Legal Reform for Hungary’s Private Sector

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Defining real property rights and creating the conditions for free and fair competition and efficient exit of firms are perhaps the most contentious and confused areas in Hungary’s current legal landscape — largely because they tread so heavily on vested interests. Other areas of law — including intellectual property, company, foreign investment, and contract law — are less problematic.
This paper — a product of the transition and Macro-Adjustment Division, Country Economics Department — is part of a larger research effort in the Department on the economic implications of legal reform in Central and Eastern Europe. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Rebecca Martic, room N11-054, extension 39065 (October 1992, 45 pages).

Hungary is in the midst of a fundamental transformation toward a market economy. Although it was formerly in the forefront of efforts to reform socialism, after 1989 the goals of reform changed from market socialism to capitalism, as the old Communist regime lost power and the idea of widespread private ownership gained acceptance. The legal framework — the “rules of the game” — is now being geared toward encouraging, protecting, and rewarding entrepreneurs in the private sector.

Gray, Hanson, and Heller describe the evolving legal framework in Hungary in several areas, including constitutional, real property, intellectual property, company, foreign investment, bankruptcy, contract, and anti-monopoly law. These areas of law serve to define property rights, the means of exchanging them, and the rules for competitive market behavior. In essence, they form the bedrock of a legal system for a market economy.

In Hungary as in the other countries of Central and Eastern Europe, defining real property rights and creating the conditions for free and fair competition are perhaps the most contentious and confused areas in the current legal landscape — largely because they tread so heavily on existing vested interests.

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Hungarian Legal Reform for the Private Sector

Hungary is in the midst of a fundamental transformation towards a market economy. Although it has long been in the forefront of efforts to reform socialism itself, after 1989 the goals of reform changed from market socialism toward capitalism, as the old Communist regime lost power and the idea of widespread private ownership gained acceptance. The legal framework--the "rules of the game"--is now being geared towards encouraging, protecting, and rewarding entrepreneurs in the private sector.

This paper describes the evolving legal framework in Hungary in several areas--including constitutional, real property, intellectual property, company, foreign investment, bankruptcy, contract, and antimonopoly law. These areas of law serve to define (i) property rights, (ii) the means to exchange them, and (iii) the rules for competitive market behavior. In essence they form the bedrock of a legal systems for a market economy. The paper also addresses the capacity of Hungary's legal institutions to implement the new legal reforms. As in the other countries of Central and Eastern Europe (CEE), defining real property rights and creating the conditions for free and fair competition are perhaps the most contentious and confused areas in the current legal landscape--largely because they tred so heavily on existing vested interests. Other areas of law, including intellectual property, company, foreign investment, and contract law, are less problematic.

Constitutional Law

No written constitution existed in Hungary before 1949. Rather, constitutional principles were derived from various pieces of legislation, similar to the tradition of England. In Act XX of 1949, the People's Republic of Hungary adopted a Constitution based on the Soviet model. Under this Constitution the economy was based on the concept of "social

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1 This paper is part of a larger research project sponsored by CECSE and LEGEC to study evolving legal frameworks in Eastern Europe. Other studies include Gray et al., The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland ("Poland"), Gray et al., Romania's Evolving Legal Framework for Private Sector Development ("Romania"), Gray and Stiblar, The Evolving Legal Framework for Private Sector Development in Slovenia, and Gray and Ianachkov, Bulgaria's Evolving Legal Framework for Private Sector Development.

2 This paper does not discuss certain other areas of law that are also important to the private sector, including privatization, banking, taxation, and labor law. Although a critical area of reform, privatization is a transitional issue, whereas the paper seeks to address the longer-term legal structure. The other areas of law are omitted due both to space limitations and to likely coverage in other World Bank or external studies.
ownership of the means of production" (Section 6(1)), a vague notion akin but r.. . . identical to state ownership. This Constitution also established the primacy of the national economic plan in guiding the economy (Section 7). Not only did state planning control the economy in this and other socialist countries, but, by virtue of appearing in the fundamental law, it governed the entire legal culture in the country as well.

In 1972, this Constitution underwent extensive amendment in order to accommodate the New Economic Mechanism of 1968.3 For example, for the first time it recognized and protected personal property and the economic activities of small-scale private producers of commodities (Sections 11 and 12). Such protection, however, was balanced against the needs of the "public interest," which in practice left great discretion to the state in regulating both state-owned and private business.

On October 18, 1989, Parliament passed the most significant constitutional revisions to date. This amendment is often referred to as the "new" Hungarian Constitution, as approximately 80% of the 1949 version was abrogated. Drafted on the threshold of Hungary's democratic and economic reforms, the amendment was a political compromise between the old school communists and the new generation of politicians gradually replacing them. The new version was subsequently amended several more times in 1990. It is unclear how long this version of the Constitution will remain in force. Its preamble envisions it as a transition document, but no further fundamental revision is expected in the near future.

The current Hungarian Constitution is composed of 78 sections falling within 15 chapters:

I. General Provisions
II. Parliament
III. The President
IV. The Constitutional Court

3 The New Economic Mechanism was Hungary's first major attempt at economic reform. It maintained national planning but ended the practice of imposing production targets on state-owned enterprises. Rather, a system of economic regulations and incentives (e.g. taxes, prices, and credit policy) was designed to induce firms to meet national planning targets. This experiment was popularly known as "goulash communism." Most of the lessons of that period were, however, negative, as decentralization led to overinvestment and lack of fiscal discipline exacerbated macroeconomic imbalances without significantly increasing efficiency. See J. Kornai, "The Hungarian Reform Process: Visions, Hopes, and Reality," *Journal of Economic Literature*, Vol. XXIV, December, 1986; A. Gelb and C. Gray, *The Transformation of Economies in Central and Eastern Europe: Issues, Progress, and Prospects*, The World Bank, 1991; and Sajo, Andras, "Diffuse Rights in Search of an Agent: A Property Rights Analysis of the Firm in the Socialist Market Economy," 10 *Int. Rev. of Law and Economics* 42 (1990).
Rights and Duties of Citizens

Much of the amended Constitution deals with rights and duties of citizens. Chapter I deems Hungary a democratic constitutional state and asserts its commitment to a market economy and its encouragement of entrepreneurship and competition. It establishes protection of private property, including compensation in the event of expropriation, and general rights to freedom of association. Most of the fundamental rights and duties of citizens are contained in Chapter XI. These include rights to liberty, personal safety, and freedom from torture. Democratic rights, such as freedom of thought, speech, the press, and religion, are also guaranteed. These latter rights, as well as the right to compensation in the event of expropriation, were also guaranteed by Hungary's socialist constitution, but were always subject to the higher "interests of socialism."

Other sections of the Constitution promise certain economic rights. Labor is guaranteed "the right to work, to freely choose [a] job and occupation" and "to have an income [commensurate] with the quantity and quality of the work performed by him/her" (Section 70/B). Every woman is guaranteed pre- and post-natal care (Section 66), and children are guaranteed "all the protection and care required for proper physical, mental and moral development" (Section 67). Although laudable in intent, the broad language of these rights may create expectations that Hungary is unable to fulfill.

Structure of Government

Section 2 declares Hungary a democratic constitutional state based on the separation of powers among Parliament, the Council of Ministers, and the Judiciary. This is a radical change from the previous system, in which absolute and undivided power was vested in the Communist party. The unicameral Parliament has 386 members4 elected for four year

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4 The current Parliament was elected in 1990 based on the negotiations embodied in Act XXXIV of 1989 on the Election of MPs. Rules governing MP status, including immunities, are governed by Act IV of 1990 on the Legal Status of MPs.
terms. Its primary legislative duty is to pass laws and constitutional amendments. Any legislation affecting the fundamental rights of citizens must take the form of a Constitutional Act. In light of past practice under socialism, in which Parliament was relatively inactive and the Council of Ministers governed by passing decrees, this requirement that Parliament make the laws is meant to ensure that the democratically elected body governs the citizenry.

Parliament elects Hungary’s highest ranking officials, including the President, the Council of Ministers, the Parliamentary Commissioners of Citizens’ Rights, the President and Vice-Presidents of the State Audit Office, the President of the Supreme Court, and the Chief Public Prosecutor (Section 19). A member of Parliament, the President, or the Council of Ministers may introduce legislation. After proposals are passed by Parliament, they must be signed by the President to become law. The President may refuse to sign an Act of Parliament by passing questions about the Act to the Constitutional Court. The precise boundaries of presidential power to veto executive decisions of the government remain unclear, but in general the President has much less power than the Presidents of either Poland or Czechoslovakia.

The Constitutional Court

The Constitution also introduces Hungary’s first Constitutional Court. This court is composed of 15 judges elected by Parliament. Each sits for a nine year term, which may be renewed once. These judges are prohibited from political activity and party membership, a restriction that applies to local and county judges as well. The Court’s purpose is to interpret the constitutionality of legal rules, including international agreements, and to annul parliamentary acts and other regulations it finds unconstitutional. It may also review draft

5 In enforcing this Parliamentary primacy, the Constitutional Court has several times overruled decrees by the Council of Ministers on the grounds that the decree either conflicts with a law or that the subject of the decree falls within an area that can only be addressed by Parliament through passage of a law. Interview with A. Nemeth, June 5, 1992.

6 See, e.g., "Court Vague on Goncz-Antall Media Debate," Budapest Week, June 11-17, 1992, at 3 (Constitutional Court decision on "the country’s hottest political debate since the elections, pitting the [President and Prime Minister] against each other, [concerning] their respective rights to hire and fire people in key positions.").

7 Act I of 1989 establishes the Court. Its purposes are detailed in Act XXXI of 1989, and detailed regulations on structures and procedures are set out in Act XXXII of 1989.

8 The power automatically to annul laws and regulations is strong relative to the powers of other constitutional courts in the region. For example, the decisions of Romania’s and Poland’s Constitutional Courts can be overturned by a two-thirds’ vote of their respective Parliaments. See Gray, et al, Poland and Romania, supra note 1. In Hungary, the Parliament may not overrule a Constitutional Court decision except by changing the
laws before they are voted upon in Parliament, although in reviewing draft laws, the court has sometimes been accused by members of Parliament of impinging on legislative authority. The court has sometimes declined to rule on draft laws in order to avoid violating the principle of separation of powers.

