Rights of Minority Shareholders

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INTRODUCTION

A shareholder without voting strength or power to influence decision making on his own it's considered a minority shareholder. To be a minority shareholder could be tricky when it comes to protect your investment and its fruits. To avoid abuses from the majority, rules to protect minorities have been put in place in many jurisdictions. As for example, shareholder's agreements, the right of minorities to appoint a Director or other officers, rights to sell or buy shares at a fair value, the right to convene general assembly's, the right to get information from the management, etc.

Somehow, these rights may get in conflict with a fast decision making capability, impairing the management or the majority shareholders, which in turn may be a form of abuse from the minorities.

Therefore we would like to find out how these minority rights are handled in different jurisdictions.

1. Current scenario at your jurisdiction:

1.1. How and to what extent are *minority shareholders* protected in publicly and privately held corporations in your country, either as to legal or firm level protection?

Under Hungarian law, the privately held corporations are called "zártkörűen működő részvénytársaság" or "zrt." in its abbreviated name, while the publicly held corporations are called "nyilvánosan működő részvénytársaság" or "nyrt". The difference between a privately held corporation and a publicly held one is that only the latter type can be listed in the stock exchange. The instruments of constitution of both types can be viewed in the Metropolitan Court as registry court. Regarding the protection of the minority rights and possibilities of the shareholders can be similar in case of both company types: the provisions relating to these rights must be in line with the respective general rules of Act V of 2013 on the Civil Code, however, based on the relevant sections of the Civil Code more advantageous provisions for minority shareholders can be incorporated into (i) the articles of association in case of privately held companies and (ii) by-laws in case of publicly held companies. So the law is very definite in terms of more advantageous provisions: there are no limits, in theory. The way this is implemented in practice, is a different story.

Legal level protection:

As far as the minimum legal protection is concerned, these are the following according to Act of V of 2013 on the Civil Code:

"Section 3:103

[Requesting convocation of the supreme body]

(1) Those members of the business association together controlling at least five per cent of the voting rights may, at any time, request that the business association's supreme body be convened, indicating the reason and the purpose thereof, or the passing of a decision without a meeting. If management fails to comply with such request within eight days of the date of receipt, and fails to convene the meeting of the supreme body at the earliest possible date, and fails to provide for the passing of a decision out of session, the court of registry shall convene the meeting of the supreme body at the request of the members making the proposal, or shall empower the requesting members to convene the meeting, or to carry out the procedure for the passing of a decision out of session.

Section 3:104

[Requesting special audits]

(1) If the business association's supreme body has refused - or did not present for decision - a proposal that the last financial report, or any economic event which has occurred in connection with the activities of management during the last two years, or any commitment be examined by an auditor to be engaged specifically for this purpose, such examination shall be ordered, and the auditor shall be appointed, at the company's expense by the court of registry upon a request by any one member or members controlling at least five per cent of the votes submitted within a thirty-day preclusive period calculated from the meeting of the supreme body.

Section 3:105

[Initiating the enforcement of claims]

If the supreme body of a business association has refused - or did not present for decision - a request to enforce a claim against the members, executive officers, supervisory board members or against the auditor of the business association, any one member or members controlling at least five per cent of the votes may move within a thirty-day preclusive period calculated from the meeting of the supreme body to enforce such claim themselves on behalf and for the benefit of the company.

Section 3:106

[Prohibition of derogations]

Any provision of the instrument of constitution which derogates from the provisions of this Chapter to the detriment of minorities shall be null and void.

Section 3:259

[Right to make additions to the agenda]

(1) Where a group of shareholders together controlling at least five per cent of the votes in a private limited company propose certain additions to the agenda in accordance with the provisions on setting the items of the agenda, the matter proposed shall be construed to have been placed on the agenda if such proposal is delivered to the members and the management board within eight days of receipt of the invitation to the general meeting.

(2) Where a group of shareholders together controlling at least one per cent of the votes in a public limited company propose certain additions to the agenda in accordance with the provisions on setting the items of the

agenda, or table draft resolutions for items included or to be included on the agenda, the matter proposed shall be construed to have been placed on the agenda if such proposal is delivered to the management board within eight days following the time of publication of notice for the convocation of the general meeting, and the management board publishes a notice on the amended agenda, and on the draft resolutions tabled by shareholders upon receipt of the proposal. The matter published in the notice shall be construed to have been placed on the agenda.

