms, monitoring, and organization of a company or a group of companies in a manner that satisfies owners’ objectives’ objectives, and the interest of other stakeholders as well”

— Miklós Dobák (2006) Corporate Governance in Central and Eastern Europe, Society and Economy vol. 28.2006/1, pg.27

“Corporate governance establishes clear structures regarding accountability, responsibility, and transparency at the head of the company, and defines the role of boards and management”

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21 Miklós Dobák (2006) Corporate Governance in Central and Eastern Europe, Society and Economy vol. 28.2006/1, pg.27
“Corporate governance primary includes careful management of the company (drafting and implementation of strategy), financial planning and its execution, the controlling of the company’s internal processes, issues of business ethics, transparent operation of the company, principles and procedures regarding the disclosure, and corporate social responsibilities.”

In light of the above enumerated various definitions one can draw the conclusion that corporate governance is the mixture of all of these, and certainly a very complex system of mandatory and non-mandatory regulations and control mechanisms inside and outside the corporation with the primary intend to protect the interests of the different stakeholders. With respect to the global economic expansion and the growth of multinational corporations it became more and more important to elaborate a cross-country variation on how large business entities should be governed on an international level. The big scandals of the beginning of the 21st century in connection with Enron, Wordcom, Global Crossing in the U.S.A. or the Mannesmann and Volkswagen (VW) incidents, the Parmalat accounting scandal and mutual fund fraud and the Société Generale derivatives trading scandals in Europe, causing billions of dollar and euro losses drew the attention to the importance of sound corporate governance theories. That is why numerous legislative and non-binding regulatory mechanisms were established internationally in order to reinforce the checks and balances of the governance of the corporations. The Organization for Economic Co-operation and Development (hereinafter referred to as OECD) reviewed its Principles of Corporate Governance of 1999 in 2004. The ‘Public Company Accounting Reform and Investor Protection Act’ commonly known as the ‘Sarbanes-Oxley Act’ was passed by the Congress of the U.S.A. in 2002 with the clear goal to set new and enhanced standards for the management and boards of public companies and for public accounting firms. Numerous regulatory measures were taken by the European Union in order to make the corporate governance more effective.

22 Ulrich Steger and Wolfgang Amann (2008): Corporate Governance, How to add value. pg 4., John Wiley & Sons Ltd, The Atrium, Southern Gate, Chicester, West Sussex, England


Having presented the various definitions of corporate governance, in the subsequent section I will elaborate the significant differences between the two main models of corporate governance: the Anglo-American and the Continental European. As the driving model behind the legal and dogmatic regulations of business entities in Hungary until the newly passed Act IV of 2006 on Business Association has historically been for long time the German legal system.\textsuperscript{25} I will focus on the German characters of corporate governance in a greater detail especially in case of the German ‘co-determination’ or ‘Mitbestimmung’ system.

4.2 The different models of corporate governance

Numerous corporate governance theories were elaborated internationally as governance models differ from country to country and constantly change throughout time. Two main categories of corporate governance models can sharply contrast: the Anglo-American and Continental European. The European corporate governance system can further be divided into the German model, the Latin model (Spain and Italy) and the structural model (the Netherlands). The Japanese corporate governance model can be distinguished as the third main category due to its unique solutions.

4.2.1 The Anglo-American model of corporate governance

Generally the US and UK corporate governance systems were considered as regarding shareholders as the owners of the corporation “to be suffering from the detrimental effects of short-termism induced by pressures coming from the stock market” at the same time supporting radical innovation and cost competition. The Anglo-American corporate governance model can be characterized as having a rather weak owner and a strong manager structure. The weak owner structure is due to the widely dispersed ownership structure of the US and UK companies. The Anglo-American model is also often called the liberal model or the model that is based on ‘Liberal Market Economies’ (LMEs) in contrast to the German or Japanese models built on ‘Coordinated Market Economies’ (CMEs). The Anglo-American corporate governance model is therefore often described as a market based one which can also be reinforced by the relatively high number of successful hostile takeover bids. The Anglo-American management structure is characterized by the so called

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28 Ibid: at 689, category established by Pistor.
‘one-tier board system’ where there are shareholders as the owners of the company on the one hand and the board of directors who manage the day-to-day life of the company or supervise the management of the company on the other hand. “In a publicly held company the board of directors must serve a dual function of allowing managers the flexibility they need to run the business while setting policy, appointing the principal senior executives, selecting the officers who in reality manage the business and monitoring the managers to limit self-dealing and poor management. The board of directors also reviews the company’s financial plans.”

Directors of the one-tier board model can be distinguished on the bases of their relation to the company. On the one hand executive directors are employees of the company and have direct reporting duties towards the company whereas on the other hand non-executive (also called as independent) directors have an independent, non-employee status and their task is to evaluate and monitor the company.

The typically dispersed ownership which reduces the controlling ability of the owners causes the tension between the shareholders and managers discussed in detail in chapter 2 of the present work.

4.2.2 The Continental models specially the German model of corporate governance

In contrast to the Anglo-American model, the Continental corporate governance model is generally characterized as focusing on the corporation as an independent social entity representing many stakeholders and concentrating on long-term development. The Continental corporate governance model also has the feature of a weak manager vs. a strong ownership managerial structure. The strong ownership feature in case of the Continental Model can be explained by the significant presence of dominant shareholders.

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(also called ‘controlling shareholders’ or ‘blockholders’ in case one shareholder owns at least 20% of the voting rights).  

These controlling shareholders are often powerful individuals or families also possessing the majority-voting shares of the company enabling them to control the management board as well. “Going by the median fraction of votes owned by the largest shareholder in all listed companies, ownership is highly concentrated in Germany and Italy, and diffused in Britain and America, with France in an intermediate position. Remarkably, in half of the listed German and Italian companies, one blockholder owns at least 57 percent or 55 percent, respectively, of the votes.”

A further important feature of the Continental Model of corporate governance is that hostile takeover bids rarely succeed due to the little-dispersed ownership structure and the fact that the economy is significantly less market based than the Anglo-American system. Another reason behind the few hostile takeover actions is the high presence of inter-company shareholdings and the significant influence of the banking sector in financing and supervising the companies.