The Hungarian Constitutional Court has extremely broad jurisdiction, perhaps the broadest of any constitutional court in the world. Va 1 complaints are not limited to contesting the constitutionality of existing laws and administrative regulations, but they extend even to allegations of "negligence" against the legislature for not having passed a law, if such law’s absence creates an unconstitutional situation. 9 If the court agrees that lawmakers should have passed such a law, Parliament is given a limited period of time in which to pass the missing legislation, although the procedure for enforcing this time limit is unclear. 10 One example of this proactive role is the Court’s request in January 1990 that Parliament set up an administrative court system by April 30, 1991. 11 In fact, the need for such court system arose in part because of the Constitutional Court’s ruling that raising interest rates on housing loans was unconstitutional, because it needed to be passed by a two-thirds Parliamentary majority rather than a simple majority. This ruling stimulated petitions on a wide variety of economic problems not remotely related to the court’s role as guardian of the Constitution. The Court believed that an administrative court system was needed to handle these economic cases. Parliament failed to set up such a system, but a crisis was averted because the regular courts decided to take on such administrative cases.

Constitution. For example, in a case concerning the voting rights of expatriate Hungarians, the Parliament passed an Act, the Court struck it down, and the Parliament then implemented the Act by amending the Constitution.

At present, regular courts, including the Supreme Court, are not allowed to declare an Act or regulation unconstitutional, although they may stay a case and refer the matter to the Constitutional Court. There are discussions to amend this procedure so that regular courts can also rule on the constitutionality of laws and regulations, with appeal to the Constitutional Court.

9 J. Pataki, "The Constitutional Court’s Search for Identity," Report on Eastern Europe 2:25, June 21, p. 7. The Court has interpreted its jurisdiction to hear such omission cases to be limited to those situations where the missing regulation is affirmatively required by a higher Act or Decree, or where the omission violates basic rights.

10 J. Pataki, id., p. 7.

11 A. Nemeth, personal interview, June 5, 1992; see also Pataki, supra note 9, p. 7.
Not only does the Court have broad jurisdiction, but it also allows extremely broad access. Under the court's rules, any citizen is entitled to present a complaint to the court.\textsuperscript{12} The rules of open access and permissible claims have led to a virtual flood of cases.\textsuperscript{13} About 1500 cases were filed and 235 cases decided in 1990. In 1991, 2200 cases were filed, of which about 400 were accepted for review (the balance being dismissed as moot, repetitive, or otherwise technically flawed) and about 250 were decided. Of these decisions, about 50 resulted in annulment of laws or regulations.

In sum, the Constitutional Court is an important and powerful institution in Hungary, and its activity can have a major impact on private sector development. One landmark decision, for example, was that declaring the original Compensation Act unconstitutional because it unfairly discriminated in favor of former landowners and against owners of other types of assets.\textsuperscript{14} Another important decision was that declaring as unconstitutional the prohibition of foreign ownership of land.\textsuperscript{15}

\textbf{Rights to Real Property}

As in other CEE countries, clarifying real property rights is perhaps the most difficult and slow-moving area of legal reform in Hungary. It not only confronts the vested interests of former owners, existing users, and newly emerging business interests, but it must be carried out in a setting plagued by poor records, struggling institutions, and a legacy of distorted public policies.

\textbf{Defining Basic Ownership Rights}

\textbf{Socialist ownership}. Apart from the Constitution, which gives very general conceptions of property, the most important law in defining fundamental property relations in

\textsuperscript{12} Plans to limit this access by requiring the litigant to have a direct interest are under active consideration. Other countries often restrict access to constitutional courts. For example, in the United States one can present a constitutional issue to the Supreme Court only if one has been directly affected by the issue, and the Supreme Court has discretion whether to consider the case.


\textsuperscript{14} See pp. 11-12 for further discussion of this Act.

\textsuperscript{15} See p. 9 for further discussion.
Hungary over the past 30 years has been the Civil Code of 1959, as amended. Before 1959, property rights were governed by a mixture of numerous laws, collected "customs of judgement," and some decisions of higher courts. The drafting of the Code in 1959 consolidated these various sources. Although modeled after the German Civil Code (Das Bürgerliches Gesetzbuch), the Code was drafted during the socialist period and thus also reflected socialist ideology. The sections on property ownership in particular were perforated with government usurpations of property rights.

A common element of socialist law throughout Central and Eastern Europe was the recognition of several categories of property, including social and cooperative ownership, personal property, and private property. In Hungary, these categories and their accompanying rights were set out in Part III of the Civil Code. Assets under "social" ownership included property specifically owned by the state, capital equipment (i.e. major "means of production"), and other property of "crucial importance for the national economy." Socialist ownership dominated industry, applying to over 99 percent of Hungary's industrial production. This property was deemed owned "by the entire people" and enjoyed greater legal protection than other forms of property. For example, all Hungarian citizens were obliged to protect state assets, and the Civil Code promised compensation for losses, injury, and death resulting from this duty.

Similar to socialist property was "cooperative" property. When over 90% of Hungary's land was nationalized, it became cooperative property. This differed from socialist property in that it was the "indivisible property of a group of citizens spontaneously associated for common production, distribution, or meeting demands." While in this form ownership appeared to remain vested in individuals, ownership rights were still limited. Upon the winding-up of the cooperative, the property did not revert to the cooperative's

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18 Compare Romania, whose 1864 Civil Code remained intact after the introduction of socialism. See Gray, et al, Romania, supra note 1.

19 This refers to property set out in both the Civil Code and the Constitution, namely oil and minerals, lakes, rivers and riverbeds, railways, banks, the Post Office, and the telephone, radio, and television networks (Civil Code, Para. 172).

20 Civil Code, Para. 89.

21 Civil Code, Para. 179.

22 Civil Code, Para. 90.
members but continued to be part of the cooperative property, managed by countrywide organs representing the interests of the cooperatives.23

"Personal" property was that which served personal needs, including family houses and apartments24, vacation homes, furniture, and personal items such as clothes.25 These items were by law and in practice freely transferable. However, entrepreneurship was stifled by the prohibition of commercial trading; all transfers were supposed to meet only personal or familial needs. Also, separate pieces of legislation restricted the size and number of properties that individuals could own. Families were restricted to owning a maximum of one home (either a house or an apartment), one vacation home, and one agricultural plot. Families acquiring additional property, for example through marriage or inheritance, were by law required to sell the excess.

"Private" property was defined as the individual ownership of means of production. While the Civil Code did recognize "the private property of small producers which serves useful business activity,"26 it also granted the state wide power to restrict its use through taxation or simply by decree.

Redefining ownership rights. Hungary has gone far over the past three years in redefining property rights and removing the stigma and legal impediments attached to private27 ownership. The Constitution and Civil Code have been amended, and many other laws affecting rights in real property have been adopted (as discussed below). Section 9(1) of the newly amended Constitution abolishes the preferential treatment of socialist property by granting private property equal rights and protection. In support of this right, Sections 13 and 14 of the Constitution guarantee compensation in the event of expropriation of property. The Civil Code28 also guarantees "adequate compensation" for property expropriated for the public interest. Although under socialism such compensation was rarely paid, Hungary seems to express a greater commitment to abiding by this fundamental principle by elevating this guarantee from the Civil Code to the constitutional level.

23 See Molnar, supra note 17, p. 8.


25 Civil Code, Para. 91.

26 Section 93.

27 Hereinafter "private" property refers to any individually-owned property, rather than the narrower socialist usage of the term.

28 Civil Code, Para. 177.
As with the Constitution, the most important provisions on property in the Civil Code have been amended. Private ownership is now fully accepted in Hungary, and the privatization program is attempting to transfer the bulk of state assets into private hands. Law XIV of 1991 abolished all forms of socialist ownership, abrogated privileges of state and cooperative ownership as related to private ownership, reviewed the range of exclusive state property and inalienable assets, and empowered the state to cede certain property, such as forests and land, to private owners. Remnants of the prior system in related Code sections are no longer enforced and should be interpreted in the spirit of the recent amendments, a necessary process pending a thorough overhaul of the Civil Code. Although these prejudicial provisions of the Civil Code could perhaps be eliminated with a quick amendment as was done in Poland, the Hungarians have opted to undertake a more systematic revision to the Code over the next several years under the auspices of a special codification committee appointed by the Ministry of Justice.

In the area of real estate, Act I of 1987 on Land (as amended through 1991) has been instrumental in freeing up the private market for real estate. This Act, which covers not only land but also buildings and other constructions, defines the rights of owners and users and clarifies conditions for the purchase and sale of real estate. Although somewhat unstable in its specifics due to continual amendment, this Act has served the important function of removing the administrative barriers to private acquisition of real estate. For example, it eliminated the "trustee-management" form of land-holding common during socialist times, and it lifted the former 50 hectare maximum on private land ownership. Now a private Hungarian person (either natural or legal) may acquire real estate without any legal limitation. However, other practical impediments discussed below, such as ambiguity to title and access to credit, continue to retard the development of a real estate market.

**Foreign ownership.** Under Act I of 1987 on Land, foreigners are prohibited from owning agricultural land (unless allowed by another law). Foreigners may, however, own non-agricultural land and immovable real property after receiving permission from the

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32 The Act of Land in uniform pattern with Decree 26/1987 (VII.30) MT by the Council of Ministers and Decree 8/1987 (IX.1.) MEM by the Minister of Agriculture, translated in Hungarian Rules of Law in Force i./Nr. 10, Budapest, 1990, June 1.

33 Sarkozy, supra note 31, ch. III, p. 3.
Ministry of Finance. This permission is guided by the discretionary standard that the purchase may not "harm the Hungarian State or its autonomy, does not harm local governments nor cultural and touristic interests." Apparently, Hungarian expatriates whose property was expropriated can secure this permission easily; similarly, foreigners who buy out their partners in a joint venture also tend to obtain permission.