(3) Any provision of the articles of association which provides for a larger percentage of votes as a precondition for putting additional items on the agenda, or which provides for a shorter time limit for exercising such right relative to what is contained in this Act shall be null and void.

Section 3:261 (4)

A group of shareholders together controlling at least five per cent of the voting rights in a private limited company, a group of shareholders together controlling at least one per cent of the votes in a public limited company, and any creditor of the limited company who has a claim that is not yet due at the time of distribution and reaches ten per cent of the share capital may request the court of registry to appoint an independent auditor to examine the legality of such distribution within a preclusive period of one year from the time of distribution, with the costs advanced.

Section 3:266

[Exercising minority rights]

A group of shareholders together controlling at least one per cent of the votes in a public limited company shall have entitlement to exercise minority rights.

Section 3:280 (3)

(3) A general meeting may not be held by conferencing if objected to in writing by a group of shareholders controlling at least five per cent of the total number of votes - indicating the reason - within five days after the date of receipt of the invitation or from the date of publication of the public notice, and if they request that the general meeting be held the conventional way.

Section 3:290 (3)

(3) In the case of private limited companies, if so requested by a group of shareholders together controlling at least five per cent of the voting rights, a supervisory board shall be installed."

Firm level protection (examples from by-laws of a publicly held company, namely Gedeon Richter Plc.):

"7. 12 Any shareholder of the Company, any member of the Board of Directors or of the supervisory Board may request the court to annul the resolution passed by the organs of the Company with reference to the point that such resolution violates the law, or these Statutes […].

11.4 The Board of Directors shall have the right to call an extraordinary General meeting at its discretion. The Board of Directors shall also call an extraordinary General Meeting if persons authorized by the Civil Code or these Statutes request from the Board of Directors that a General Meeting be held. If shareholders holding at least one percent of the votes request for the convening of a General Meeting, stipulating its reason and purpose, such a General Meeting shall be convened. (Sections 3:103 and 3:266 of the Civil Code) In

the cases determined by the Civil Code, the Supervisory Board, and the Court of Registration are entitled to convene an extraordinary General Meeting.

11.5.3 If shareholders with at least one percent of the votes inform the Board of Directors in writing at the latest within eight days following the publication of the agenda about their proposal to amend the Agenda – in accordance with the provisions on detailing the items of the agenda -, or table draft resolutions for items included or to be included on the agenda, the Board of Directors shall render an opinion on the request and publish a notice on the amended agenda and the tabled draft resolution within eight days. The issue indicated in such notice shall be regarded as added to the agenda. The Board of Directors may reject the shareholders' request in the fulfilment thereof infringed upon the law. If the Board of Directors rejects the shareholder's request, the Board of Directors shall publish a notification to that effect along with the reasons for the rejection (based on Section 3:259 of the Civil Code)."

1.2. Do they have in essence real choices, or are the ones that are in the hands of the dominant group, either managers or major shareholders, or are they restricted to those that do not challenge the majority power, representing the status quo?

Yes, they have real choices as detailed in Act V of 2013 on the Civil Code and in the by-laws of the company concerned as more advantageous provisions for minority shareholders can be included into such corporate documents (see section 1.1). This is always a case by case matter and difficult to generalize. For example in the case of Gedeon Richter Plc., the by-laws do not contain substantial additional possibilities for the minority shareholders except for as listed above under section1.1.

1.3. Has the law and precedents of your country evolved in ways that increase *minority shareholders* ability to defend against expropriation by those in control (misuse of assets, reallocation of profits, transfer pricing, etc.) ?

The New Civil Code (the provisions of the previous Act IV of 2006 on Business Associations were also incorporated into it) introduced some modifications that may trigger some real changes and can lead the previous trends more to the above direction:

- less than 5% of stock-holders can request special audits or initiate the enforcement of claims if the by-laws stipulate these rights,

- regarding the suggestion of auditors examination of the company's business activities, a new provision stipulates that such application can be refused by the competent court in case proposers use it as a misfeasance.

1.4. Is the legal dimension the prevalent one in the Corporate Governance (CG) atmosphere, or is the firm level CG the common manner to protect minorities?