The German management structure is based on the so called two-tier system. Essentially this means that all stock corporations obligated to follow the duel board structure consisting of a management board responsible for directing the day-to-day business of the company and a supervisory board having the main task of monitoring the management board’s actions and advising its members. The members of the two boards are irreconcilable which basically means that the members of the supervisory and management boards can not be members of both boards at the same time, in fact the independence of the members of the two boards are provided by strict regulations. “The role of the (Anglo-American) unitary board is monitoring the management primarily in the shareholder’s interest; the (Continental-European) supervisory board’s task is supervising in the interest of a wider range of stakeholders of the company. In fact, the essence of the two-tiered structure is the explicit representation of stakeholder interests other than of shareholders: no

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31 Ibid.:118-119
major strategic decisions can be made without the cooperation of employees and their representatives.”32

4.2.2.1 The unique ‘Mitbestimmung’ system of German company law

‘Berle and Means theory of corporate governance’ logically describes the necessary steps that have been taken in the last century by the management (the ‘control’) towards gaining more and more direction over the US quasi-public corporation, and as a result this ended up in a very significant power over the direction of the large American corporations.

The German company law took however a totally different way, which can be based upon the assumptions of the German legislators. After the second World War, in order to avoid the fall of a complete nation into the dictatorial pattern of the Third Reich again, the codetermination corporate system was invented with the aim of making it compulsory for labor and management to work together at the level of supervisory board and thereby avoid the emergence of very strict class distinctions existing before the war which partially led to the totalitarian system. Essentially this is the main reason behind the establishment of the German co-determination or ‘Mitbestimmungs’ system. In my opinion the intent to avoid that the History repeats itself by determining the corporate structure in Germany did somewhat puss off the development of the German corporate sector from the natural way of ‘corporate evolution’. In the USA where these measures were not introduced, ‘Berle and Means’ could evaluate a corporate governance theory that seems to be almost entirely relevant even today, after more than seventy years of its first publication while the German codetermination system –although triumphing in the 60ths and 70ths – is now bleeding from numerous wounds.

The German codetermination system at first sight prevented the evaluation of the preconception of Berle and Means: the total separation of the owner and the management (the ‘control’). In my view however this separation was not hindered but postponed. The control over the corporations’ management by the employees and shareholders at the very beginning did create an ideal situation where the shareholders (the ‘owners’) could have a word to say in the management of the corporation in a way that they could control the board through the supervisory board.

Later on however the management and the supervisory board became interrelated, or in other words to say, the members of the board became interdependent with the employees (and not with the shareholders). Emphasis has to be laid on the wording of the statute in contrast to the practice: according to the German Act on Public Limited Companies (Aktiengesetz, 1965): S 111 AktG provides “(1) The supervisory board has to control the management. (2) The supervisory board may inspect and examine the books and documents of the company, in particular its financial means, its inventory of securities and commodities (...) it commissions auditors to examine the annual accounts of the company and the group (...)”\textsuperscript{33} In practice however “instead of devoting its time and energy to that task, the main activity of the supervisory boards often consists of discussing labor and social matters. The control of the management board is pushed to the background.”\textsuperscript{34} Another disadvantageous practice is that “candidates for the management board need to compete for the goodwill of the employee members on the supervisory boards to be appointed as management board members unless they are willing to run the risk of going through an embarrassing appointment procedure.”\textsuperscript{35} This practice certainly has led to serious coziness between the members of the management board and the employees sitting in the supervisory board. The faith in the system that once in the 1960’s was believed to serve not only the common wealth of the employees but the entire German economy collapsed, and with the so called ‘Mannesmann Incident’ and the ‘Volkswagen (VW)

\textsuperscript{33} text of S 111 AktG para 1 and 2 quoted in Jean J. du Plessis, Bernhard Grobfeld, Claus Luttermann, Ingo Saenger, Otto Sandrock, (2007) \textit{German Corporate Governance in International and European Context}, Springer-Verlag, Berlin, Germany, pg. 120

\textsuperscript{34} Jean J. du Plessis, Bernhard Grobfeld, Claus Luttermann, Ingo Saenger, Otto Sandrock, (2007) \textit{German Corporate Governance in International and European Context}, Springer-Verlag, Berlin, Germany, pg. 125-126

\textsuperscript{35} Ibid: pg. 129.
Incident’ it became evident that the supervisory board lost its former ‘watchdog function’ and the German co-determination corporate system suffered from serious inconsistencies. The two scandals showed the German businessmen that the corporate law based on the co-determination system is full of gaps, and that the phenomenon that board members and members of the supervisory board can change chairs lead to corporate mismanagement, lower value shares of the corporation and a paralyzing mutual dependency which causes the shareholders and the corporation a detrimental outcome at the end of the day.

The history of the German co-determination corporate structure is nowadays undoubtedly facing serious troubles and the evasion of German corporation with more and more cases of German Corporation transformed into English PLC-s with the only intention to avoid the burdens of the co-determination corporate structure (likewise the Hungarian companies settling down in Slovakia however with a completely different motive: namely tax-evasion) German legal corporate system that was somewhat diverted from the natural way of development is waiting for assistance to fill the gaps.

The different theories of corporate governance seem to advance in the same direction. Several legal measures were introduced in Japan, France and the Netherlands which allow the company to choose between one-tier or two-tier board. On the level of the European Union with the introduction of the Council Regulation 2157/2001/EC of 8 October 2001 the Statute for a European Company (SE) the liberalization of corporate law was enhanced as the regulation replaced the mandatory law in terms of the board structure and introduced the concept of choice of board structure.
4.3 Concluding Remarks to Chapter 4

In this chapter I have discussed the different definitions of corporate governance and made the conclusion that corporate governance is the mixture of legal, economical and ethical regulations that differ according to a country’s historical, cultural, economical and legal conditions. Corporate governance can also be interpreted as a complex system of binding and non-binding regulations and control mechanisms inside and outside the corporation with the primary intend to protect the interests of the stakeholders and to enhance the effectiveness and profitability of a company. By making a careful analysis of the two main theories of corporate governance (the Anglo-American and Continental European) if we think of the similar mission on the one hand of supervisory board in case of the two-tier board system and on the other hand of the non-executive or independent directors of the one-tier board system we can conclude that the different governance systems have different tools to deal with the same basic monitoring tasks.

In the next chapters I will focus on the Hungarian and Central-Eastern European model of corporate governance, and based on the conclusions of the foregoing chapters I will categorize the Hungarian corporate governance characteristics in this so far discussed complex system.
5. Corporate Governance in Hungary

In this chapter I will focus on the structure and division of the main Hungarian business entities in order to introduce the recent developments relevant for showing the Hungarian Corporate Governance system. In the second section I will go into details concerning the Hungarian regulations on corporate governance and also look into the principal-agent problem in case of the Hungarian management bodies and shareholders. In the third section I will briefly present the MOL\textsuperscript{36}, show its privatization process, and the so far biggest scandal that affected a listed Hungarian Public Limited Company: the so called ‘MOL-OMV struggle’.

