Chapter 2
Default Rules on Companies in the New Hungarian Civil Code

András Kisfaludi

Abstract The starting point of the present study is that company law has been incorporated into the new Hungarian Civil Code. Company law had been regulated separately over the centuries and under different social structures, but this scheme was overwritten by the new Hungarian Civil Code, despite it being not only tradition but also considerable counter-arguments that were against this incorporation. The most significant impact of the placement of company law into the Hungarian Civil Code arises from how it is regulated. Upon examination of the pros and cons of mandatory and default rules, and taking the internal and external characteristics of the relationships regulated by company law into consideration, the Hungarian legislator voted for a blended solution: default rules shall primarily be applied except for when the protection of a third party’s interest justifies the mandatory rules. Chapter by chapter, this study unfolds the debate on the proper place for the regulation of companies (by separate law or in the Civil Code), then analyses the regulatory methods and finally presents the actual regulation regime of the new Hungarian Civil Code and reveals some of its consequences.

2.1 Introduction

The title of this study contains two implied statements that are worth closer examination for understanding the driving force behind the choice of regulatory method in the new Hungarian Civil Code with regard to companies. The first statement is that the Civil Code, which came into force on 15 March 2014, includes among many subjects other than the regulation of companies. This basically changed the previous situation when company law was regulated in separate law and, being so, it was a certain distance away from the core of the civil law, although it was acknowledged that it belongs to the domain of the civil law.
The second relevant statement included into the title is that the Civil Code regulates companies by default rules, i.e. by rules from which company members may deviate if they want to. It is also a new element in the regulation of company law that will have a more serious impact than the placement of the regulations in the Civil Code. The two abovementioned statements are interrelated. Whether companies can be regulated in the Civil Code is dependent on how we perceive these institutions. If we treat them as private institutions, they can be the subject matter of private law regulation, and legal regulations having a private law nature allow it to be questioned whether their regulation should be mandatory or not.

The aim of this study is to examine what reasons led the legislator to regulation by default rules, how this regulation works, who and what kind of advantages may be gained from such a regulation, and what kind of problems in application can be anticipated.

In Sect. 2.2 I will address the arguments that were raised in the discussion about the proper place of regulation of companies, and try to explain why it was a defensible and progressive solution to insert the body of company law legislation into the Civil Code. Section 2.3 will describe the possible regulatory methods that could have been applied in the regulation of company law in the Civil Code and summarise the advantages and disadvantages of different solutions. In the next section (Sect. 2.4), I will present the actual regulations that were enacted in the new Civil Code in this respect and in the Conclusion (Sect. 2.5) I will deal with some possible consequences and problems of the relevant rules.

2.2 In or Out of the Civil Code?

It is one of the basic characteristics of a code that it aims to regulate its subject matter as a whole; it tries to cover a certain field of law in its entirety. The new Civil Code had the same principle from the very beginning of its preparation. The Concept of the Code was drawn up by the Codification Committee and confirmed by a governmental decree in 2003. These Principles laid down the general requirement that the Code should regulate the legal relationships belonging to the domain of civil law as broadly as possible. However, this expectation could not mean that the Code covers all the relevant relationships without exception.

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1 It was ordered that the Draft of the Concept of the new Hungarian Civil Code should be published and discussed by the Government Decision No. 1009/2002. (I. 31.) Korm. After expert discussions, the Concept was modified by the Codification Committee and the final version was confirmed by Government Decision No. 1003/2003. (I. 25.) Korm. The Concept was published in a special edition of the Official Journal (Magyar Közlöny) in February 2003.

2 The Principles of the New Civil Code was approved by Government Decision No. 1003/2003. (I. 25.) Korm. and published in the (Magyar Közlöny 2003/8.) as an attachment of the same decree.
On the one hand, taking the constitutional rules on the hierarchy of the sources of law, the legislator cannot forbid regulating the same subject matter in another piece of legislation on the same level of the hierarchy. The new Civil Code is an ordinary act of Parliament, and because such an act has no special status, one of the subject matters of the Civil Code can therefore be a subject matter of any other piece of legislation given by the Parliament. These special laws may modify the Civil Code, provide additional regulation or even contradict the code.