As regards relations between members and founders, and between them and the legal person, and as regards the organizational structure and operational arrangements of the legal person, in the instrument of constitution the members and founders may derogate from the provisions of the law relating to legal persons, save where Subsection (3) applies.

"(3) Members and founders of a legal person may not derogate from the provisions of this Act:
a) if it is precluded by law; or
b) where any derogation clearly violates the interests of the legal person's creditors, employees and minority members, or it is likely to prevent the exercise of effective supervision over legal persons.
Any provision of the instrument of constitution which derogates from the provisions of this Chapter to the detriment of minorities shall be null and void."

As shown above, the Civil Code stipulates a dispositive regulation, however, in certain cases, including the protection of minority, the dispositivity is not allowed for the detriment of the minorities.

In line with the above, the rules and regulations of the Hungarian Civil Code are the prevalent ones in the protection of minorities regarding corporate governance; the firm level governance can be regarded only as supplementary provisions and only if these are not detriment of the minorities.

1.5. What is the role of ownership concentration in the protection of the minority?

According to the relevant provisions on corporate matters of the Hungarian Civil Code, the role of ownership concentration in the protection of minority is to maintain the internal balance of the company's operation even in such situations when a

shareholder or majority of the shareholders has/have decisive vote providing specific possibilities for the minority against such shareholder(s) as detailed under section 1.1.

1.6. Is benchmarking used as a mechanism for minorities to select the country or firm better suited to risk profile and protection from rights deprival?

As far as country selection is concerned, minority protection and local corporate law is one of those important factors that should be considered like taxation and business environment. The different levels of minority protection (information rights, consultation rights, rights to challenge majority decisions and other specific rights) are usually taken into consideration in structuring of a transaction, as well as which types of shareholders can benefit from such protection, and the quality of enforcement of such rights in various jurisdictions.

Regarding the role of the minority rights in selection of firms, financial investors may take into account these factors in their decision making while compiling their portfolio, however, in our region this question should weigh less than other business and legal matters due to fact that there are no substantial differences between the concerned jurisdictions in terms of protection of minority shareholders.

1.7. Is the formation of group dynamics among dispersed shareholders working in your country?

The general main legal rules apply, as discussed above. Group dynamics, in a sense that certain shareholders pursue their own interest are a different practical category but the same legal terms shall be applicable, as generally.

1.8. What is the role of market liquidity in the *minority shareholders* exit option?

Liquidity is essential element of the exit option of the minority shareholders', since it secures that a minority shareholder has not only the option to exit, but he will receive

fair market value of its shareholding within reasonable time following the exercising of his exit option.

Apart from publicly traded blue chip companies where the liquidity of the minority shareholdings is secured (depending on the size of the minority shareholding), it can be quite difficult to establish the liquidity of the shares of minority shareholders, because their shares may not be attractive for third parties' due to various reasons. In such cases the minority shareholder has only a theoretical exit option which cannot be converted into cash; therefore, it does not provide sufficient protection for minority shareholders.

In order to avoid such situation, it is recommended that the exit option is combined with an obligation-to-buy and valuation mechanism, which provides sufficient legal ground for minority shareholders to demand the acquisition of their shares by their shareholding partners against a price calculated on a pre-agreed basis. The application of this method creates an artificial liquidity of shares, although its enforcement may be a problematic and time consuming, which ultimately deteriorates the liquidity of shares as well.

1.9. Have legal reforms in your country given tools to majority to use compliance as an instrument to somehow "legalize" minority expropriation?

EU law already recognizes the allocation of rights to shareholders acting in concert, even though it is essentially in the stock market sphere, to authorize closure offers (buy-out offers), or indeed the expropriation of ultra minorities.

On various occasions, majority (or 'controlling') shareholders may be obliged to offer to buy the shares of other shareholders in order to become owners.

Under Hungarian company law, in the case of the acquisition of a significant share of the company (generally more than 75 %) in an unlisted company, a member (shareholder) of the company being taken over may request that his shares be bought up by the owner of the significant share. The right of minority shareholders may be exercised within 60 days of them being notified of the acquisition of the significant

share. The owner of a significant share must buy such shares at the market value in force when the request was submitted, with this value being no less than the value of the shares which represent the company's own equity.