In contrast, Hungarian corporate entities that are either partly or even wholly foreign owned are entitled to own real property under the Foreign Investment Act of 1988, discussed below. The only limitation on this ownership is that, under Section 19, the property must be related to the company's objectives. The original purpose of this limitation was to prevent speculative buying by foreigners; however, real estate development appears to qualify as a proper business purpose.

Assigning and Securing Title

Once basic rights to private property have been defined, the next step is linking those rights with specific owners. This is the most controversial aspect of reform, as it raises the possibility of a redistribution of assets that could decidedly influence the pattern of wealth for the foreseeable future.

Clarification of state property ownership. The need to define owners applies to both public and private sectors. On the public side, assigning specific ownership rights to state-owned property (including property of state enterprises, public office buildings, and public housing) to various levels of government is proving problematic in Hungary, as in several other CEE countries.

Two recent laws address this thorny question. First, Act LXV of 1990 on Local Government transferred control over all state enterprise property to the State Property Agency responsible for privatizations. Under this law, disputes still persist among the municipalities, the districts, and the State Property Agency as to ownership of enterprise specific property. Second, Act XXXIII of 1991 on the Transfer of State Property to Local

34 Section 38(1). Foreigners are defined as natural persons who are not Hungarian citizens, Hungarian citizens domiciled abroad, and business organizations not created under Hungarian law. An exception for Hungarians domiciled abroad allows them to own property through inheritance.

35 Local governments have the power to veto a sale. See Invest in Hungary, 1991/6 at 29.

36 The problem is particularly acute in Poland, where the move to decentralize government has been very strong. See Gray et al, Poland, supra note 1.

Authorities\textsuperscript{38} transferred to local governments ownership rights in most other state-owned real property—including apartments, non-residential units such as small shops, and numerous other state-owned buildings.\textsuperscript{39} The Ministry of the Interior is charged with implementing this Act by setting up district and county level committees to review each land parcel transfer. With ownership rights comes the clear legal authority to sell this property. Such authority is critical to the development of the real estate market, because it identifies competent sellers to potential buyers, enables enforceable contracts of sale to be concluded, and thus reduces the longstanding dilemma of unclear or clouded title.

\textbf{Claims of former owners.} Title to both publicly and privately held real estate is not likely to be complicated by restitution (or "reprivatization") in Hungary as it is in Poland, Romania, East Germany, Czechoslovakia, or Slovenia.\textsuperscript{40} Hungary's solution to the perceived injustices caused by socialist expropriations is Law XXC, the Compensation Act of 1991. This law partially compensates both Hungarians and foreigners whose property was expropriated through regulations enacted after 1939. Compensation takes the form of lump sum payments in the form of coupons, the amount of which is determined by the value of the nationalized property. Damages measuring up to HUF 200,000 will be compensated 100%; from HUF 200,001-300,000, 50%; from HUF 300,001-500,000, 30%; and over HUF 500,001, 10%. The maximum payment will be HUF 5 million.\textsuperscript{41}

The coupons function as transferable bearer securities and pay interest (75\% of the basic interest rate of the central bank) until the summer of 1994. Compensation coupons may be used as full or partial payment for property sold by the state, including apartments, shares in privatized state-owned industries, and farmland.\textsuperscript{42} A separate law is planned to

\textsuperscript{38} Magyar Kozlony, Aug. 2, 1991 87. Szam, Paras 1-2. This act also transfers historical architecture (para. 3), undeveloped land not covered by the Transformation Act XIII of 1989 (para. 9), public utilities exclusively serving that community (para. 11), public transportation (para. 14), and certain parks (para. 25).

\textsuperscript{39} Conflicting claims now exist between the two levels of local government, the municipalities and the districts, although it is generally anticipated that the district; will assume ownership rights. Buildings on plots of land larger than 1000 square meters are transferred to the State Property Agency, and former Party property is transferred to the Hungarian Treasury Trust under the Ministry of Finance.

\textsuperscript{40} See various county studies cited in note 1.

\textsuperscript{41} Compensation Act, Para. 4.

\textsuperscript{42} Id., Para. 7-8.
enable the coupons to be transformed into life annuities to provide social insurance for their holders. It also seems possible to pledge the coupons as collateral for loans.\footnote{Id., Para. 7.}

Only former land owners may use their coupons to purchase farmland. Such land will be auctioned and sold to the highest bidder.\footnote{The original draft Compensation Act of April, 1990, allowed former farmland owners to exchange their compensation coupons for their original land. The Constitutional Court declared this unconstitutional, as it discriminated against former owners of urban and industrial property, who were given coupons but not the possibility of in-kind restitution.} In theory, former land owners may repurchase their original land, if they prove to be the highest bidder and if their particular parcel is auctioned off. However, the land that will be auctioned is not likely to be the most fertile; the best land is currently held by cooperatives, which are expected to retain possession of their land under the new law on cooperatives (Law I of 1992 on Cooperatives; see also Law II of 1992 on Rules of Transition). Cooperatives are setting aside 2.4 million hectares and state farms about .4 million hectares for compensation auctions.

During the window for submitting claims (August-October 1991), 805,000 individuals submitted 3.3 million claims worth about HUF 60 billion. About 3 million claims refer to confiscated land. Another HUF 20-30 billion in claims are expected from the extension of the Act to cover claims during the 1939-49 period by Jews and Germans; and a final HUF 20 billion from a proposed extension to cover those politically persecuted. In total, it is estimated that the government will pay out a total of about HUF 100 billion (approximately $1.3 billion). It is expected that about half the vouchers will be used to purchase land and the other half split among apartments, shares in privatized enterprises, rental rights to small shops, and annuities. The distribution of vouchers began March 31, 1992 and is expected to take up to 2 years.

Although Hungary's solution to the restitution problem avoids much of the inequity and inefficiency created by other countries' schemes, some doubt its plan will achieve its restitutionary goals. For example, in light of the shortage of attractive privatized assets, vouchers (and shares bought with them) may in fact be worth only 30% of their face value. Furthermore, alternative investment options (e.g. life annuities) will probably yield insignificant regular payments.

Land registration. Developing an adequate registry to determine legitimate title for privately-owned property is less controversial than allocating property, but it is no less fundamental. As noted earlier, most housing remained in private hands throughout the socialist period. Buyers have always had an incentive to register their purchases in the property registry, because under the Civil Code title passes only when it is recorded in the
registry, and registered owners have priority over other claimants (i.e. unrecorded transaction are not enforceable against third parties). Thus, the existing property registry, which is based on the German model, provides adequate proof of private title in many cases, including private houses and apartments.

This is not to say, however, that the land registry is an accurate portrayal of current ownership in the economy. Some private buyers avoided registration during the socialist period if their individual holdings exceeded permissible levels. Furthermore, nationalizations by the state and transfers among public owners--particularly of trustee rights sold by state enterprises since the late 1970s--were not typically recorded in the land registry; nor were individual flats registered in many large state housing developments. Agricultural land records are in the poorest condition because of extensive nationalizations and regrouping of cooperatives. Finally, missing records, inadequate staff, and lengthy delays in the land registration process--six months being the current norm--add to uncertainty in real estate transactions.

Financing the Acquisition of Property

Commercial property. On the commercial side, mortgages of real property have long been legally possible. The Civil Code provides for the use of real estate (usually the piece of property being financed) as collateral. However, such mortgages have been rare, primarily because commercial ventures have been rare. Local financing of commercial property has become more available, at least for property being privatized by the government. The National Bank of Hungary refines credits extended by commercial banks to private Hungarian citizens for purchasing state assets (including real estate) sold by the State Property Agency ("SPA"). Despite this availability of financing, as well as the growing need for commercial mortgages, real estate lenders may be discouraged by the new Bankruptcy Law (discussed below), which grants priority to wages, including severance payments, and tax claims over registered mortgage liens. Direct foreign financing of commercial property development is not possible in practice, as foreign banks are prohibited from registering mortgage liens on Hungarian real estate.

Private real estate developers argue that the main constraints are not regulatory--compared with western regulatory hurdles--but are the unrealistically high prices asked by

45 Para. 117.

46 Paras. 265-269.

47 This credit may also be used for purchasing shares in companies being privatized at a preferential rate of 75% of the NBH refinancing rate. This scheme is limited to support of the privatization process and is not available to individuals purchasing previously privately-owned or privatized property.
local governments. In addition, local government and SPA requirements for public tenders have tended to stifle deals.

Residential property. As with commercial property, mortgages on residential real estate have long been legally permissable yet little used in practice. Lenders have been discouraged from making substantial mortgages because of the lack of effective legal mechanisms to repossess the collateral in case of default. Tenant protection laws, grounded in the still-applicable 1971 Housing Act, make foreclosure and eviction a cumbersome and futile endeavor. Under this law, those seeking to carry out evictions must provide alternative living quarters -- a difficult process giving the shortage of available housing. Because evictions can take up to five years to clear all procedural hurdles, there are few, if any, cases of foreclosure resulting in eviction. Wage garnishment and third party wage guarantees have typically been used as alternatives to secure mortgages, but these alternatives are limited by priorities given to tax, alimony, and other possible claims.

Housing reforms in 1983 allowed captive household deposits to be used as mortgage collateral in lieu of the actual property and established a housing finance system of subsidized interest rates. This scheme resulted in a stock of housing loans with market value significantly below its book value--a stock noted as the single most important factor leading to the technical insolvency of Hungary's portfolio-holding institutions. In mid 1991, this old portfolio was cleaned up. The loans were taken away from the banks, borrowers were offered substantial loan forgiveness in exchange for accepting new terms, and the remaining portfolio was returned to the banks as market rate loans with an explicit budget allocation to cover the loan forgiveness.


Sagari and Chiquier, id.