On the other hand, the concept of an omnipotent code has some substantive limits as well. Regulating legal relationships of a similar character is not a value in itself. The main advantage of such a piece of legislation is that the rules included in a code are governed by the same regulatory concept and principles, and they constitute a coherent and interrelated system, in which the parts of the system can co-operate with each other smoothly, because the notions within the system have the same meaning and the possible contradictions show themselves more obviously than in if they are regulated in different laws and, therefore, such contradictions can be avoided more easily. However, these advantages are not limitless. A code should keep the same level of abstraction, more or less. Rules having some technical character should not be included into the code even if their subject matter belongs to civil law regulation. The legislator had to find a balance in deciding how far the scope of the code should be extended. Where the advantages of coherent and systematic regulation overwhelm the disadvantages of very detailed, particular and technical rules, regulation in the Code can be justified.3

With the abovementioned regulatory principles of the Code, it was obvious that a general Civil Code had to determine what kind of persons could become participants in a civil law relationship, otherwise the regulation would have been incomplete. A coherent and overall regulation inevitably needs to regulate the question of who can hold rights and obligations in civil law relationships. It was out of question that, beside natural persons, legal persons can also be subjects to such relationships. What kind of legal persons can be the subject of civil law regulation and to what extent these legal persons should be regulated within the Civil Code was, however, disputed. The main problem was organisations that do not have their roots in private autonomy but in public functions can also appear in civil law relationships. Such organisations are generally regulated in public law, where the approach to the regulatory subject matter and, consequently, the method of regulation is quite different from that of private law. These public organisations normally fit into a hierarchical system in which the participants are not equal; some of them are superior to others. Private law is not an appropriate tool for regulating such relationships. It can handle relationships between parties having equal rights and having the freedom to enter into legal relationships at their own risk. Consequently, the new Hungarian Civil Code only includes the specific regulation of those legal persons with internal and external relationships of a private character.

As for the companies\textsuperscript{4} it is well known that historically they were strongly connected with the state; they were founded by an act of the state, and their function was not only to organise economic resources of their investors for a common economic goal, but primarily to provide a state concession for certain economic activities that were not allowed for those who were not parties to the company. It is obvious that such types of companies cannot be typical private law institutions, because they do not fit into the concept of private law regulation.

However, the situation has changed dramatically in this respect. As a result of gradual development companies have been freed from direct state intervention. The role of the state has been limited to normative legal regulation and registration. Within the framework of legal regulation it is in the competence of private actors to decide to form of a company and to determine the rules of the operation of the company. Furthermore, if the conditions of the formation of a company laid down in general laws are observed by the founders, the state cannot refuse its registration; consequently, the state has no right to decide in an individual case whether it is possible to form a company or not.\textsuperscript{5}

In such circumstances, companies became private institutions that could become subject to regulation under private law. Being so, company law legislation could be a natural part of the new Civil Code.

Inevitably, there were some counter-arguments against including company law legislation in the Civil Code. These arguments went in different directions and included:

(i) Hungarian legal traditions justified separate company law legislation;
(ii) Company law is a mixed body of law, not only containing substantive private law rules but also public law and procedural rules;
(iii) Company law is a rapidly changing field of law, and regular modification would jeopardise the stability of the Code;
(iv) Company law legislation necessarily contains a series of technical rules that do not reach the level of abstraction that is a feature of the whole Civil Code.

It is worth noting that these arguments did not question that company law belongs to the domain of civil law. This approach was expressed in positive law as well. In the former legislation,\textsuperscript{6} commercial companies were regulated in a separate

\textsuperscript{4}Company in Hungarian legal terminology is a general term for organisations formed by the will of the members, who pursue economic or business activity through this organisation whose property is provided originally by the members and where the profit of the economic activity can be divided among the members. This general term embraces not only those organisations which are qualified as companies or corporations in common law systems but also business partnerships and limited partnerships. However, for the purpose of this paper I use the term of company for the business associations.