5.1 The structure and economic importance of Business Entities in Hungary

According to the 2006 Hungarian Companies Act (Act IV on Business Associations), several business associations may exist in Hungary

1. General (unlimited) partnership (Kkt)
2. Limited partnership (Bt)
3. Limited liability company (Kft)
4. Private company limited by shares (Zrt.)
5. Public company limited by shares (Nyrt.)
6. Co-operative association (Egyesülés)
7. European Economic Interest Grouping (EGE)

\textsuperscript{36} Magyar Olaj- és Gázipari Nyilvánosan Működő Részvénytársaság, the most significant Hungarian Oil company, public limited company by shares, a listed-corporation
8. European Company Limited by Shares (SE)

Other business forms are Representation Offices, Branch Offices, Civil law Associations and Joint Ventures.

Most of the Hungarian business associations are closed business associations: there are limited partnerships and limited liability companies (with around 200 000-300 000 of each entity form). Another dominant form of business associations are the private company limited by shares ‘zártkörűen működő részvénytársaság’ or ‘Zrt’ and the public company limited by shares ‘nyilvánosan működő részvénytársaság’ or ‘Nyrt’ (around 4500-5000 together). The regulatory division of stock corporation into ‘Zrt’ and ‘Nyrt’ was introduced in line with reforms of the Act of 2006 on Business Associations. A subtype of ‘Nyrt’ the listed publicly held stock corporation (tőzsdére bevezetett részvénytársaság – listed Nyrt) is also regulated in the new Hungarian Companies Act. Based on the regulations of the Companies Act of 2006 the internal corporate governance of the private companies limited by shares (‘Zrt’-s) significantly differs from the public company limited by shares (‘Nyrt’-s). On the one hand the number of ‘Zrt’-s have been rapidly increasing in the past ten years\(^37\) the number of ‘Nyrt’ have not grown and is around 100 out of which 50 were listed on the Budapest Stock Exchange\(^38\)

Other business entity forms are rather unimportant in corporate governance terms, based on their numbers and incomes. The economic importance of medium-sized and large companies is high in Hungary as they play an important role in producing goods for exportation, but the number of medium-sized companies are way backward in number in comparison to the so called ‘micro companies’ (companies employing less than ten employees) which seem to overwhelmingly dominate the Hungarian corporate structure.


### Figure 1. Number of registered economic corporations due to their economic activity

<table>
<thead>
<tr>
<th>Form of economic activity</th>
<th>Registered entities</th>
<th>Number of organizations subject to liquidation, bankruptcy proceedings</th>
<th>Newly registered entities through the year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31. December</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
<td>2008</td>
</tr>
<tr>
<td>Corporation with legal entity</td>
<td>297 060</td>
<td>324 906</td>
<td>22 021</td>
</tr>
<tr>
<td>Out of which is:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limited liability company</td>
<td>292 165</td>
<td>319 849</td>
<td>21 446</td>
</tr>
<tr>
<td>Joint stock company</td>
<td>4 828</td>
<td>5 020</td>
<td>548</td>
</tr>
<tr>
<td>Co-operative</td>
<td>5 245</td>
<td>4 365</td>
<td>1 158</td>
</tr>
<tr>
<td>Other corporation with legal entity</td>
<td>6 347</td>
<td>6 466</td>
<td>210</td>
</tr>
<tr>
<td>Organizations obliged to transform</td>
<td>45</td>
<td>36</td>
<td>37</td>
</tr>
<tr>
<td>Enterprise with legal entity</td>
<td>308 697</td>
<td>335 773</td>
<td>23 426</td>
</tr>
<tr>
<td>Corporation without legal entity</td>
<td>218 309</td>
<td>208 326</td>
<td>17 267</td>
</tr>
<tr>
<td>Out of which is:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unlimited partnership</td>
<td>6 486</td>
<td>6 153</td>
<td>532</td>
</tr>
<tr>
<td>Limited partnership</td>
<td>211 823</td>
<td>202 173</td>
<td>16 735</td>
</tr>
<tr>
<td>Other enterprise without legal entity</td>
<td>34 143</td>
<td>35 481</td>
<td>24</td>
</tr>
<tr>
<td>Terminated legal form</td>
<td>275</td>
<td>241</td>
<td>259</td>
</tr>
<tr>
<td>Partnership without legal entity and unincorporated enterprise</td>
<td>252 727</td>
<td>244 048</td>
<td>17 550</td>
</tr>
<tr>
<td>Companies and partnerships</td>
<td>561 424</td>
<td>579 821</td>
<td>40 976</td>
</tr>
<tr>
<td>Sole proprietor</td>
<td>1 000 022</td>
<td>1 012 770</td>
<td>–</td>
</tr>
<tr>
<td>Out of which is:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sole proprietor with licence</td>
<td>400 308</td>
<td>372 786</td>
<td>–</td>
</tr>
<tr>
<td>Corporation and unincorporated enterprise, total</td>
<td>1 561 446</td>
<td>1 592 591</td>
<td>40 976</td>
</tr>
<tr>
<td>Central budgetary and social security institutions</td>
<td>13 674</td>
<td>13 321</td>
<td>–</td>
</tr>
<tr>
<td>Non-profit organizations</td>
<td>79 062</td>
<td>80 332</td>
<td>312</td>
</tr>
<tr>
<td>Organisation of employees' part ownership programme</td>
<td>117</td>
<td>107</td>
<td>–</td>
</tr>
<tr>
<td>Total:</td>
<td>1 654 299</td>
<td>1 686 351</td>
<td>41 288a</td>
</tr>
</tbody>
</table>

5.1.1. Definition of small and medium sized businesses\textsuperscript{40}

I would like to devote this subsection to present the so called small and medium sized business sector (or ‘KKV’ ‘kis- és középvállalkozási szektor) because I do not want to undermine the whole sectors economic importance in Hungary although the present paper’s intention is to evaluate the Hungarian corporate governance specifics in light of the western-type corporate governance structures which primary is relevant in case of the listed stock corporations. The operation and competitiveness of the so called ‘KKV’ sector has a huge influence on the performance of the Hungarian economy and the situation of the total employment figures of Hungary. The number of small and medium sized businesses has been constantly increasing in the past twenty years and the ‘KKV’ sector produces the 45\% of the Hungarian GDP and more than 60\% of the employed persons in Hungary –around 2 million individuals- are working in the small and medium sized business sector.\textsuperscript{41}

In Hungary in the definition of businesses by size we apply the limits of employees determined in Act XXXIV of 2004 on Small- and Medium-sized Businesses. According to the general regulations:

1. \textit{Small-and medium-sized} businesses are those, in which the total workforce is less than 250, and the annual net revenue is a maximum of 50 million Euro equivalents in Forint, or its balance sheet total is a maximum of 43 million Euro equivalents in Forint.