If a shareholder in a Hungarian company wishes to sell his shares, the other shareholders, the company or a person appointed by the shareholders' meeting have a right of pre-emption in that exact order for the amount which needs to be transferred by a sale purchase agreement. This right of pre-emption may be excluded from the company's articles of association.

2. Looking forward at your jurisdiction:

2.1. What is the way to avoid *minority shareholders* from suffering mayor shocks, -if applicable in your country- due to restrictive visions as to minority rights, without falling into abuses of minority rights? Is it possible to harmonize both?

The lack of shareholder engagement in the course of business, as pointed out by the Green Paper on the EU Corporate Governance Framework, is one of the main factors behind the abuses seen in practice.

These abuses can take the form of two types of behavior:

a) the excessive pursuit of satisfying shareholders' personal interests; and

b) promotion by the company directors of business strategies that are incompatible with the nature or the object of the company.

In order to promote balance between shareholders' rights and obligations, while promoting long-term value creation by the issuing company, it is recommended to adopt a directive affirming the principle of the primacy of corporate benefit. In addition, in Hungarian company law, members responsible for the management of a

company shall - as a general rule - give priority to the interests of the company when carrying out their duties.

Summary of harmonization of rights and interests:

a) governance practices identified as 'good' are those that help create value over the long term;

b) this creation of long-term value relates to the organization as a whole, as part of a process of promoting its own interest (corporate benefit), and not just that of shareholders;

c) as a result, this value creation, in line with an approach whereby specific interests converge rather than take precedence over each other, must also be defined within the framework of a collective approach, through the notion of concerted action.

2.2. Is *minority shareholders* activism taking place in your country, and to what extent?

There is currently no publicly available data as per the frequency of minority shareholders practice in Hungary, as this is normally the internal matter of the companies. Publicly available information shall be considered only those which are officially (and finally) decided by the competent courts. There is no data from 2015 at the court registry as per the pending litigation procedure, however in 2013, the court has brought decision in about 12 cases in this matter, while in 2014 the decided cases reached about 14 court procedures.

2.3. What is the trend in your country for the protection of *minority shareholders*?

Basic principle of corporate law is the protection of minority shareholders regardless of its forms, namely individual or collective character. Interest reconciliation of the management is limited by rights of minority shareholders and autonomy of ownership more and more.

During the operation of general meeting of public limited company it is a task to resolve the vindication of rights of minority shareholders and to secure possibility of informatics to facilitate cooperation between minority shareholders. As in the case of public limited company, there is enough to hold 1% of the votes to have minority rights oppositely to 5% that is the minimum ratio in other business association.

Principles of protection of minority shareholders are the followings in new Hungarian Civil Code:

a) requesting convocation of the supreme body,

b) requesting special audits,

c) initiating the enforcement of claims,

d) prohibition of derogations in the instrument of constitution.

Minority rights may be ensured should the case occur of necessity of lawful operation, and exercising these rights shall not intent to influence of management of business association.

Provisions on minority rights of shareholders in effect become more consequent and more transparent from time to time. Further back equity capital was the ground of exercising minority rights, which lined up to percentage of votes.

There is only one restriction of minority rights of shareholders opposite to previous regulations in Hungary as mentioned under point 1.3, namely misfeasance: it is not automatic to practice minority right by shareholders in connection with requesting special audits.

According to the relevant provisions of Act V of 2013 on the Civil Code:

"Chapter XVIII - Protection of Minority Stakeholders
Section 3:104
[Requesting special audits]

(1) If the business association's supreme body has refused - or did not present for decision - a proposal that the last financial report, or any economic event which has occurred in connection with the activities of management during the last two years, or any commitment be examined by an auditor to be engaged specifically for this purpose, such examination shall be ordered, and the auditor shall be appointed, at the company's expense by the court of registry upon a request by any one member or members controlling at least five per cent of the votes submitted within a thirty-day preclusive period calculated from the meeting of the supreme body.
(2) The court of registry shall refuse the request in the event of abuse of minority rights by the members presenting the request."

2.4. What is the impact of the Sarbanes-Oxley Act (SOX) in your country, as a canon to regulate domestic capital markets and CG?