After being rejected on procedural grounds in 1990 by the Constitutional Court, the law was correctly passed in mid-1991. The law gave borrowers three options: (1) to have the loan converted to a 15% fixed rate loan with the possibility of having the rate adjusted from year to year; or to have half the loan forgiven -- that is, bought out by the government -- and the other half (2) repaid in full by the borrower or (3) converted to a market rate loan. To the government's surprise, over 40% paid back the loan, an indication of the monetary overhang in the economy; about 40% converted to market rate loan and the balance took the 15% loan. See Hegedus and Tosics, East European Housing in Transition: The Case of Hungary, mimeo, at p. 29 (1991). The Polish Parliament similarly responded to their credit crisis by rewriting existing housing loans to eliminate unsustainable subsidies. Id. p. 2.
By 1989 interest rate subsidies were eliminated so that current loans, when they are issued, carry market interest rates—now about 35% for 15 year fixed rate loans.51 While interest rate subsidies were eliminated, numerous other up-front subsidies remain, for example, based on the number of children or the purpose of the loan. Because Hungarian banks are inexperienced in underwriting techniques and because fixed rate mortgages are risky in the presence of significant inflation, few mortgages are being written. In practice, banks will make small loans only up to the amount of subsidies covered by the government. Most transactions are conducted in cash.

A final area of concern in financing real property is the legal status of multi-family dwellings, because the availability of clear title to individual units is important if such units are to serve as mortgage collateral. Law Decree 11 of 1977 on Condominiums updates the 1920s condominium law and places Hungary well ahead of many CEE countries. However, inadequacies in the law, particularly in the procedures to secure voting majorities for major decisions, threaten to paralyze the process of renovation and rehabilitation of the Hungarian housing stock.

Regulatory Issues

The rental sector. A large and healthy rental sector is one of the best indicators of a well-functioning real estate market, allowing wide household choice and facilitating labor mobility.52 Hungary’s restrictive eviction procedures are the key bottleneck to a fluid rental market. As in the case of mortgage foreclosure, landlords seeking to evict tenants who have defaulted on their rent are obliged first to find an alternative unit for the tenants before evicting them.53 Unlike the case of mortgage default, renters who default on their rent

51 See Hungarian-American Enterprise Fund study on the Creation of a Computerized Land Registry, 21 (1991) quoting rates of 40-50% for terms between 2 and 15 years. The primary mortgage lenders are the National Savings Bank and the Cooperative Savings Bank. Under their policy loan maximums are set such that households pay no more than one third of verified household net income.

52 Labor mobility is particularly critical during this transition period, as many old enterprises are forced into major restructuring or liquidation and newly emerging private firms expand employment opportunities.

53 The draft Rental Housing Bill currently being discussed would begin the process of removing some of the worst constraints on eviction, particularly by eliminating the requirement that an alternative unit be provided.
payments are not subject to garnishment of wages. However, an expedited lease termination procedure is available for certain types of public landlords.  

Rent control for publicly-owned residential property is one of the most politically difficult issues on the current policy agenda. Current rent levels do not allow local governments to recover even operating costs for housing stock, much less capital costs—a condition which has contributed to chronic under-maintenance and the increasingly dilapidated condition of much of the housing stock. According to most observers, central government regulations still determine rent levels for the public housing stock, although some argue that this power has been devolved to local governments. Rents in these units probably will not be raised without clear central government action.

In a second group of quasi-public units, the central government eliminated rent control on "forced tenancies" in January 1992. These 100,000 private units were forcibly created during the period of mass expropriations and allocated according to state rules. Tenants generally now view these units as public housing and have resisted owners' attempts to raise rents since January, usually by successful appeals to local district councils.

In the slowly emerging purely private stock, there are no rent controls. Rental agreements are set by lease and are usually for a fixed term. Disputes between landlords and tenants in private housing are typically handled directly by self-help measures because of cumbersome enforcement procedures and the overburdened judicial system.

Zoning and construction standards. Zoning is another area in need of clarification. Hungary has emerged from socialism with a very diffuse and inefficient pattern of land use. Currently, the land use system is in limbo. Old regulations are not necessarily being followed, no general land use framework has been set, and authority to regulate has not been vested fully in local governments. Although questions of title are being addressed, authority over zoning and building regulations has yet to be distributed among local actors. Currently this authority may be exercised by district or county governments, city planning departments, public utility authorities, county commissioners, or a number of central Ministries. Because owners are unsure from whom to seek necessary permits, they often attempt to secure

54 The Court Enforcement Office sits at the center of the debt collection and eviction process in Hungary. In 1991, the Budapest Office received about 3,000-4,000 new claims each month for debt collection and had only 16 enforcement officers for the whole city. The Office not been active in mortgage foreclosures and has rarely pursued evictions in the case of non-payment of rent by renters of privately-owned apartments (of which around 100 private cases were submitted monthly to the Budapest office.) Although courts have rendered thousands of verdicts for eviction, the Office carries out only about 10-30 evictions per year from private rental units, after an average eviction process of 4-5 years.
permission from everyone--both those who currently appear to exercise authority and those who formerly did so. This is time consuming.

Furthermore, not only is there a surfeit of potential regulatory authority in some areas, but there is a problematic lack of it in others. For example, some regulations needed by private real estate developers--such as regulations governing commercial scale residential, commercial, or industrial subdivision of undeveloped land--still do not exist. Nor is there an appropriate regulatory framework governing infrastructure needs and financing for private land development--for example, a framework that would permit exactions, special assessments or land readjustment. A 1991 modification of the Building Law does permit conversion to industrial uses of agricultural land at the urban fringe (usually the most dynamic area for commercial land development) upon payment of a transfer fine to a land protection fund, but the actual impact of such regulation needs to be tested. Rules for real estate brokers and for resolving property valuation disputes are not in place. Finally, building standards are governed by the 1990 National Building Code and the old 1986 Budapest city planning rules. A new Construction Law has yet to be written with affordable building standards for the types of buildings market systems are likely to demand.

In summary, a modern land use planning system with clearly defined procedures is required, one that offers wide discretion to the market, provides a dispute resolution mechanism that fairly balances interests of neighbors, developers, and city government, and forces development to internalize its environmental costs.

Rights to Intellectual Property

The legal framework for intellectual property protection in Hungary has generally been considered better than that available in other CEE countries. However, inadequate means for investigation and enforcement remain a problem, resulting in widespread piracy, mainly of software, music, and pharmaceuticals. As Hungary begins to recognize and protect private property rights generally, intellectual property may also begin to be better protected. This will require, however, stronger investigative and enforcement policies, without which infringements will be difficult to curb.

Patents

As in other CEE countries, Hungarian patent law had little meaning within the domestic economy during the socialist period. Just as the state owned most of the physical means of production, so it owned the rights to most inventions used in production. Almost all workers were employees of the state, and there was little competition or reward for entrepreneurship in ideas. The main demand for intellectual property protection arose from foreign firms doing business in Hungary.
Hungary’s current domestic legislation on patents stems from the socialist period and includes Patents Act No. II of 1969, Decree-Law No. 5 of 1983 on Patents, and Decree No. 28 of 1978 on the Protection of Industrial Designs. As with many western laws, these laws give an inventor exclusive rights over an invention for 20 years from the date of application. Like other socialist patent legislation and unlike most western law, however, Hungarian patent law prohibits certain inventions from being patented, including medicines and chemically fabricated products, food products, and "immoral" or illegal items. The Patent Office is planning to propose an amendment to the Patent Act to delete article 6(3) (excluding pharmaceuticals and chemicals from patentability) in order to harmonize the Act with the European norm and allow Hungary to apply for associate membership in the European Patent System. This amendment is expected to be passed in 1992, and a complete revision of the Patent Act is expected to be presented by 1994.

The law also provides for "compulsory licenses," by which the state can grant use rights to third parties if an invention has not been sufficiently utilized within three years of its being patented. In this situation, parties may negotiate the proper licensing fee, but if a fee cannot be agreed upon by the patentee and the licensee, it will be fixed by the court. It remains to be seen whether or not this provision will be removed or will remain in place, as a similar provision has remained in Romania’s new patent law of 1991. Practically speaking, however, the compulsory licensing power is unlikely to be used much in practice, as compulsory licenses are often ineffective due to the user’s likely need for the patent holder’s technological expertise and cooperation.

A related provision allows the government to license any patent at will for purposes of national defense. It is unclear what type of compensation is available in such circumstance, although the constitution provides a general guarantee of compensation in cases of expropriation. As with the compulsory license provision, it remains to be seen whether this state power will remain in Hungary’s patent law.

Hungary has been a signatory to the Paris Convention for the Protection of Industrial Property (1883) since 1967. This is the major international treaty protecting patents and trademarks. The two most important rights granted by the treaty are national treatment of foreigners and right of priority in registration. The right to national treatment obligates countries to treat foreigners as they would their own nationals under their own laws. The right of priority gives the holder of a patent one year to file in other member countries without losing priority rights over other potential claimants to the invention. However, the criteria for patentability is still a question of domestic law. Thus, the Paris Convention

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55 Patentable inventions must be novel, meaning that the public must not have access to the design through the print media or common knowledge or practice.

56 Compulsory licensing provisions are well-known throughout the world and are permitted under the Paris Convention.
would do little to protect patents without a Hungarian law that provided reliable substantive patent rights.

All patent applications are submitted to the National Patent Office, which conducts a formal examination of the application. The process takes approximately 18 months, normal by western standards. The application fee itself is nominal (HUF 1000-2000), as is the annual fee (HUF 6000) for the first five years. Thereafter, the fee grows incrementally, reaching HUF 24,000 in the 20th year. Decisions of the Patent Office may be appealed to the Metropolitan or Regional Court, and from there to the Supreme Court.

**Trademarks**

Trademarks in Hungary are protected by Act No. IX of 1969. This law grants exclusive rights of use and transfer of registered trademarks for an initial period of 10 years, renewable for 10 year periods thereafter. Like patents, trademarks are to be registered at the Patent Office. Fees are HUF 3000 for the first ten years plus and additional HUF 1000 for international registration.

As a signatory to the Paris Convention, Hungary grants national treatment and right of priority to foreign trademark owners. Right of priority lasts six months for trademarks, as opposed to one year for patents. The Paris Convention does, however, provide a bit more substantive protection for trademarks than for patents by automatically protecting well-known marks, apparently without requiring that the mark be registered in other member countries.