2. \textit{Small enterprises} are businesses in which the total workforce is less than 50, the annual net revenue or its balance sheet total is a maximum of 50 million Euro equivalents in Forint,


\textsuperscript{41} \url{http://www.vallalkozastan.hu/data/pagecontent/0/ERENET/kkvhelyzete_szabo.pdf} (accessed: 24.10. 2010).
3. A micro-business is a small business, in which the total workforce is less than 10, and the annual net revenue or its balance sheet total is a maximum of 2 million Euro equivalents in Forint.

4. An enterprise is considered small-or-medium-sized, if all together the state’s, local government’s or any large enterprises’ share in the business, either on the basis of capital or voting rights, does not exceed 25 percent.

The most dominant entities in Hungary are mostly owned by foreign investors or are Branch Offices of foreign companies. After the collapse of the Soviet Union in the 1990’s privatization and foreign direct investment have been the motor of the Hungarian economy. At present, the private sector constitutes more than 80% of the nation's GDP. “Foreign ownership of industry is prominent -with Foreign Direct Investment in excess of $60 billion plunged into the country's economy. Investment made up 20.9% of gross Hungarian GDP in 2007.”

Hungary conducts most of its trade with fellow European countries like Germany, France and Italy. Germany remains the dominant trading partner with 28.1% of Hungarian products (Hungarian industries include metallurgy, textiles, chemicals, mining, motor vehicles and construction materials, agricultural products include sunflower seed, corn, wheat, dairy products, sugar beets, cattle, pig and poultry) being exported into the country. Other notable countries include United Kingdom (4.3%) and Slovakia (4.6%).

In conclusion we cannot state that big corporations are dominating the Hungarian markets, because the Budapest Stock Exchange and the Hungarian stock market is rather undeveloped and undercapitalized, even in comparison with the Vienna Stock Exchange not to mention the Anglo-American liberal market economies. In terms of the application of the western-type corporate governance theory in Hungarian corporate circumstances we can focus on the registered joint stock companies (around 5000 in 2009) out of which around hundred are listed-stock corporations. Basically three corporations MOL, OTP, Magyar Telekom are dominating the capital market.

ibid: Figure 1.
After reviewing the structure and economic importance of the main Hungarian business entities in the next chapter I will try to position the Hungarian corporate governance system in light of the so far examined international corporate governance theories and the unique Hungarian way of corporate development after the 1990’s.
5.2 Hungarian regulations on Corporate Governance

In this section I will focus on the regulatory framework of the Hungarian corporate governance also pointing out the specific evolution of the corporate governance system.

The Hungarian corporate governance model was influenced heavily since the end of the 19th century by the German legal scholars as the Hungarian company law followed the German dogmatical theorem, and thereby the Continental-European model of corporate governance. After the Second World War as Hungary became under the Soviet influence, capital market, stock corporations and private stock associations lost their importance. Under the soviet-oriented planned economy due to the massive nationalization the main actor of the economy was the State. From the beginning of the 1980’s (this period is also called as the ‘soft dictatorship’) some forms of private business associations -like family undertakings or co-operatives- were re-established as an answer to the irrationalities of the socialist economic system. Some forms of large state owned corporations (like Tungsram) had management boards directing these corporations similarly to the capitalist companies.

From 1988 with the introduction of Act XXIV on Foreign Investment and Act VI on Business Associations the regulatory framework was also established for a transition period to change from the socialist economy to the capitalist system. From the beginning of the 1990’s the Hungarian corporate governance model was influenced by the high foreign direct investment rates. Hungary attracted foreign investors because the privatization process of former socialist and state owned property for cheap price was very profitable.

The change of the political and economical system, the massive inflow of foreign direct investment and the privatization process heavily influenced the Hungarian corporate governance model. The Companies Act CXLIV of 1997 followed out the spirit of the German corporate governance system and introduced a two-tier board system. The significant presence of Anglo-American investors however made it necessary to introduce the concept of choice of board structure. This is the reason why with the entering into force of the Act IV of 2006 on Business Associations, from 2006 ‘Nyrt’-s are eligible to choose
between the Continental two-tier and the Anglo-American one-tier board structure.\footnote{However the three largest listed stock corporations (MOL, Magyar Telecom and OTP) have not opted for the one-tier board structure} This basically means that the 2006 Companies Act supported the idea of deregulation and to widen the scope of corporate management structure which reflected commitment to the liberal market shareholder capitalism.

The practical implication of Corporate Governance as such is rather undeveloped in Hungary even though there were two ‘recommendations’ on this specific field by the Budapest Stock Exchange (hereinafter referred to as: BSE).\footnote{BSE Recommendations of 2004 and 2008, at \url{http://www.bse.hu/data/cms61401/CGR_080516.doc} (accessed: 12.09.2010)} According to the 2008 BSE Recommendations: “Companies listed on the stock exchange are required to express their views on their corporate governance practices in two ways. In the first part of the statement they have to give an accurate, comprehensive and easily comprehensible account of the corporate governance practices applied by their company in the given business year, including their corporate governance policy, and a description of any unusual circumstances. In the second part of the statement, in accordance with the "comply or explain" principle, they have to indicate their compliance with those recommendations (…)\footnote{\url{http://www.bse.hu/data/cms61401/CGR_080516.doc} (accessed: 12.09.2010) pg. 7.}

According to Act IV of 2006 on Business Associations the above statement has to explain the reason(s) in case of any deviation from the Corporate Governance Code, the report has to be submitted to and approved by the shareholders meeting, and the approved version must also be disclosed on the ‘Nyrt’s webpage.\footnote{Act IV of 2006 on Business Associations, Section 312. para. 1-3} As soft law however these Recommendations have non-mandatory nature, therefore non-compliance can not be effectively sanctioned. Although the publicity ensured by the obligation of disclosure of the report on the Corporate Governance Code on the company’s homepage certainly enforces the responsible corporate governance behavior of the company.
5.2.1 The principal-agent problem in practice: Shareholders vs. Management

The Companies Act IV of 2006 gives high authority to the management in terms of day-to-day direction of the Company. The Board of Directors’ duty is to manage the public limited company by shares in the interests of the company as a whole, and the members of the management board are liable toward the company.\(^{49}\) However, the situation is more complex, and Board of Directors does not have free hands in terms of the long-term management of the ‘Nyrt’ as the shareholders possess powerful tools ensured by law to control them.