I. ESTABLISHED INDEPENDENT OVERSIGHT

SOX imposes heavy regulatory and financial costs and compliance burdens on a company. Small companies that need access to the public capital markets get hurt by not having this capital source available to them, due to associated costs. Venture capital firms, which fund new technologies, products and services, have also traditionally liked the go-public route as a means of securing capital beyond the initial stage of company development. Given that small start-up companies have very limited amounts of cash, they are less able to fund the heightened levels of administrative costs of being a public company.

Key points in SOX are the followings:
I. Public company oversight board
II. Auditor independence
III. Corporate responsibility
IV. Enhanced financial disclosures
V. Analyst conflict of interest
VI. Commission resources and authority
VII. Studies and reports
VIII. Corporate and criminal fault accountability
IX. White-collar crime penalty enhancements
X. Corporate tax returns
XI. Corporate fraud and accountability

Principal components and maxims of the Sarbanes-Oxley Act of 2002:
a) Established independent oversight of public company audits;
b) Strengthened audit committees and corporate governance;
c) Enhanced transparency, executive accountability and investor protection;

d) Enhanced auditor independence.

European Union was just as determined as the United States to increase investor protection and prevent corporate scandals, therefore on May 21, 2003 the European Commission presented an action plan for "Modernizing Company Law and Enhancing Corporate Governance in the EU", a major part of the European response to Sarbanes-Oxley.

Provisions of Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC have been implemented into Hungarian existing legal order by Act LXXV of 2007 on the Chamber of Hungarian Auditors, the Activities of Auditors, and on the Public Oversight of Auditors. Above-mentioned provisions improve authenticity and reliability of reports of companies.

"EuroSox" of the European Union is equivalent to SOX. Components of EuroSox:

a) The European Union's Financial Services Action Plan (FSAP);
b) The 4th directive Annual Accounts of specific type of companies (78/660/EEC);
c) The 7th directive Consolidated accounts (83/349/EEC);
d) The 8th directive of Company Law 1984 (84/253/EEC) and 2006 (2006/43/EC);
e) The Consolidated Admissions and Reporting directive (CARD) (2001/34EC);
f) The Transparency directive (2004/109/EC);
g) The Insider Dealing directive (1989/592/EEC) & The Market Abuse directive (2003/6/EC);
h) The interaction between EU directives and other regulatory initiatives.

a) The European Union's Financial Services Action Plan

There are 42 original measures in the FSAP. Some are non-legislative, a few are regulations, and there are almost 30 directives. Over 20 of the original measures are likely to affect the financial sector. (Please refer to separate paper on FSAP).

b) The 4th directive Annual Accounts of specific type of companies

Safeguard shareholders' investments

Effective Corporate and IT Governance, internal controls and risk management

Increase in disclosure requirements

c) The 7th directive Consolidated Accounts

Principle elements of the risk management system

Principle elements in implementing internal controls initiatives

Exemptions related to national regulations

Description of the Corporate Governance codex

da) The 8th Company Law Directive on Statutory Audit

Approval, continuing education and mutual recognition of statutory auditors and audit firms

Registration of statutory auditors and audit firms

Professional ethics, independence and objectivity

Auditing standards

Audit reporting

Auditors' liability

8th Directive allowed of construction of structural terms and conditions of quality control of audits for national legislation.

db) The 8th Company Law Directive and Corporate Governance

The impact of MiFID on corporate governance

The role of the board of directors and executive management

Internal controls and external auditors

dc) The 8th Company Law Directive: Committees and Interpretations

The European Group of Auditors' Oversight Bodies (EGAOB)

The Audit Regulatory Committee (AuRC)

The European Forum on Auditors' Liability

e) The Consolidated Admissions and Reporting directive

CARD deals with the admission of securities to official listing on a stock exchange and the information to be published on those securities.

f) The Transparency Directive

The harmonization of transparency requirements

Annual financial reports

Half-Yearly financial reports

Transparency and information for holders of securities

g) The Insider Dealing and Market Abuse Directive

The Market Abuse Directive is also a part of the Financial Services Action Plan because the Insider Dealing Directive was out of date and incomplete (market manipulation missing) and the member states approach to tackling market abuse were too diverse with different systems and powers existing across the EU.

