Company & Commercial - Hungary

Managing risks in limited liability companies

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The main forms of business entity used in Hungary are limited liability companies and private companies limited by shares. The main difference between the two is that limited liability companies are not entitled to issue shares or any other type of security - only companies limited by shares may do so. Although this is the most frequently mentioned difference, there are several other risks related to limited liability companies that require careful consideration.

Consequences of ownership: how to sell a quota

Limited liability companies are not entitled to issue shares or any other type of security. The owner of such a company is entitled to receive a quota that represents its rights and obligations in the company. One owner may hold only one quota. Quotas are not materialised in any way - they are established by and recorded in the founding documents of the company.

The transfer of a quota implies the transfer of ownership of a non-material interest. Consequently, procedures requiring material actions (eg, handover, deposition and subscription) are insufficient for the purpose of a quota transfer.

However, the Hungarian corporate registry system is precisely detailed and strictly regulated. All changes to corporate information in the registry must be notified to the companies court within 30 days of the effective date of the change. Thus, a change in the corporate data of a limited liability company that affects the accuracy of the registered information - including a change of quotaholder - must be notified to the court in order to give the change corporate effect. As a result, the quota transfer procedure allows a party to transfer a non-material ownership interest and give effect to the transfer for civil and corporate law purposes.

In order to fulfil these requirements, the quota transfer combines two types of transfer:

- civil law transfer by means of a quota sale and purchase agreement; and
- corporate transfer by means of various corporate documents related to the quota sale and purchase agreement.

The civil law transfer and the corporate transfer cannot be separated: neither works without the other, and both the civil and corporate law conditions must be met.

A quota sale and purchase agreement need not be concluded in writing under Hungarian law. However, irrespective of the governing law, the agreement must contain provisions that make the transfer effective under Hungarian law. These provisions mainly relate to the list of corporate documents that are required to give corporate effect to the transfer, indicating the required signatories, formalities and process of issuing such documents. Most significantly, they set out a procedure which enables the buyer to enforce the issuance of all necessary documents.

The required documents need not be complicated. They include a notice from the new quotaholder to the company, indicating certain details of the acquisition, and a new list of quotaholders indicating the new quotaholder - the latter document must be signed by the managing director of the company. The real issue is not the complexity of the documents, but rather the risk that the managing director of the company may be unwilling to issue the new list of quotaholders.

The list of quotaholders determines whether the quota transfer can have corporate effect, and only the managing director of the company can issue it. The managing director is normally appointed by the previous quotaholders and may be bound to them by a relationship of trust. As the new quotaholder is not entitled to vote unless named in the list of quotaholders, it may be impossible to change the managing director if the incumbent director is unwilling to cooperate. Thus, the managing director can block the transfer process; time-consuming procedures are necessary in order to compel cooperation - if this is even possible - or to have the director replaced through a court supervisory procedure.

In light of this, the main purpose of the quota sale and purchase agreement should be to ensure that all necessary documents are available to initiate the corporate registration procedure.

Decision-making process: escaping deadlock

Limited liability companies may be established with one or more quotaholders. If the company has only one quotaholder, this sole quotaholder may resolve on any issue that falls within a quotaholder's competence. Where there are two or more quotaholders, issues falling within their competence must be decided by the quotaholders' meeting by a simple majority (ie, 50% plus one vote).

Although this structure sounds simple and logical, it may cause serious trouble in companies that are owned 50-50. If a limited liability company has two quotaholders, each with a 50% ownership interest, (or more quotaholders with a combined 50% in the same group of interest), it is impossible to decide on any issue unless both quotaholders agree.

The strategy of 50-50 control may work well as long as the quotaholders have a common understanding on all matters related to the company. However, the same strategy may completely block the company's operations when the quotaholders cannot agree on a matter, which must necessarily remain unresolved until the quotaholders agree.

Furthermore, liquidation may prove impossible, as this also requires cooperation and corporate decisions from the quotaholders. In addition, the quotaholders may be unable to exit the company because of background corporate rules requiring the cooperation of quotaholders in the form of resolutions for all types of exit scenario.

As a result, and given that a quotaholders' resolution may not be enforced by an external body (ie, a court or other authority), the company may find itself in deadlock with no exit possibilities.

Management structure: how to control a managing director

It is a basic principle of Hungarian company law that an issue which does not fall within the exclusive competence of the quotaholders' meeting falls within the competence of the company's management.

The law provides for a list of issues that fall within the exclusive competence of the quotaholders' meeting; the quotaholders may decide to supplement the list with additional issues. Such additional issues must be listed in the company's articles of association.

The more that power is withdrawn from the managing director in this way, the more the quotaholders must become involved in the daily business of the company and will be required to make day-to-day business decisions by means of resolutions. Consequently, the list of issues that fall within the competence of the quotaholders' meeting must be carefully considered to ensure that the company's management positions are not relegated in importance, with all management decisions being handled by the quotaholders.

However, no matter what kind of power remains with the managing director, the signatory right of the director in respect of third parties cannot be limited in any way, which means that whatever the managing director signs will be binding on the company. There are background rules on the managing director's liability that the company may invoke, but the main principle is that a managing director's signature is binding.

Although there are other corporate techniques to help control the management positions, such as the use of joint signatory rights and the appointment of a supervisory board, the position of the managing director can never be entirely controlled by legal techniques alone.

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