Hungary is also signatory to the most current text of the Madrid Agreement Concerning the International Registration of Marks (Stockholm, 1967). The Madrid Agreement protects both trademarks and service marks by allowing members of signatory countries to register their trademarks with the International Bureau of the World Intellectual Property Organization (WIPO) in Geneva. The mark must first be registered in the country of origin, whose administration applies for registration with WIPO. Registering with WIPO protects a mark in all signatory countries. Upon notification of WIPO registration, however, national administrations may still be authorized by national law to declare that certain trademark protection cannot be granted in that territory. Thus, like the Paris Convention, the Madrid Agreement depends ultimately on domestic law to protect substantive rights.

**Copyright**

The current Hungarian law providing copyright protection is the Hungarian Copyright Act No. III of 1969 (as amended in 1978, implemented by Decree No. 9 of July 12, 1983). This law is considered to be the most advanced of all CEE copyright laws, mainly because it contains some protection for computer programs (since 1983) and is generally consistent with

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57 Effective as of July 1, 1970.
European norms. In keeping with the commonly accepted language of copyright protection, this law protects "literary, scientific and artistic creations." While such language in other countries is often interpreted not to include computer software, the implementing decree of July 12, 1983 explicitly includes "computer programs and the related documentation."

Sound recordings are protected under Decree No. 19 of 1975 on the Protection of Producers of Phonograms. This protection grants producers the exclusive right to reproduce, distribute, or publicly perform the work in question but neglects the more important economic rights to commercial renting and lending. Furthermore, no criminal sanctions protect the rights that are granted in the decree.

Registration of copyrighted work is not required under Hungarian law. Upon creation works are protected. Generally, works are protected for 50 years after the death of the author. Sound recordings, however, are protected for only 20 years.

Chapter V of the Copyright Act lays out certain restrictions on contracting with Hungarian authors or users. Such contracts must be made through intermediary agencies listed in Section 20 of the Implementation Decree. One such agency is ARTISJUS, a governmental agency functioning as a performing rights society, a copyright licensing agency, and a copyright spokesman for the government. In addition, most copyright disputes are mediated by ARTISJUS, although they may be brought before the Metropolitan Court.

In cases of copyright infringement, civil remedies include injunctions, damages, fines, and possibly destruction of the offending material (Copyright Act, Chapter XIII, Arts 52-53). Under the Penal Code, infringements of Hungarian copyright law qualify as misdemeanors.

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58 Copyright Statute of 1979, as amended up to 1978, Chapter I, Article 1. A non-exhaustive list of protected works, similar to Art. 2(1) of the Berne Convention, appears in the Decree of the Minister of Culture of December 29, 1969 (as amended through August 24, 1988).

59 Decree Concerning the Implementation of the Copyright Act No. III of 1969, Decree No. 9 of December 29, 1969, as amended up to July 12, 1983, Article 1. A related advance in this field is the recent Act on the Protection of the Topography of the Microelectronic Semiconductor Products.


61 Act No. III of 1969, Art. 15.

62 Decree Law of 1975, Art. 1. The international norm for such protection is 50 years.

63 Decree No. 9 of 1969, as amended up to July 12, 1983, Article 1.
Some observers advocate additional criminal sanctions in cases of willful infringement, as exist in most European countries. Such sanctions are expected to be included in an upcoming amendment to the Penal Code.  

Hungary has been a signatory to the Berne Convention, which protects literary, scientific, and artistic works, since 1922. It adheres to the most recent revision of the Berne Convention, the Paris text of 1971, which extends the period of protection from 25 to 50 years. Under Berne, no formalities are required to protect a work in other member countries. Whereas in the country of origin protection may depend on registration, no central registration exists for international protection; upon creation, works are protected. Hungary has also been a signatory to the Universal Copyright Convention since January 1971 (including the Paris Act, July 1974) and the Geneva Phonograms Convention since 1975.

Company Law

Company law plays a central role in market economies. It sets guidelines for the internal organization of private companies and for systems of corporate governance. Together with securities legislation, it tries to protect outside investors and the public by specifying minimum requirements for capital and for the publication of information about the company. It also tries to encourage entrepreneurship by setting limits to the liability of investors. Because the notions of private capital, private investment, and private commercial liability are relatively new in Hungary and other reforming socialist economies, all of these functions of company law are also relatively new in the CEE context.

The idea of firm-level independence and autonomy is not an entirely new concept in Hungary. From 1875-1948, Hungary's company law had been developing in tandem with those of its western neighbors. The law was abandoned after the introduction of socialism and, although it was never formally abrogated, it did cease to develop. For two decades after 1948 Hungary followed the classical model of centrally planned socialism. Then, in an attempt to move away from classical socialism toward a socialist market economy, Hungary adopted the New Economic Mechanism in 1968. As discussed earlier, the NEM delegated more decision-making to the enterprise level. Enterprises were still expected to meet their production targets under the state economic plan, but they were freer to make their own decisions regarding the means (including labor and investment needs) to meet those ends. Enterprise autonomy was first legally recognized in Act No. VI of 1977 on State-Owned Enterprises. The true landmark of enterprise management reform, however, appeared with the 1984 amendment to this act, Decree No. 22. The amended act introduced the concept of

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the self-managed enterprise, whose management could take one of two forms: the enterprise council (a representative body of employees) or the general assembly of employees. As a result of this law, approximately 80% of Hungary's enterprises became self-managed, while the remainder stayed under central state administrative control.

In the late 1980s Hungary made a series of reforms designed to further its transformation to a market economy. Unlike Poland, it did not revive its prewar company law. Rather, Hungary used the opportunity to draft an entirely new code, the Act on Economic Associations, based upon German and Austrian models. As in other CEE countries, Hungarian company law serves companies being newly established as well as the "corporatization" of formerly state-owned enterprises. The law recognizes a number of business forms of organization, including the joint stock company, the limited liability company, and both general and limited partnerships.

The Joint Stock Company

In Hungary the joint stock company is often referred to as the "company limited by shares" or "share company." It resembles the French societe anonyme (S.A.), the German Aktiengesellschaft (A.G.), and the American publicly held corporation. It is designated by the letters "Rt." in its name. This form is most appropriate for companies seeking a large number of shareholders and is the most conducive to public offerings.

Capitalization and disclosure requirements. A joint stock company may be founded by one or more individuals. Minimum capital is high: HUF 10 million (approximately

65 Self-management was a concept that had been followed in neighboring Yugoslavia since the early 1950s. For an incisive analysis of its economic impact, see M. Hinds, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," World Bank, 1990.


67 Corporatization refers to the legal transformation of state owned enterprises into corporate forms set out in the Act on Economic Associations. The process by which this is accomplished is dictated by the Transformation Act (Act XIII of 1989 on the Conversion of Economic Organizations and Business Associations).

68 The limited liability form had been available for use since 1972, but this was restricted to joint ventures with foreign participation. Decree of Minister of Finance 28 of 1972.
$125,000), of which at least 30% must be paid in upon registration. The par value of each share must be at least HUF 10,000 ($125), or a value divisible by 10,000. The total amount of the par value of all shares constitutes the company’s registered capital. The value of non-cash contributions may be included in capital, if checked by an auditor and disclosed by the founders in a written declaration.

This form of company provides the most freely transferable vehicle for investment. Bearer shares are freely transferable, as are registered shares (Sec. 240). The form also offers the greatest flexibility in obtaining capital, although many of the financial instruments envisioned in the Company Act (as discussed below) are not yet used in practice, due in large part to a lack of familiarity by Hungarian investors.

A wide variety of stock classes is authorized by the Company Act, although shares within the same class must have identical face value. Voting rights of different shares may differ without limit, if so specified in the company’s charter. While voting rights are generally proportional to share value, the articles may limit those rights. Preferred shares may be issued that entitle the owner to priority in the distribution of dividends, although the total value of preferred shares may not exceed 50% of the company’s registered capital (Sec. 242). Such preferred shares may carry limited or zero voting rights if so detailed in the company statute. Companies may also issue interest-bearing shares (Sec. 245). This share is a modern hybrid, possessing characteristics of both debt and equity financing. Like debt, interest-bearing shares earn a rate of interest, as determined by the company statute, regardless of whether the company has shown a profit that year. Like equity, such shares may also be entitled to receive dividends. In light of the demands such financing may put on such a high minimum capital requirement discourages the formation of companies and would seem inadvisable for Hungary at this time.

Sec. 253. While not explicitly stated in the law, it is presumed that the Court of Registration, in reviewing the Articles of Association, may challenge this valuation.

Foreigners may acquire bearer shares, but these must be converted into registered shares within three months of acquisition. Sec. 240.


Compare the Polish company law, which places a maximum of 5 votes on any one share. See Gray et. al., Poland, supra note 1.

If dividends due on preferred non-voting shares are not paid for two consecutive years, those shareholders are entitled to voting rights until those dividends are distributed.
a company, these shares may total only 10% of the company's share capital. While this share type has not been used much yet in practice, owners of interest-bearing shares are entitled to "the other rights attaching to the share (including the right to a dividend)" (Sec. 245), including voting rights. It would also be possible to structure preferred shares without voting rights to resemble interest-bearing shares.

Varied instruments of debt financing, including convertible and preference bonds, are also possible under the Company Act (Sec. 246), although the value of convertible bonds may not exceed 50% of the company's registered capital. A convertible bond entitles its holder to convert the bond into equity shares on terms detailed in the bond itself, which is favorable to the holder when dividends exceed the bond's interest payments. A preference bond entitles its holder to the option of buying a proportional number of new shares, should the company decide to issue them. Apparently such a bond may be exchanged for the new shares, but the rate of conversion is an open question. While there is no practice yet, Hungarian lawyers read the statute to allow conversion only at par value, not at market value.

Finally, workers' shares are envisioned by the Company Act (Sec. 244). These may be distributed to current employees free of charge or at a rate lower than the issuing or market price. Their total may not exceed 10% of the company's registered capital. The shares may be transferred to other workers and pensioners.