Insider dealing

Market manipulation

Competent authorities with "investigatory powers"

How the directive is implemented under the Lamfalussy process

h) Interaction between EU directives and other regulatory initiatives

The three major Compliance directives and the Financial Services Action Plan

How to comply with both the 8th Company Law Directive and the Sarbanes Oxley Act

The 8th Company Law Directive and the Financial Conglomerates Directive

The 8th Company Law Directive and the Savings Tax Directive

International Compliance 'Best Practices' in the post-Parmalat EU and the post- Enron USA.

There is limited mention of IT Compliance and Governance in SOX. This issue is dealt with in a separate paper on IT issues in EuroSox.

Taking into consideration the provisions of SOX in Hungary, the structure of internal audits contains the following elements:

a) counting aspects,

b) overview of the procedures,

c) information flow,

d) determining key aspects of controlling,

e) estimation of efficiency of planning,

f) evaluation of current situations and documentation thereof,

g) preparing correction plans.

II. CORPORATE GOVERNANCE (CG)

The main problem in connection with CG resides in alienation from company interest by self-assertion of members and management of the companies.

As a resolution for the above-mentioned problem, OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations (hereinafter referred to as "Code") were issued. Relevant provisions of this Code - such as transparency, exemption from discrimination - are in harmony with current EU-legislation therefore it is highly suggested to taking into consideration in Hungary as well.

By implementing proposals for corporate governance there is an opportunity to reach well-grounded decision and to operate the companies transparently with the goal of higher business interest, capital investment and strengthen of investors trust

SOX does not specify concrete regulations on internal audit system; management of the companies may reach decisions on controls. European companies with their main listings on European exchanges already meet though audit standards.

Experience teaches us that the value of most corporate governance regulation lies in the deterrent effect of stringent enforcement.

2.5. Do you think it advisable to rescue the concept of "Popular Capitalism", as defined in the fifties by the great jurist Joaquin Garrigues, in view of the present circumstances regarding status of minorities?

We do not wish to stand behind or go against this concept; our standpoint is that shareholders do not own the corporation, which is an autonomous legal person and shall bring its decision according to certain business interests.

2.6. What should be the role of minorities as to the flaws of executive pay packages that reflect structural problems in underlying governance agreements, as pointed out by Lucian Bebchuk, Harvard Law Professor?

Compensation agreements are always the focal point of the relationship between the shareholders and the management. As it is pointed out by Lucian Bebchuk, dispersed shareholder ownership has less incentive to monitor management and invest effort in reducing managerial opportunism than large outside shareholders. Consequently, companies with dispersed ownership and strong minorities may have governance problems and the management may have higher degree of freedom and power. These anomalies can be observed in the relevant compensation agreements, which are often concluded between weak minority shareholders and strong management. It was shown in studies that firms having a shareholder with a stake larger than the CEO's ownership interest pay their CEOs 5% less in total compensation than firms without such a shareholder.

3. Precedent cases at your jurisdiction:

3.1. Please report some recent judicial cases regarding *minority shareholders* issues.

- In a recent court decision – considering that the relating legal provisions sometimes do not provide detailed rules on certain matters – some further expectation of the legal practice (as case law) was elaborated, i.e. the

determination of the exact scope of tasks and duties of the administrative body of the company. If the minority shareholders request the calling of the shareholders meeting – it shall be the decision of the management, whether calling the shareholders' meeting is possible (decision shall be brought within 30 days). Furthermore, other administrative actions shall also be made by this body, such as invitations shall be sent, disclosures shall be made, etc. As the Civil Code does not contain some important details in this matter, it was necessary to elaborate these rules via case law.

- Another recent court decision clarified that the rights of the minority shareholders cannot be derogated just because another questions shall also be discussed within the framework of a shareholders' meeting. It is possible to discuss other matters, - as there might be economic and timing reasons to do so -, but there should be always enough time for discussing the issues which have been raised by the minority shareholders.
- If the minority shareholders initiate the company to hold a shareholders' meeting on an extraordinary basis, either (i) the company registration court shall invite the members or (ii) such minority shareholders will be empowered to send the invitations on their own. Anyway, according to the ruling – and the settled case law – the management of the company cannot be obliged to send invitations for such an extraordinary shareholders' meeting.