Firstly, according to The Companies Act IV of 2006 the shareholders appoint the members of the Board of Directors in the shareholders’ general meeting. The members of the Board of Directors may be re-elected and may be freely removed by the shareholders at any time even without any cause\(^ {50}\).

\[Section~24.\]

\((2)\) The mandate of an executive officer shall take effect by its acceptance by the person concerned. Executive officers may be re-elected, and may be freely removed by the business association's supreme body at any time.

Hungarian law does not require any cause from the shareholder meeting for removing the management which can be a very powerful tool to control the management, especially if the shares of the company are concentrated in several large blockholders’ hands.

Secondly in case of the two-tier system the Supervisory Board members -whose main duty is to monitor the action of the management board-, are also elected by the shareholders’ meeting. Moreover in contrast to the discussed powerful rights of workers in the German co-determination system, Hungarian company law does not really give powerful tools to the employees to control the management board because in case of two-

\(^{49}\) Act IV 2006 Hungarian Company Law, Section 30 para. 2  
\(^{50}\) Act IV 2006 Hungarian Company Law, Section 24 para. 2
tier system the labor representatives can maximally fill one-third of the Supervisory Board seats\textsuperscript{51} the two-third of the seats are elected by the shareholders meeting.\textsuperscript{52}

Although to the above enumerated tools of the shareholders ensure shareholders a relative strong control over the Board of Directors, the managers can benefit over the shareholders in order to reduce these controlling tools, as it is the duty of the Board of Directors to keep the register of shareholders:\textsuperscript{53}

**Register of Shareholders**

*Section 202*

(1) The management board of a private limited company or its representative appointed according to Subsection (2) shall keep a register of shareholders, including holders of interim shares, in which to record the name (corporate name) and address (registered office) of shareholders or their proxy (hereinafter referred to collectively as "shareholders"), or in the case of jointly owned shares, the name (corporate name) and address (registered office) of the joint representative, furthermore, the number of shares or interim shares (percentage of control) of shareholders as per each series of shares, as well as any other data prescribed by law or specified in the articles of association of the company.

The articles of association may render the transfer of shares to the consent of the company. In this case, the Board of Directors is the institution competent to give the consent unless the articles of association contain provisions to the contrary:\textsuperscript{54}

*Section 205.*

(1) The articles of association may contain provisions to render the transfer of shares subject to the consent of the private limited company (Civil Code, Section 215).

(2) Granting the consent for the transfer of shares as required by the articles of association shall fall within the competence of the management board, unless the articles of association contain provisions to the contrary.

\textsuperscript{51} Act IV 2006 Hungarian Company Law, Section 38 para. 1
\textsuperscript{52} In case of the one-tier system Act IV 2006 Hungarian Company Law does not give controlling rights to labor representatives per se by ensuring seat in the Supervisory Board.
\textsuperscript{53} Act IV 2006 Hungarian Company Law, Section 202 para. 1-2.
\textsuperscript{54} IV 2006 Hungarian Company Law, Section 205 para 2.
(3) Consent may be refused on substantial grounds, in particular, if:

a) the shares in question are to be acquired by a competitor of the company; or

b) in consideration of the purpose of the company and the sphere of its shareholders, refusal is justified by some other reason set forth in the articles of association.

(4) If the management board fails to respond within a period of thirty days after receipt of the announcement of the intention to transfer the shares in writing, consent shall be considered to have been granted.

This is a very significant power in the hands of the management, because they may prevent the transfer of shares if the new owner would be against their interests. The Hungarian Company Law on corporations is permissive regarding management, as the list of rights and duties is not exhaustive. All rights and duties that are specified by Hungarian Company Law regarding the Public Limited Company by shares and not assigned to any other organ of the company are attributed to the Board of Directors.

The members of the Board of Directors are involved into the day-to-day business of the company having the necessary data and information to manage the business of the corporation. Their knowledge of the information and the power to use this knowledge give them competitive advantage against shareholders, as they could use these for their own benefit and not for the benefit of the shareholders or of the company as a whole as regulated by Act IV 2006 Hungarian Company Law (Section 30 para. 2). This problem is also emphasized by the ‘Berle and Means’ corporate governance theory and characterized as the power of the management to hinder the proper flow of information about the company.

As above discussed the Hungarian Companies Act enables shareholders to remove directors at any time without any cause at the very beginning of the 2006 Company Act, in General Provisions applying to all types of companies (Section 24. para.2). This is a very powerful tool in the shareholders’ hand to control management and this rule would theoretically ensure that directors should manage the company according to the interests of shareholders. However, the majority of shareholders’ vote is required for the dismissal which significantly weakens the shareholders’ position as the large Hungarian listed stock corporations’ ownership structure is rather dispersed, thereby banning the easy removal of

55 More on this in chapter 1.
managers. In addition, the large Hungarian listed stock corporations are mostly owned by foreign investors or are Branch Offices of foreign companies therefore the –dispersed- Hungarian shareholders’ interest often cannot be protected.

We can conclude that the Hungarian 2006 Act on Business Association “did not reflect the priority given to the protection of shareholders’ interests and corporate transparency laid down in the BSE recommendations”\(^{56}\) rather it “reflected the priorities of senior corporate management, easing corporate management’s ability to manage its shareholders. By reducing the specific legal requirements on corporate governance, reducing ‘hard’ regulation, the Companies Act increased \textit{de facto} the importance of the BSE’s ‘soft regulation’ and ‘best practice’ requirements, whilst reducing its likely effectiveness.”\(^{57}\) The fact that the BSE Recommendations are not mandatory and no sanctions could be imposed on the company for non-compliance, in addition the wide possibilities of management to avoid the powerful control of the shareholders, suggest that in light of the principal-agent problem in case of the Hungarian corporate governance system, the management seem to dominate the field and further legislative actions should be taken in order to improve the effectiveness of the Hungarian Corporate Governance.


5.3. The MOL-OMV struggle

5.3.1. MOL

MOL is the most significant Hungarian oil company, founded in 1991 and gradually privatized from 1993. Since 1998, it expanded in the Central Eastern European Region and by 2008; it became one of the biggest players in oil industry in the Region and the largest Hungarian Multinational Corporation. MOL has the Continental-European or two-tier board structure.

The ownership structure of MOL is dispersed and Hungarian ownership is only about 21-22 per cent in the company. That structure has varied in the last two years, mainly because of the company’s strategy against the merger with OMV.