\textsuperscript{5}These principles are expressly laid down in the new Hungarian Civil Code in Section 3:4(1) and (4).

\textsuperscript{6}Speaking about old legislation I mean the laws prior to the new Civil Code. The new Civil Code is Act No. V of 2013 which came into force on 15th March 2014.
law; however, there was a rule providing that in those matters where this separate law had no special regulation then the rules of the Civil Code must be applied. In the new situation, when company law legislation is an integral part of the Civil Code, it is more obvious that general civil law rules are applicable to the field of company law.

As to Hungarian legal traditions, it is true that the companies had been regulated in a separate law, not in the general Civil Code. This goes back to the middle of the nineteenth century, when Hungarian company law legislation started and it reached its peak in the Hungarian Commercial Code, which covered the regulation of commercial companies in general. However, one should not overlook the fact that at this time Hungary had no Civil Code at all and so there was no choice as to whether companies were regulated in a Civil Code or a Commercial Code. The regulation of commercial relationships was needed to strengthen the triumph of capitalism over feudalism, and the Commercial Code was a weapon in the battle between these two social systems. A general Civil Code was not absolutely necessary, and Hungary did not have such a code until 1959. At this time, there was a socialist economic and social system which was based on state ownership and the direct state management of the economy. This system did not need, and the more, could not have handled significant privately-owned companies, so it was obvious that the Civil Code did not contain regulations on them. Summarising these facts, we can conclude that when there were private companies there was no Civil Code, and when there was a Civil Code there were no private companies. In current circumstances, where we have both private-sector companies and a new Civil Code, legal tradition cannot be decisive. The current situation is completely different from any former situation, therefore the reference to legal tradition is meaningless.

The statement that the existence and the operation of companies is influenced by different branches of law is true in itself, but it does not follow from this fact that the law shall reflect this complexity with a unified, comprehensive Act. In a legal system where private law and public law legislation is basically separated, such a separation can be maintained in the field of company law as well. The substantive private rules can be regulated by civil law, specifically by the Civil Code, while the connected rules—e.g. the rules on registration of companies, the rules of state supervision over the activity of the companies, the rules on competition matters, the rules on taxation and accounting—can be laid down in separate rules, and it is not necessary to mix the regulation of these matters with private law rules. The new Civil Code follows the principle of leaving procedural and other non-private law matters to separate laws, and tries to keep the Code as pure substantive legislation. The same principle could be followed in the field of company law legislation. Similarly to the former situation, when substantive company law was regulated in

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7 Act No. IV of 2006 (this act was ineffective from the date of coming into force of the new Civil Code, i.e. from 15 March 2014).
8 Section 9(2) of Act No. IV of 2006.
9 Act No. XXXVII of 1875.
an independent piece of legislation and the related matters were regulated in separate laws, the rules of the former Companies Act can be taken over by the Civil Code, and the other laws can keep their separate function, and this separation can even be strengthened by the new legislation. The separation of substantive law from related legal matters was not perfect in the former legislation and cannot be perfect in the new Civil Code either. At a certain point, the substantive company law legislation contains, for example, procedural rules that shall be applied in the enforcement of substantive law. The new Civil Code is intent on purifying the regulations of substantive law\textsuperscript{10}; however, the result cannot be total separation. There are still some rules of a procedural character, but fewer of them than in the former legislation.

Looking back to the modern history of the Hungarian company law legislation it is true, that the frequency of the change of the law was particularly high. The Companies Act of 1988 (which was the first company law legislation after the Commercial Code of 1875 and the law on limited liability companies in 1930) was replaced by a brand new act in 1997, and then this new one was substituted by a new law in 2006. That Companies Act was in turn repealed by the new Civil Code in 2014. One could have the impression that company law requires completely new overall regulation every nine years, on average. However, a code should not be changed so frequently. A code should reflect stability, and subject matters that are best served by more flexible regulation cannot be the subject matters of legal regulation according to a code. Taking these theoretical requirements as granted, company law can still be a proper subject matter for its regulation in the Civil Code, because frequent changes in the regulatory regime are not a necessity. There have been no such changes in the social and economic system that could necessitate the introduction of a totally new Act on company law. The company law system has not fundamentally changed; the principles of company law have remained unchanged and so any alteration that was necessary in company law could have been realised by simple modification of the existing law.