Also worthy of mention is the golden share, which enables the state to exercise 51% voting power if it owns at least 33.3% of the shares (Sec. 269). Generally, the golden share is meant to give veto power to its holder over certain company decisions (as indicated in the company statute) that could be harmful to national welfare. This privilege is usually reserved for government and is most often used by governments privatizing industries that they consider strategic for the national economy. It enables them to prevent "undesirable" parties from taking control, without forcing the government to own a full 51%. Use of the golden share by former socialist governments has been looked upon with suspicion, mainly because it locks in government control at the expense of a developing market for corporate control. The Hungarian government has sought a golden share in some of its privatized industries, for example in the tourism company Ibusz, one of Hungary's most profitable industries. Overall, golden shares have not been common in Hungary.

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75 For example, the articles of association of Rolls Royce in Great Britain allow the government to control voting concerning its "nuclear business," and the articles of the British Airport Authority subject the disposal of airports to the government's consent. Graham, All that Glitters: Golden Shares and Privatised Enterprises, 9 The Company Lawyer 23.

76 See the Ibusz prospectus found in the First Privatization Program, State Property Agency, Budapest, 1990. In April 1992 a golden share was used in the privatization of the Hungarian State Insurance Co. Dutch Aegon bought 75% of the shares, but for five years
Rights and duties of shareholders. Shareholders are entitled to dividends in proportion to their share value, and, in the event of liquidation, to a proportional share of the company assets. The distribution of dividends is at the discretion of the directors, but dividends may not debit the registered capital. All shareholders may attend the general meetings, and those holding voting shares may vote in person or by proxy. A simple majority is needed to elect and recall members of the Board of Directors and the Supervisory Board, to approve the balance sheet and profit distribution, to permit the issuance of convertible or preference bonds. A three-fourths majority is needed to amend the Articles of Association, modify rights attached to a particular type of share, and merge, dissolve, or convert the company to another form. Because this three-fourths majority is required to make many key business decisions, in practice investors have generally sought this level of control when buying companies privatized through the State Property Agency.

The company law protects the rights of minority shareholders, defined as representing 10% of the shares (or a smaller percentage if included in the company’s charter). The minority rights protected include the right to call a general meeting, to place a specific item on the meeting’s agenda, and to request the supervisory board to examine management’s activity. Any shareholder, member of management, or member of the supervisory board may appeal to the Court any decision of the general assembly thought to infringe the Company Law, the articles of association, or any other law.

Corporate governance. All joint stock companies in Hungary must have three layers of governance: the executive officers, the Board of Directors (or "Administrative Board"), and the Supervisory Board. In addition, an outside auditor is always required. Executive officers may be appointed for a definite period of no more than five years, but may be re-elected or re-called at any time. Although executive officers are held to a general duty of care defined by the Civil Code, principles of officer and director liability are not yet well-developed.

The Board of Directors must consist of between 3 and 11 members. Conflict of interest provisions attempt to prevent members of the Board from concluding in their own

major decisions such as capital increase or decrease must be approved by the Hungarian partner.

77 These shareholders must hold voting shares. Also, if these two requests are not honored, the Court of Registration has the authority to enforce the requests.

78 Sections 273-275.

79 Section 276. The shareholder may not have voted for that decision. Exceptions to this are error, fraud, or threat.
names transactions similar to that of the company, being a partner with unlimited liability in any company similar to this company, and being a leading official in similar companies.\footnote{Section 280.}

The Supervisory Board is charged with overseeing the activity of the Board of Directors, although the respective competencies of the two Boards are determined largely by the specifics of the company’s charter. It must consist of between 3 and 15 members, who may be elected from either among the shareholders or from outside. If the company employs on annual average 200 employees, one-third of the supervisory board must be elected by the employees.

**The Limited Liability Company**

The limited liability company form resembles the German GmbH and the French SARL. It is identified by the letters "Kft." or "Ltd." appearing after its name. As in other CEE countries, this form of company is more popular than the joint stock company among Hungarian investors because of its simpler structure and lower capital requirements. Many larger foreign investors, in contrast, choose the joint stock form because of the greater ability to tailor share structure and voting and other rules to their particular needs. The limited liability company is primarily intended as an investment vehicle for a relatively small group of investors who know and deal with each other on a regular basis. During the first quarter of 1992, 2507 limited liability companies registered in the Budapest Court of Registration.

**Capitalization.** A limited liability company may be founded by one or more individuals, apparently with no maximum limit.\footnote{Some other European countries impose a maximum limit (such as 50) on the number of partners in this form of company in order to differentiate it more clearly from the joint stock form and force conversion to the latter form (with its stricter capital and information requirements) as the company grows in size.} Its minimum capital must be HUF one million (approximately $12,500), lower than that for the joint stock company but still a high barrier for new private entrepreneurs. This capital is divided into stakes of a predetermined amount. Each stake must be at least HUF 100,000 and exactly divisible by 10,000 (Section 159). Parties holding a stake in the company are referred to as members. One stake may be held by several individuals, who together are deemed to be one member, who exercise their rights through a common representative, and who are jointly liable for the obligations of the members. Each member may hold no more than one stake, but the value of that stake may increase (or decrease) in proportion to his or her contribution (Section 169). Contributions may be either cash or in-kind. Upon foundation of the company, at least 30% of the initial capital (but not be less than HUF 500,000) and at least 50% of each stake must be paid in,\footnote{Section 160.} the rest payable within two years. Members’ stakes are freely transferable to any
other member of the LLC, but before being sold to outsiders they must first be offered to other members, the company, or someone chosen by the membership. These requirements are absolute, and the deed of association may not stipulate more favorable terms. Unlike the joint stock company, the limited liability company may not recruit contributors through public appeal (Section 156).

**Rights and Duties of Shareholders.** Members are entitled to dividends and, in the event of liquidation, assets in proportion to the size of their stakes. Voting rights are determined by the size of each stake; each HUF 10,000 unit entitles its holder to one vote. Thus, each member has at least 10 votes, but variations above this minimum may be determined by the deed of association. Apart from the obligation to pay in one’s primary stake, members bear no liability for the LLC’s debts.

Members must hold meetings at least once a year. Decisions are passed by simple majority unless otherwise stipulated in the articles. However, members may pass decisions by mail without holding a meeting, subject to the normal requirements for voting majorities, unless any member requests a meeting be convened to discuss the decision. Minority shareholders (i.e. members representing at least 10% of the current registered capital) may call a meeting of all members. As with the joint stock company, any amendment to the company’s deed of association requires a three-fourths vote.

**Company governance.** The LLC may be managed by one or more directors or managers, elected by members representing a majority of the company’s assigned votes to serve for terms of 5 years. A Supervisory Board with at least 3 members is mandatory for the LLC only if its capital exceeds HUF 20 million, the members exceed 25, or the annual average number of employees exceeds 200. In the latter case, one-third of the members of the supervisory board must be elected by the employees as with the joint stock company. An independent auditor is required if the company’s initial capital is greater than HUF 50 million, or if the company is held by one person.

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83 Section 171. This is different from the stricter rule found in some other European countries that a stake cannot be sold to outsiders without the express and unanimous permission of insiders. What constitutes a valid offer in the LLC case is somewhat unclear under the Hungarian formulation. The ability to formulate a tighter preemption rule under a separate shareholders’ agreement is another reason that some foreign investors prefer the joint stock form.

84 Section 190.

85 Section 13(1-2).
Partnership Forms

Two common forms of partnership are included in the Company Act, the general partnership and the limited partnership. In the general partnership, all partners are jointly and severally liable for the partnership's liabilities. The limited partnership consists of limited partners, whose liability is limited to their contribution to the partnership, and one or more general partners, who are responsible for actively managing the company and whose liability is unlimited. Both forms are quite flexible, as partners are able to negotiate their own arrangements concerning capital contributions, distribution of profits and losses, and allocation of voting and managerial rights. As is common in CEE countries (with the exception of Poland), Hungarian partnerships are not pass-through entities and are thus subject to tax at the entity level.

Procedures for Setting Up a Company

The first step in setting up either a joint stock company or a limited liability company is drafting the Articles of Association, which must then be signed by all the founding members and the company attorney (Section 19). Although the Articles must be notarized, this procedure is not so expensive or time-consuming as in some other CEE countries, because the job of notaries is not to approve the form of the documents, but merely to certify that the signatures are authentic.

Within 30 days of the Articles being adopted, the company must apply to the Court of Registration to register the company (Section 23). Included in its application must be a registration fee equalling 2% of the company's initial capital and a certification from the bank that the initial capital is on deposit. This step is known to be slow--taking on average about 6 months--and cumbersome, although the Court of Registration is now fully computerized. The delay is caused by the enormous backlog of applications, mistakes generated by the relative inexperience of lawyers filing registrations, and careful court scrutiny of each application for conformity to Company Act requirements. If some provisions do not comply with the Act's formal requirements, the Court may return the Articles for changes. As local lawyers gain more experience with the Company Act, they are using simpler articles of association (which closely track the Act's language) and are having fewer returned for corrections.

86 Section 55.

87 In an apparent effort to protect creditors, the Company Act limits natural individuals to membership in one business organization in which he or she carries unlimited liability. Section 6.

88 See, for example, Gray et. al., Poland, supra note 1.
The company attains legal personality upon its registration in the Trade Register (Section 24). It may then access its bank deposit and formally begin its activities. In addition, it may then ratify any actions taken by the founders between the period the articles were adopted and the company registered.

Foreign Investment Law

Since Hungary opened its doors to foreign investment in 1988, the country has enjoyed a level of foreign investment unmatched by any other CEE country. This was initially due to Hungary’s original foreign investment law, Act XXIV of 1988, which was the most liberal investment law in the region at that time. The law has been modified periodically since then, but it still retains the basic features that are attractive to foreign investors.

Ownership and Forms of Investment

The law allows foreign individuals and entities to own up to 100% of a Hungarian investment, including the real property associated with it. The forms for such investment are governed by the Law on Economic Association discussed above and include both incorporated firms and branches. No special permission is needed. In the event of expropriation, the law guarantees foreign investors full compensation in the currency of the original investment.