The Board of Managers has twelve members. In 2009 the majority of Board of Directors and Supervisory Board were declared independent according to the annual report. According to the independency criteria of MOL in line with the Act IV of 2006 on Business Associations, a former employee of the company becomes independent after a five-year period.

We can conclude that the rather high number of independent directors underlined by the fact that eight owners one by one have more than 5 percent of the company’s shares would suggest that the shareholders as blockholders dominate the field. As we will see the

60 For the exact structure See: http://www.mol.hu/en/about_mol/investor_relations/shareholder_info/ownership_structure/ (accessed 07.04.2010)
opposite was true in case of the MOL-OMV struggle. I will focus on the next section to show how the management -with the help of the Hungarian state to some extend- hindered the takeover action of OMV to merge with MOL.

5.3.2 MOL Privatization

The privatization is a process of converting state owned enterprises like the predecessor of MOL, the OKGT (National Crude Oil and Gas Trust) to private enterprises. This is normally accomplished with the purpose to make the enterprises once fully owned by the state better organized as private firms are considered to be more efficient, more profit oriented and under constant shareholder control. In case of the MOL privatization numerous levels of the basic rules of privatization attached during the course however were not or not fully considered and the privatization process has been criticized heavily.

At the beginning of the 1990’s two main problems occurred in connection with the privatization process. One can be concluded as the lack of real transparency in the privatization process the other problem occurred in relation with the proper valuation of the assets that did not meet the market price. To illustrate this through an example in 2004 when the last big package of the state owned shares were sold (approximately 25%) about 11 million shares were publicly offered at a price of HUF 6500. This was heavily criticized by some politicians and claimed that the real market price of the shares were around HUF 7000.

The whole process of privatization and the selling of all state owned shares were questioned even by some members of the Medgyessy cabinet in 2004 which took part in the final stage of the privatization. Many criticisms have appeared in respect to the privatization. Let me quote Andras Deák, who said that because of the lack of transparency in the privatization process at the moment we do not really know who owns in

65 Ministry of Foreign affairs, energetic expert
reality the 50% of MOL (mainly because of the complex corporate structure of the private companies owning the company).

At the very beginning of the privatization process the main aim was to sell shares to several hundred thousand mini investors (individuals) that could even buy it for the so-called compensation bonds (kárpótlási jegy) in order to make the process easier.\(^{66}\) Significant part of the criticism came in respect of the transformation of the above mentioned initial purpose of the privatization (to let mini investors become owners) and the latest tendencies, claiming for example that the selling of the 25% of the state owned shares served only fiscal reasons, i.e. to complete the budget deficit of the time\(^{67}\). Many claim now that the state should have maintained an at least 8-10% ownership ratio in order to sustain powerful position to influence the corporations decision.

In conclusion considering the pro-s and con-s in light of the MOL privatization, we can say that the privatization process of the MOL was not meeting the general expectations of privatization\(^{68}\), namely the adequate transparently of the process and the adequate market value of the shares that have been offered publicly.

5.3.3 MOL-OMV struggle in light of the principal-agent problem, showing the power of management and its lobbying activity\(^{69}\)

After introducing the MOL and its privatization in this subsection I will focus on the struggle between the MOL and OMV, the biggest Austrian Oil Company, a declared rival of MOL in the Central Eastern European Region. I will briefly point out the most important aspects of the struggle of the two companies to reinforce my point in the conclusion of

\(^{66}\) Ákos Bod Péter, at the time the head of the Hungarina National Bank, http://csepel.info/?p=4684

\(^{67}\) Medgyessy cabinet (2002-2004)

\(^{68}\) enumerate at the beginning of the section, discussed in detail in lecture -Economics of the Public Sector- of professor Hoós, spring 2010.

\(^{69}\) Ibid.CEU Business School Working Paper, pg. 23-32 serves as the main source of this subsection concerning the events of the struggle of the two companies.
section 5.2, that the management board dominates Hungarian listed stock corporations and the controlling mechanisms of the shareholders have to be furthered.

On 25 September 2007 the Chief Executive Officer (hereinafter referred to as CEO) of OMV announced a bid for Mol ordinary shares (the bid was of HUF 32,000 per share) in order to officially gain control over the MOL shares. The bid officially stated that the merger is between the two companies and would create a Central Eastern European giant Multinational Corporation which would serve the stability of the oil and gas industry of the region. “The offer was conditional on the removal of the 10 per cent voting cap”70 (…) “and cancellation of the shares under management control but currently parked with friendly partners, which OMV claimed were appropriately treasury shares and thus should not carry voting or financial rights.”71 Part of the OMV bid was the proposal that after the merger of the two companies the Management Board should consist of the most talented directors of the two companies. It is no wonder that the Board of Directors refused the whole OMV bid. The Chairman of MOL, Mr. Zsolt Hernádi said that the merger would be a disadvantage for the shareholders and the employees of MOL and he also emphasized that the takeover of MOL by the Austrian oil company would endanger the Hungarian oil and gas supply as MOL being a strategic company for the Hungarian state72.

The MOL management Board declared the OMV bid as a hostile takeover action and used anti-takeover actions to wreck the merger. The Board of Directors emphasized the stakeholder interest (as above mentioned MOL was not only anxious about its shareholder but about the employees and the whole Hungarian population) and in April 2007 repurchased up to 10 percent of (the voting cap) its registered share capital and transferred them to OTP, MFB Invest, Magnolia Finance Ltd and BNP in addition sold 8 percent of its treasury shares to the Oman Oil Corporation and 7 percent of its shares to CEZ, a Czech energy company.73 OMV heavily criticized the actions taken by the MOL Board of

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70 MOL did not fulfill the BSE Recommendations on Corporate Governance on the one share – one vote rule as the articles of association of Mol did not allow any of its shareholders to possess over more than 10 percent of the voting rights.


72 Business Hungary A publication of the American Chamber of Commerce in Hungary (September 2007) – Volume XVIII/7, Budapest

Directors in order to regain the ownership and the voting majority and declared it as contrary to shareholder values and corporate governance ethics.

5.3.4 Lobby power of the Board of Directors of MOL: the ‘Lex MOL’

In the following I will briefly focus on the role of the state. The Hungarian government had a very close association with MOL. This was due to the strong lobby power of the Board of Directors of MOL but also due to the fact that the Hungarian state owned a ‘Golden Share’ in MOL until 2007.

Both the socialist-liberal government and the conservative opposition emphasized the interest of the Hungarian state and population and passed the so called ‘Lex MOL’ in October 2007 in order to widen the definition of the strategically important companies and thereby introducing powerful tools for these national strategic companies to be employed against such takeovers.