The other great change that could have had an impact on company law legislation was Hungary’s accession to the European Union, but our earlier company law legislation had been already harmonised with the European law so it could not justify a brand new Act on company law either. Complete alignment with European law could have been completed by modifying the existing laws. Furthermore, the changes in European law with regard to companies are not too frequent to preclude the regulation of company law in a Civil Code.

Finally, the opponents of company law regulation within the Civil Code allege that company law is burdened by a lot of technical rules concerning the operations of companies, and such operational rules are below the abstraction standard of the

\textsuperscript{10}The regulations on expelling company members can be mentioned as an example. The former legislation not only had rules on the conditions, the substantive basis of expulsion, but gave also special rules of the legal procedure aiming at such expulsion. The new Code left out these procedural rules with the aim of these special terms being regulated by procedural rules, e.g. by a Civil Procedural Code.
Code. In my opinion, substantive company law regulations should always be reflections of conflicts of interests of different groups connected with the company. Sometimes these conflicts are not obvious, and may remain covered by the appearance of technical norms. It is said, for example, that the rules on the competence of different company organs or on the necessary proportion of votes in decision making are mere technicalities, and therefore they do not fit into the Civil Code, which is designed for handling real conflicts. However, after a deeper analysis, one can conclude that the company law rules having a *prima facie* technical character handle genuine conflicts of interest. Competence rules are relevant in the conflict between company shareholders and its management. The voting rules have an impact on the relationship between the majority and minority shareholders. These operational rules are indeed rules handling conflict of interests and doing so they have precisely the same character as any other classical civil law rules; therefore they reach the abstraction level of the Civil Code.

Summarizing the above arguments, I believe that it is an amply justified conclusion that company law matters having a civil law character need to be regulated in the Civil Code and also that such regulation is possible.

### 2.3 Regulatory Methods in the Civil Code

Civil law regulation can basically follow two different methods. One possibility is to introduce mandatory legal norms that have to be applied unconditionally; consequently, the parties to the legal relationship are not allowed to depart from such regulations according to their will. The second option is to set up default rules from which the interested parties can deviate by their common will. Such rules will be applied only if the parties do not agree otherwise.

The choice of the applicable method is not arbitrary. Rules regulating legal relationships having an absolute structure (i.e. legal relationships where only one party is determined personally and everybody else is obliged to refrain from breaching the rights of the named obligee) cannot be default rules, because it is impossible to reach an agreement among all interested parties, since the obligors are not and cannot be determined individually. Furthermore, deviation from the legal rules cannot be acceptable if the parties’ agreement upon such deviation results in external effects. If the rights or obligation of a person who is not a party to the agreement on deviating from the legal rules could be influenced by the agreement, it could transfer costs to a third party, which would be inconsistent with the principle of private autonomy that governs private law in general.

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11These two methods in their pure version, as they are described here, are the extremes. There are some further possibilities in between. For example the legislator may limit the directions or measures of the deviation from the rules, or may regulate the possible alternative rules as well, letting the parties to choose a readymade alternative provision instead of the general rule.
That is why property law is regulated overwhelmingly by mandatory rules. Since everybody is obliged to observe the rights of the owner, everybody is subject to a certain property law relationship, where only the owner is individualised. However, the owner cannot agree with every other interested person upon the alteration of the rules regulating the property law relationship.