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89 As of late May, 1991, Hungary had $1.2 billion in foreign capital (over half the total foreign capital in all of eastern Europe) invested in 5000 joint ventures. Germany and Austria are partners in approximately 2000 of these ventures, and approximately 40% of this $1.2 billion comes from U.S. investment (fewer in number but typically larger in size). Most joint ventures are small service and/or trade operations, employing only one or two people. Around one half of all joint ventures consist of $160,000 or less. K. Okolicsanyi, Joint Ventures Begin to Have a Significant Impact on the Economy, RFE/RL Report on Eastern Europe, May 24, 1991, p. 23.

90 A previous requirement that the Minister of Finance and the Minister of Commerce approve foreign ownership exceeding 50% was repealed in 1990. Act XCVIII of 1990, Sec.1.
Profit repatriation

While the Hungarian forint is not yet formally convertible, the foreign investment law does allow foreign investors to repatriate their forint profits in the currency of the original investment (at the official exchange rate), "provided the company has the equivalent amount in forint on reserve." This language has been a source of confusion for many investors but has been understood to mean that profits must be actually received and deposited in the investor's account before repatriation is possible. In practice, this means companies must obtain bank certification that the forints have been deposited. And while the law is unclear on the point, some lawyers understand that companies may apply for such certificates only at the year's end, when the company declares its annual dividend. Other lawyers, however, argue that profits may be repatriated at any point during the year, based on an approved temporary balance sheet and subject to the requirement that the profits be returned to Hungary if there is a negative profit balance at year end.

Foreign individuals and companies with foreign participation are permitted to maintain hard currency accounts in any Hungarian commercial bank. Hungarian companies receiving capital contributions from foreigners in hard currency may also deposit them in such accounts.

Tax and Customs Incentives

Hungary's corporate tax rate is currently 40%, but the foreign investment law offers generous tax incentives to foreign investors. These incentives are industry specific and

91 The foreign investor is also entitled to this repatriation right if the company is liquidated or the foreign investor sells his interest. Additionally, 50% of the taxed personal income of foreign managerial employees may be fully repatriated.

92 Details regarding foreign exchange rights are covered under the Planned Foreign Exchange Policy, Law-decree No. 1 of 1974 concerning planned foreign exchange policy (as amended through 7/2/1990); translated in Hungarian Rules of Law in Force I./Nr. 12.

93 Act XXIV of 1988 on Foreign Investment, para. 32(1); see also Company Act para. 9(1).


95 Id.

96 Para. 15 (4).
depend upon the amount of foreign investment. An annex to the Foreign Investment Law identifies areas of particular importance to the Hungarian economy. If more than 50% of a company's sales revenue is derived from these activities, the founding capital exceeds 50 million forints, and the foreign contribution is at least 30%, the company receives a 100% tax holiday for the first five years, followed by a 60% holiday for the second five years. Other sectors receive smaller tax benefits. For example, companies building or operating a new hotel with founding capital above 50 million forint and with a foreign contribution is at least 30% receive a 60% tax holiday for the first five years and a 40% holiday for the second five years. In addition, taxes are rebated on profits reinvested by the foreign partner in Hungary.

On the customs side, foreign investors importing capital equipment will not be charged customs duties if 1) the equipment is part of the foreign investor's contribution, or 2) it is paid for out of the company's hard currency account. If, however, during the subsequent three years the company sells or leases that equipment, then the company must pay the customs duty applicable at the time of importation. Customs free zones for foreign investors are also envisioned by the act. Companies incorporated in these zones will be exempt from Hungarian customs, excise, and exchange control regulations, as well as price controls and state supervisory regulations. They may maintain accounting systems in fully convertible currencies. Companies seeking to incorporate in such zones must obtain approval of the Ministry of Finance. Customs free companies have already been established in certain industries, with special rules on how the plant is built and operated--requiring security fences, guards, and documents--to segregate customs-free goods.

The generous tax incentives offered to foreign investors in Hungary have been widely criticized by economists and tax policy experts. Not only do they discriminate against domestic investment, but tax incentives--holidays, in particular--can cause tremendous revenue loss and severely complicate tax administration. Recognizing these problems, Hungary has moved recently to eliminate these special tax incentives for foreign investments. They are to last for a maximum of 10 years and be available only to companies that are substantially in production before the end of 1993.

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97 Earlier versions of this law granted an automatic 20% tax cut for companies with either foreign equity of at least 20% or HUF 5 million.

98 These include electronics, car parts, machinery, engineering units, pharmaceuticals, packaging technology, agricultural and food technology, energy conservation, telecommunications, tourism, and public transportation.

99 The hotels covered by this section include not only those constructed by the company in question (Para. 15 (2)(a)), but also renovations that classify a building as a hotel or that upgrade a preexisting hotel to a higher classification (Para. 15 (3)(b)).
Dispute Resolution

The Hungarian foreign investment regime gives substantial freedom to private investors to choose the mode and venue for purposes of dispute resolution. Given the relative lack of commercial experience and precedent in the Hungarian legal system, joint venture agreements often provide for arbitration to resolve disputes that may arise. At present approximately half of all disputes are arbitrated through the Hungarian Chamber of Commerce, and about half in other international forums. Apart from the Articles of Association, which must be governed by Hungarian law, any other agreement related to the setting up or operation of a joint venture may be governed by foreign law if the parties so choose.\(^{100}\)

Hungary has been a signatory to the International Convention for Settlement of Investment Disputes since October 1986. This Convention guarantees a forum in which private citizens of signatory states may arbitrate against governments of other signatory states.

Contract Law

The ability to contract freely with others and the assurance that contracts will be enforced are among the most basic requirements of a legal framework for a market economy. Freedom of contract allows resources to gravitate to their most valuable uses. On the other hand, freedom of contract often conflicts with other social concerns, such as protection of the labor force from harsh employer policies, protection of consumers from warranty disclaimers, and, more generally, protection of weaker parties from one-sided contracts. Striking a proper balance among these various competing interests and imposing constraints to that end on pure freedom of contract is a primary function of contract law in market economies.

Contracts under Socialist Law

Contract law in Hungary, as in all of its European neighbors, has been broadly governed since 1959 by the Civil Code and more specifically by companion laws and implementing regulations and decrees. Two distinct spheres of contractual relations existed during the socialist period: the private and the commercial, or "economic." The private sphere consisted mainly of personal agreements among individuals, usually for small monetary amounts or equivalents. For these contracts, the Civil Code was and still is adequate to set a framework for bargaining and to resolve any disputes that may arise. Contracts between citizens, or between citizens and economic organizations, did not differ essentially from similar contracts in western market economies, although their scope was

\(^{100}\) For example, Swiss law is commonly chosen to govern shareholders' agreements.
influenced by the economic policies of the state—most importantly the restrictions on ownership of private property and the means of production.

More significant for Hungary’s economy were the "economic" contracts. These refer to contracts between state enterprises that were instruments of the state economic plan. Because state-owned enterprises were expected to fulfill their production quotas under the state plan, and because the socialist industrial base existed primarily of monopolistic suppliers, state-owned enterprises had little choice regarding with whom and to what extent they contracted. Thus, inter-enterprise agreements were in essence translations of plan targets into contractual form. If the term "contract" implies bargaining in pursuit of one’s own interest, the term "socialist contract" seems an oxymoron.

The primacy of the plan led to certain aspects of contract law unique to socialist systems. For example, there arose a "duty to contract." Although this duty originally applied to specific plan targets, it seemed to develop into a general duty to conclude economic contracts, even when the contract was not part of the plan. This duty was actionable, meaning that anyone who breached it could be formally challenged in a "precontractual arbitration."[^2]

Like Poland, but unlike Romania,[^2] Hungary did specifically incorporate socialist principles into its Civil Code. Thus, the civil code allowed for mandatory conclusions of contracts by statute or ministerial decree (Para. 198); nullification of contracts injurious to socialist norms (Para. 200); modification and conclusion of contracts by the courts to further national economic interests (Para. 206); and definition of the contents of contracts (such as prices) by legal rule (as determined by state arbitration), regardless of the wishes of the parties (Para. 226).

Until the 1970s, disputes resulting from socialist contracts were usually withdrawn from the jurisdiction of the courts and relegated to so-called Decisional Committees, which functioned more as administrators of the state plan than impartial jurists.[^3] Because contracts were designed to implement the central plan and because of the scarcity and monopolization of most resources, the preferred form of remedy in case of breach was specific performance. In contrast, monetary damages tend to be the preferred remedy in a

[^1]: Para. 208.

[^2]: See Gray et al, Poland and Romania, supra note 1. Poland’s Civil Code was drafted in 1964, during the socialist period, while Romania’s Code dates from prewar times and was never amended during the socialist period. The same socialist contract rules existed in Romania, however, but with a different legal base.

[^3]: Government Decree No. 51 of 1955 (VIII.19). This mechanism was abolished in the early 1970s, after which inter-enterprise disputes were heard by the county courts (discussed below under Judiciary).
market economy, where the damaged party can typically reenter the market and negotiate another contract for those goods or services.\textsuperscript{104} In socialist economies there was often no other supplier or purchaser to which the injured party could turn. Furthermore, determining the proper level of damages would not be as straightforward given the absence of market signals.

Compared to other CEE countries, Hungary's industrial sector is generally thought to have enjoyed relatively greater freedom of contract during the socialist period. Much of this was due to management reform under the New Economic Mechanism of 1968, which shifted more decision-making power from the Ministerial level to the enterprises. Act IV of 1977 significantly modified Hungary's contract law by reintroducing the concept of freedom of contract into the commercial sphere. While management did enjoy greater independence after the reforms of the late 1960s and 1970s, enterprise output was still expected to meet the goals set by the national economic plan. Moreover, freedom of contract continued to be limited by the scarcity of both economic resources and credits. Thus, freedom of contract was substantially increased but still did not approach that found in western market economies. To this day, many transactions remain governed by the Contract for Delivery of Merchandise (Paras. 379-386) and the Contract for Delivery of Agricultural Produce (Paras. 417-426), which include many obsolete administrative requirements and restrictions.\textsuperscript{105}

\textbf{Current Status}

Commercial transactions in the economy are increasingly being conducted according to the sections of the Civil Code originally designed for small, noncommercial private transactions. These sections embody standard western contract concepts. They incorporate basic principles of offer, acceptance, and performance. They provide standard terms for about 25 types of transactions, such as sales contracts and real estate leases.\textsuperscript{106} They also provide legal doctrine to govern usurious interest rates, bad faith dealing, illegal contracts, mistake, deception, duress, capacity, and impossibility of performance.