OMV tried to defend its reasoning by stating that the actions of both the Board of Directors and the Hungarian state were contrary to good governance practices at the general meeting of shareholders in spring 2008, however in August OMV accepted its defeat and withdrew its bid.
5.4 Concluding Remarks to Chapter 5

In this chapter I have focused on the Hungarian Corporate Governance system as a whole. I began by showing the main structural division of Hungarian business entities, and their economic significance. We can conclude that the Hungarian capital market is rather undercapitalized and large listed stock corporations are mainly owned by foreign owners. Small-and mid sized companies and foreign direct investment are the main driving forces behind the Hungarian economy. The number of large listed public companies is undoubtedly few in comparison to large western market economies only reaching up to fifty. The present regulatory background of the Hungarian Corporate governance theory was shaped by the historical German-oriented Company Law, the privatization process of Hungarian state-owned companies and massive flows of foreign direct investment from the 1990’s. The newly introduced Act IV of 2006 on Business Associations and the BSE Recommendations (2004 and 2008), however broke with the former Continental-European influenced Hungarian corporate governance-tradition and reflected commitment to the liberal market shareholder capitalism. This can be traced back in the provisions of the 2006 Companies Act as it allows deciding over the managerial board to be two-or-one tier and supports the idea of representing the annual corporate governance reports of listed stock corporations to the public.

However as I have pointed out in the last part of the chapter, the non-mandatory nature of the BSE Recommendations allows the managers to use powerful tools against the shareholders. In case of a mandatory fulfillment of one-share one-vote requirement the OMV would have possibly hindered the Board of Directors of MOL to play the tactics of regaining the ownership over its shares. Another interesting lesson from the MOL-OMV struggle is that although the ownership was relatively not dispersed (as eight owners one by one had more than 5 percent of the company’s shares) the shareholders could not use their powerful tools ensured by the Hungarian company law to remove the members of the management board. The Supervisory Board’s powers have also proved to be weak in real-life situation (in the case of the MOL-OMV struggle), accompanied by a lack of out-of-court enforcement mechanisms, and slow court procedures in Hungary.
These above enumerated features of the Hungarian corporate governance system indicate that the internal control mechanisms monitoring the actions of the management are not powerful enough to hinder management opportunism.

The external monitoring mechanisms are also rather weak as in case of the Hungarian Corporate Governance system we can not talk about co-determination of worker’s union, and the state lost its potential as owner due to the privatization process thereby it has little or no actions to effectively control the management. What is more, the phenomenon of the so called ‘Lex MOL’ indicates that the Hungarian state actually intervened in the private market and one-sidedly influenced the transaction in favor of the management board. OMV heavily criticized these actions but not only OMV, the European Commission put significant critics on the actions of the Hungarian state as contradicting and restricting the free movement of capital, one of the most important of the basic four freedoms of the European Union.
6. Relevance of Corporate governance in emerging markets, focus on Eastern-Europe

Corporate governance is of great relevance to emerging markets. There are numerous reasons why corporate governance should be given more emphasis and not only on the side of the emerging markets of Central European countries, but also on the side of the developed countries as well, as the Central European corporate legal systems can serve as ‘treasury boxes’ especially as western countries corporate law also struggles similar problems than the countries of emerging market naturally on a different legal, economic and social level. Another reason for paying more attention to Eastern European corporate system, and to enhance the importance of corporate governance in these countries is the natural argument for foreign investors willing to enter or to start with a business in these markets and therefore to better understand and prepare themselves of the local conditions. International organizations (like the IMF or the Word Bank) were not successful in every field during the process of integrating the economies of these emerging countries, so an adequate knowledge of the local conditions is of particular importance, because it could have retroactive effects if uniform solutions are applied.

Focusing on the Eastern European countries, the biggest problem, I think is the lack of truthful determination firstly on appropriate comprehensive researches on the Berle & Means evaluated corporate governance and -in the experience of these- secondly the implementation of the result of these researches in accordance with the local conditions. Instead of this, both Eastern European countries that are already members of the EU (Hungary or Poland) and those who are on their way of becoming one (Serbia or Bosnia and Herzegovina) act negligently in the introduction of the corporate governance terms to their economic and legal systems, mainly trying to insist on the business and legal sector to accept central government programs devoted to corporate governance.

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These defective approaches can often cause imposition for local businesses, and instead of benefiting in practice of the introduced corporate governance theories, local businessmen naturally feel frustrated. To underline the differences and being capable to formulate a Central-Eastern European-style version of western corporate governance, in other words to create adequate researches that would result in the adoption of a profitable corporate governance system, one must rely on exact figures concerning the business and legal related activities of the local companies, which are often really hard to collect, as local businessmen are reluctant to reveal these.

It is not only the lack of adequate information what made it hard to adjust corporate governance to the Central-Eastern European local conditions and priorities. Therefore according to my point of view firstly, adequate Central-Eastern European- ‘competent’ definition of the corporate governance, a corporate governance friendly environment and locally evaluated governance structures have to be established –examples of local structures- like the Yugoslav self-management system75 as a soviet heritage exceptional even in the Easter European socialist regimes. Corporate governance friendly environment includes –among others- a well functioning legal system, political participation, anti-corruption measures, managers who possess certain qualities (knowledge of ethical, legal terms, fair expertise in economics and business strategy), the possibility of more significant labor participation in the corporate governance.

Another important and unique feature of these Central-Eastern European countries and what makes it even more important to collect expertise in the Western type corporate governance is its relevance to the public sector. As formally mentioned in case of Hungary, Central Eastern European countries have few listed public corporations in the private sector in comparison to the USA for example. However due to the socialist legacy numerous large companies are still owned by the state or have a similar “social” type of ownership, which can draw the attention to the Berle and Means corporate governance theory also to the consideration of government, as these large state owned -more or less public- corporations

cause a lot of problems to these CEE countries in terms of: economic inefficiency, employment questions and financing difficulties.

In the light of the above mentioned factors the involvement of politics in order to gain a successful implementation of corporate governance theory in these Central-Eastern European countries is of particular importance. This is also very important to fight the corruption and formulate adequate ethical regulations through the corporate governance. Not only the politics but legal scholars have a great role in formulating the legal framework by creating new branches of law and economic categories like security transactions, corporate financing and governance. These developments have to be supported to make the permissive languages of acts more exact and mandatory if necessary. Filling the existing gaps in the process of introducing and implementing an adequate, ‘Central-Eastern European conform’ theory of the Western corporate governance systems.