In the field of law of obligations (and especially in contract law), the situation is different. Contracting parties are personally identified, and their contractual agreement has legal effect only on the parties; there are normally no external effects. Contracting parties may negotiate with each other on the rules of their legal relationship without transmitting the impacts of such a negotiation onto unknown third parties. As such, the rules on contract law can generally be default rules, allowing the parties to deviate from them and substitute the law with their own agreement. Introducing regulation by default rules needs an explicit order from the legislator. The legal rules are rules by definition, ultimately applicable and enforceable by the state. If the legislator does not stick to the unconditional application of a legal rule, it has to express this will. In the Civil Code, such regulations can be found in connection with all types of obligations and there is also a special provision on contracts, stating that the parties may deviate from the legal rules.\(^\text{12}\) As a matter of course, there are certain cases where the default provisions cannot provide satisfactory regulation, even in contract law. In such exceptional cases the Code forbids deviation by special rules.

The legal relationships regulated by company law are special from this point of view. Their special nature comes from the fact that company law relationships are mixtures: the shareholders of the company are identified, so they can negotiate with each other and can reach an agreement on deviation from the law; however, the aim of their agreement is to form or operate a company which is a legal entity and is distinct from its shareholders. The aim of the existence of a company as a legal person is to facilitate this organisation in entering into legal relationships with third parties under its name, separately from its members. At this point, however, the company law relationships necessarily have an external effect.

Having this mixed nature of company law relationships, the method of legal regulation is not self-evident. There are arguments for and against both methods. In the following chart I summarise the possible advantages and disadvantages of regulating company law by mandatory or default rules.

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<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td><strong>Mandatory</strong></td>
<td>• Certainty</td>
<td>• Unable to follow individual requirements</td>
</tr>
<tr>
<td></td>
<td>• Lower direct transaction costs</td>
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<tr>
<td><strong>Default</strong></td>
<td>• Flexibility,</td>
<td>• Regulatory objectives could be missed</td>
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<td></td>
<td>• Adjustable to individual requirements,</td>
<td>• More need for judicial interpretation</td>
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<td></td>
<td>• Lower costs in general</td>
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\(^\text{12}\)Sections 6:1(3) and 6:59(2) of the Civil Code.
In my view, costs and flexibility are interconnected. It can be true that mandatory regulation is safer, because the parties do not bear the risk of autonomous regulation, and at the same time cost-effective, because the parties do not spend money on deviating from the regulations (since it is forbidden). However, these advantages are only virtual or much smaller than the advantages of regulation by default rules. The safety created by mandatory rules is much more expensive than default regulation. It may happen that mandatory regulation involves lower actual costs, but society has to pay a very high price for that. The price is a great volume of lost opportunities.

It is unlikely that the legislator could regulate company law relationships in such a diverse and complex way as the parties would ideally like. However, if regulation consists of mandatory rules then the parties have no right to add their own initiatives to this regulatory framework. Instead, they have to accept mandatory regulation or try to circumvent the rules that hinder them from reaching their goals. In the first case, the cost of mandatory regulation is that the rules applicable to the company are not effective; they do not best serve the needs and interests of the parties. The second option has great risks and therefore it also entails costs. The most obvious risk of such an attempt is that the legal system does not allow agreements that are in contradiction with the mandatory rules to be enforced; consequently, the parties may not reach the result they aimed at the time of entering into the contract.

As a matter of course, such costs have to be borne if the reason for regulation is to protect of third parties who are not participating in the contract. However, where the agreement of the parties has no external effect, mandatory rules cannot be justified. In theory, even mandatory rules could provide effective regulation, but in practice, with such a complex and diverse arena as companies, the legislator’s attempts to map and regulate all the possible needs and solutions that the parties might have without affecting third parties’ interests is impossible. That why arguments that the method of regulation should be chosen on the basis of which version needs more exceptional rules are specious. Even where there are mandatory rules, the number of possible alternative solutions is infinite. If the legislator identifies some of these possible solutions and allows their application by enabling provisions, it does not mean that only these exceptions are necessary and that there is no need for any further alternatives.