6.2 The need for enhancement of corporate governance theory in Hungary in university education

While a number of studies on Anglo-American type Corporate Governance are very high standard, giving deep analysis of the subject matter, the Hungarian solutions are rather unexplored and outdated76. In my research on Hungarian corporate governance theories I have very soon discovered that Hungarian literature not only has an economic and classical management approach to Corporate governance with few monographs and articles, but does not have a real unique translation or Hungarian term for Corporate Governance that has been widely incorporated in the Hungarian legal language. At least three different terms are

76 hereby I would like to point out that this statement applies rather in case of legal scholarly works and analyses on the Hungarian Corporate Governance system, as through-out my research I have found numerous very high standard Studies, Articles and Books on Corporate Governance from economic approach, one of which - János Hoós (2009) Corporate Governance – inspired me to do my research on Corporate Governance Theory in Hungary.
being used simultaneously: “felelős vállalatirányítás” (responsible corporate governance), or simply “vállalatirányítás” (corporate guidance), “vállalti kormányzás” (having the closest meaning in word by word translation as corporate governance, however in Hungarian terms somehow not a flawless in legal terminology).

It can also be noted that Hungarian legal scholars seem to be extremely reluctant to take a pen in hand and try to get the wheels turning of the Hungarian Corporate legislature with some Corporate Governance theory related articles, as it is mainly believed that the studies on the issue are rather of economical nature.

Although the Hungarian Act IV of 2006 on Business Associations was enacted in line with the minimum standards of the OECD Principles of Corporate Governance of 2004, the Hungarian legal education, and dogmatical approach do not give significant emphasis to the importance of Corporate Governance theories.

This is of course due to the particular system of the Hungarian corporations in general, that can not be compared with the American corporate system based on the capital market having a long history of the theory of good corporate governance practices. The development and adoption of an internationally good code of corporate governance represents the country’s commitment to improve its corporate governance system. This is naturally the particular interest of Hungary as well as a sound corporate governance system could re-attract the foreign investors. In contrast it seems that the corporate governance theories are not given due measure in Hungary, although some features of the foreign corporate governance theories did work their way through the Hungarian Company Law. Hereby I mean that due to the realization of the need for radical change in the Hungarian corporate governance system, the unitary board was introduced in Hungary as an optional model by the Act IV of 2006 on Business Associations. Before that, the German two-tier board model was the only applicable management structure however, the dual-board model remained as influential as before and an option coexisting with the unitary board.

77 There are few or no individual lectures on Corporate Governance integrated in the Hungarian legal education
I am convinced that a proper knowledge should be spread first through the legal education in the Faculties of Law in Hungary (and of course to reinforce these lectures in the economic and business education of the Economic Faculties), just as it is a well established practice to have lectures on corporate governance in every Faculty of Law in the United States. I think that it would serve for a better knowledge of the corporate governance for the future generation of businessmen and lawyers and it would also enhance the effectiveness and competitiveness of the Hungarian economy.
7. Conclusion

The present work observed the topic of corporate governance theory established in Hungary. The aim of this research was to show the present Hungarian status of corporate governance with regard to its historical, economical and legal characteristics in comparison to other corporate governance systems.

The thesis evaluates the Hungarian corporate governance sample in comparison to the general theories of both the shareholder and stakeholder theory. Based on the careful analysis of the present work one can conclude that the shareholder concept is the main theory recognized by Hungarian business law and the general legal framework regulating Hungarian corporate governance. At the same time one must also establish that the stakeholder theory and the practical implication of Corporate Governance as such can also be traced back in the Hungarian regulations. A good example are the two ‘recommendations’ on corporate governance by the Budapest Stock Exchange considered as soft laws which are placing additional tasks on managers thus serving a wider circle of stakeholder’ interests. However due to the non-mandatory nature of the recommendations whereby the non-compliance is not sanctioned the stakeholder approach is less present both on the scholarly and the practical level.

In terms of the actual governance structure of the Hungarian corporate governance approach and in light of the principal-agent problem discussed in detail by the present work we can conclude that the management has extensive powers which are often used to influence the companies every day’s life. This situation is even more typical if the ownership structure is so dispersed that no blockholders can effectively intervene in the governance of the company. The Supervisory Board’s controlling powers over the management board are also rather weak and the inefficient Hungarian enforcement system does not reduce the management control. Therefore we can point out that the discussed internal monitoring tools controlling the management’s actions are not effective in every case.
Based on the research of the Thesis the agency dilemma concerning the control of the management’s power by external monitoring tools, we can conclude that there are two main types of external controlling tools: the State or the monitoring of the public sector and the co-determination of worker’s unions. Naturally, as discussed throughout the thesis, we must also state that the capital market itself, as the third instrument, has external controlling influence in many situations. The Hungarian State’s ownership in accordance with the observed Hungarian corporations became insignificant in light of the privatization. We can establish, that due to the privatization process the state’s influence over the management faded away although the discussed phenomenon of the so called ‘Lex MOL’ indicates that the Hungarian State actually intervened in the private market and one-sidedly influenced the transaction in favor of the management board.

The Hungarian corporate governance structure can not be categorized as strictly following one of the main types of corporate governance approaches: the Anglo-American, German, Latin (Italian and Spanish) model or the structural (Dutch) models. Since the entering into force of the Hungarian Act IV of 2006 on Business Associations public limited companies are enabled to opt for Single tier Board of Directors, or two-tier board with separate Supervisory Board. As the capital market is rather underdeveloped in comparison to the Anglo-American model we can establish that Hungarian corporate governance can not be characterized as a market-based one. The Hungarian model shows a lot of similarities to the German-model due to the ‘traditional’ one-tier board structure until 2006. The internal controlling mechanisms are also more significant and similarly to the German system banks have particularly been dominant in the corporate finance practices of public-limited companies in the past twenty years in Hungary. However the German system of corporate structure is characterized by a significantly less dispersed ownership structure than in Hungary although dominated by foreign-majority ownership. In accordance with my research the Hungarian system of the co-determination of workers are rather weak particularly in comparison to the described German ‘Mitbestimmung’-system. In a nutshell the Hungarian corporate governance structure is determined by the Central- Eastern European transition process and all its concomitant circumstances creating a unique, post soviet-type of the mixed-model corporate governance system.
In conclusion of the present thesis one can establish in light of the discussed structures of Central-Eastern European emerging markets that despite the less than satisfactory privatization process and the failures of the transition period in the 1990’s, a well established high quality corporate governance system supported by an appropriate legal and conceptual regulation will have a major impact on the profitability of corporations and, as a result, on the future international competitiveness and economic efficiency of Hungary.
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