Under default rules, it is not the legislator who is expected to conclude what parties might need in all individual cases. The parties themselves will fulfil this task, and they will find the best solution for themselves, without any rule that specifically fits their expectations. Instead, the default rules try to find the most common solutions that match the needs of most interested parties, and being so, that could be applied in the majority of cases. The function of the default rules is to serve as a model. If this model is acceptable to the parties, they are exempted from negotiating over these terms, and in this way they can spare costs and effort.

Obviously there is no guarantee that legal regulation by default rules will meet the requirements better than mandatory regulation. However, in the former case, the mistake of the legislator can be corrected by the parties. Such a correction is not
cost-free, but in the long run it can show what would be a more effective legal prescription, and as a consequence it may result in better regulation. Mandatory regulation does not leave room for manoeuvre; the parties have to follow the rule (at least on the surface and, covered by the appearance, they can try to find a better solution at a higher cost), and by doing so it hinders the development of an effective law.

2.4 The Solution of the New Civil Code

Taking all the arguments described in the foregoing chapter into account, the Hungarian legislator decided that the companies will generally be regulated in the new Civil Code by default rules, and mandatory rules will be applied only when the protection of a third party interest makes it necessary.

The relevant section of the Code reads as follows:
“Section 3:4

(1) Legal subjects may freely agree upon the formation of legal persons by a contract or a deed of foundation or articles of association, and may establish the organisation and operational rules of the legal person.

(2) In the course of regulation of the organisation and the operation of the legal person, as well as the members’ or founders’ relationships towards each other and towards the legal person, the members or founders may deviate in the deed of foundation from the law on legal persons, with the exceptions prescribed in Subsection (3).

(3) The members or founders of the legal person shall not deviate from the law if

   (a) the deviation is forbidden by law;

   (b) the deviation obviously infringes the rights of company creditors, employees and minority members, or hinders the state control of the legality of the company’s operation.”

In my opinion, this text nicely reflects the dual nature of the company law relationships and tries to separate internal matters, where there is no risk of third party effects, from external connections, where the company members’ agreements could have effects on third parties. Subsection (2) contains the basic rule in this respect. This is the enabling rule, allowing the parties to deviate from the law. However, this allowance is not limitless. The deviation from the law is accepted only in internal relationships, i.e. in relationships between the company members or between the company and its members. Furthermore, in the field of company organisation—even if there are not always prima facie interpersonal relationships—deviation is allowed, because the effects of regulation are generally limited to the company.

Although in the field of company relationships described in Subsection (2), the principle is regulation by default rules, one should note that, even in this field,
situations may occur where the agreement between the parties has an external effect. The cited provision therefore forbids regulation under certain conditions in order to avoid such unintended cases.

The most obvious situation when the parties are not allowed to deviate from the law is when the wording of the act clearly and individually expresses this prohibition [Section 3:4(3)a]. There are many instances in the Code where the rule itself provides that an agreement different from the legal rule is null and void. The Code itself does not explain the reason for such a prohibition as a matter of course, but—if the legislation is correct—there always must be a good justification for that, and the valid justification could be the protection of the third parties. However, the legislator was not completely sure that all rules from which deviation shall be prohibited can be identified and therefore introduced a general prohibition, in which the relevant third party interests are specified, and any deviation from the law which could harm these interests is prohibited. With this rule the system of prohibition is complete, and covers any situation where deviation is not acceptable, even if the specific prohibition is missing.

2.5 Conclusion

The method of regulation of companies in the new Civil Code was broadly debated in public and in the legal profession. There are fears of ambiguities and uncertainties in interpretation and application of the new law. It is not worth denying that there will be some obscurity and disputes concerning whether the deviation from certain legal rules is acceptable or not. However, I believe this price is not too high for the advantages deriving from this new method of regulation. These advantageous outcomes can be summarised as follows:

1. Company founders will be able to design their company individually, in accordance with their individual circumstances. The internal relations can be adjusted to the needs of the parties, and in this way companies may better serve their members’ interests
2. The agreements of the company members will be enforceable, because any agreement deviating from the law will not be illegal.
3. Having the above mentioned advantages, the new regulatory method does not overlook third party interests; the law provides all-inclusive protection to third parties.
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