Because courts have little experience with commercial contract cases, how such provisions will be applied in commercial disputes remains to be seen. Court interpretations and decisions over the coming years will determine the true substance of contract law in Hungary and just how far "freedom of contract" extends, particularly when it collides with other social concerns.

\textsuperscript{104} In the interests of efficiency, western contract law allows parties to breach contracts when that will prove to be in their economic interest.

\textsuperscript{105} Government Decrees No. 7 of 1978 (II.1) and No. 14 of 1982 (IV.22).

Bankruptcy

Bankruptcy law serves several related functions in a market economy. First, it provides a mechanism to liquidate inviable enterprises and repay creditor's claims according to some pre-established rules of priority. Second, in cases of default in which some or all of the operations of the debtor are potentially viable, it provides a legal framework through which creditors and debtors can negotiate binding agreements to undertake financial and real reorganization. In most cases such reorganization includes partial liquidation—i.e. the sale of some of the debtors' assets. Third, the threat of bankruptcy imposes greater financial discipline on enterprise managers. Hence, bankruptcy laws are important promoters of industrial restructuring.

It is important to distinguish between two different sets of potential "users" of bankruptcy procedures. The first is the large group of state-owned enterprises that are inefficient and in need of restructuring or liquidation. For these state-owned firms, bankruptcy procedures and the threat of liquidation\(^{108}\) are thought to provide the motivation to restructure that might not otherwise exist, in part due to the pro-labor incentives caused by extensive worker self-management.\(^{109}\) The second group is the newly emerging private sector, whether enterprises or banks. For this group, bankruptcy law is part of a wider set of legal rules—which also includes provisions defining legally-enforceable security interests and methods of foreclosure—that increases the potential for debt collection and thus facilitates

\(^{107}\) The authors are heavily indebted to Izak Atiyas for his extensive substantive input into this section.

\(^{108}\) Creditor passivity in initiating bankruptcy cases has been common in CEE countries, in part because state-owned banks themselves faced "soft budget constraints" and could in essence count on bail-outs from the government if enterprise debts were in arrears. To counter creditor passivity, the Hungarian government mobilized the tax and social security authorities to initiate liquidation proceedings against enterprises which were in arrears in their tax or social security payments. The effect of this initiative was limited, because enterprises started to pay their tax and social security obligations to avoid liquidation. With a similar purpose, the liquidation law was amended to require enterprise management to file for liquidation whenever a situation of default persisted for a certain period of time, a measure that has been dubbed self-bankruptcy.

\(^{109}\) Many Hungarian state enterprises are "self-managed", i.e. managed by enterprise councils (if employment is over 500) or by enterprise assemblies (if employment is less than 500). In those enterprises, restructuring or liquidation can take place only with the consent of enterprise councils or assemblies. Even though there are exceptions, the managements of these enterprises are widely believed to be unwilling to adopt restructuring policies that may result in unemployment or indeed loss of control.
the flow of private credit in an economy. Such credit is essential for the success of new private business.

Thus serving two "masters", bankruptcy law is seriously overburdened in Hungary and other CEE countries. The reorganization and liquidation procedures are expected to play a major role in the solution of the systemic problems of enterprises and banks carried over from socialism. This may be more than can be asked of a judicial procedure; these systemic problems may instead require systemic solutions outside of bankruptcy proper. In most market economies, in contrast, the bankruptcy process works at the margin for the relatively few firms that cannot make it in an otherwise healthy economy. Such a role is important to the second "audience" in the CEE countries—the newly emerging private sector.

The New Bankruptcy Law

The Law on Bankruptcy Procedures, Liquidation Procedures and Final Settlement was passed by Parliament in September, 1991. It provides two alternative avenues for defaulting debtors—reorganization and liquidation. The first avenue, reorganization (or "bankruptcy" in the official Hungarian translation), did not exist under previous law and is similar in purpose to Chapter 11 of the U.S. Bankruptcy Code. It is a workout-oriented procedure designed to allow the debtor to achieve a settlement with creditors and continue in operation. The debtor may file for reorganization if it expects that it will otherwise be forced to default on its debts within a year, or if it is already insolvent but its creditors have not yet initiated liquidation. The debtor is indeed obligated under the new law to file for bankruptcy (i.e., reorganization or liquidation) if it is more than 90 days in default.

During reorganization, the current management remains in control of the debtor's assets. After the announcement of the bankruptcy procedure, the debtor is entitled to a 90-day moratorium on monetary claims (other than wages) that have become due. Within 60 days it must prepare a proposal for reorganization to restore solvency, which must then be approved by all creditors present at the hearing called for such purpose. If the proposal is approved, the court declares the bankruptcy procedure concluded within 15 days.

The second procedure, liquidation, can be initiated by the debtor itself or by a creditor. In addition, a reorganization procedure automatically becomes a liquidation one if the debtor and the creditors fail to reach agreement within 90 days. During liquidation, the debtor's assets are managed by a trustee, who is charged with liquidating the

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10 Bankruptcy laws in most countries do not seek unanimous agreement for the approval of an agreement. In that respect, the Hungarian law is stricter.

11 This includes banks, suppliers, and the social security fund. Until 1991, suppliers were the most active in petitioning for relief against debtors; of 528 petitions in that year, only 8 were from banks and 5 from the social security fund.
debtor's assets and repaying creditors. However, the debtor may still try to reach a settlement with its creditors during liquidation. If such a settlement is reached, the liquidation procedure is suspended. A settlement is approved only if accepted by half of the creditors entitled to vote in each class of creditors, and by creditors representing at least two-thirds of the total claims. The law also contains a "simplified" liquidation procedure for cases where the value of the debtor's assets are insufficient to cover even the costs of liquidation proceedings. In such case assets themselves may be distributed to the creditors.

The new law is different from the previous one in several important respects. First, it establishes time limits on the different stages of the bankruptcy and liquidation process in order to speed up the process. For example, following a petition, the court is required to determine whether to initiate a bankruptcy procedure within 15 days (Section 12), an action that under the old system took up to several months. In the case of petitions for liquidation, the court has to establish the presence or absence of a default within 90 days (Section 27). As noted earlier, there are strict time limits on the preparation and negotiation of a reorganization agreement. The draft law also imposes a maximum of two years for the completion of liquidation.

Second, the law tries carefully to balance the distribution of control over assets and of bargaining power between debtor and creditors. As indicated above, the management of the debtor enterprise effectively retains control and therefore has significant bargaining power during negotiations for a settlement. However, two provisions are introduced to protect creditors. First, creditors may request the court to appoint a "property supervisor", who has no management powers but nevertheless oversees the financial situation and asset management of the company to protect creditors' rights. Second, the automatic transformation of reorganization into liquidation (Art. 21) in case a settlement is not reached inhibits the debtor's managers from delaying the process or adopting an unduly tough position during negotiations.

Third, the new law encourages reorganization in lieu of liquidation when feasible, and it tries to encourage real as well as financial restructuring to make surviving firms more competitive in the longer-run. The restructuring agreement is required to contain "measures likely to result in the increase of incomes" (Art. 18,1.a). Moreover, the law explicitly mentions that "within the framework of the agreement...creditors or third parties may secure ownership rights in the property of the debtor" (Art. 17). Both provisions increase the likelihood that agreements address not only financial but also real restructuring. The creditors are also allowed to designate persons to monitor the debtor's compliance with the agreement. The ability to monitor increases creditors' confidence in agreements and therefore encourages reorganization.

Despite these positive aspects, however, there are a few areas where the current law may benefit from further improvements. An important drawback of the law has to do with the priority among claims upon liquidation. Specifically, the claims of creditors secured by liens on assets have lower priority than claims for wages and severance payments, which are
considered to be liquidation costs. This provision—a political compromise and a deviation from the international norm—is likely to dampen the incentives of secured creditors to initiate bankruptcy, to reduce the role of banks in enterprise restructuring, and to constrain the development of secured credit as a financial instrument.

In addition, the rights of dissenting secured creditors in a settlement arranged between creditors and the debtor during the process of liquidation need to be further clarified. In particular, it is not clear whether a dissenting secured creditor retains the right to exercise its security or whether an agreement can reduce its claims without its prior consent.

The Law in Practice

The number of bankruptcy filings has skyrocketed in the first few months under the new law. Although data is somewhat sketchy, the number of filings appears to have increased from 528 in all of 1991 to 3403 (786 as reorganizations and 2617 as liquidations) in the first quarter of 1992 alone. Because the law came into effect January 1, 1992 and requires reporting after 90 days in default, there was an even greater surge of 3540 filings in April—including 2259 reorganization filings and 1281 liquidation filings.

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112 This problem would not arise for settlements reached during reorganization because these agreements require the unanimous consent of all creditors. Therefore, any dissenting creditor would be able to block a proposed settlement.

113 For example, consider a secured creditor whose claim is reduced in a proposed agreement and who does not consent to the settlement. Does that creditor retain the right to execute the security? Can a settlement remove a security without the consent of the creditor? The draft law does not provide clear answers to these questions. Different countries have resolved this issue in different ways. In some countries (such as Germany) the claims of secured creditors cannot be reduced in a settlement. In the U.S., a settlement can be approved despite dissenting creditors if the court decides that the dissenting creditors are treated "fairly and equitably," which for secured creditors means that they keep their liens on assets and they get periodic cash payments equal to the value of their claims. In the U.K., a settlement cannot be approved if it affects the rights of a secured creditor to enforce the security.

114 These are filings for liquidations under the old law. K. Mizsei, "The Hungarian Transformation: A Middle of the Road Assessment," unpublished manuscript, April 1992, p. 52.

115 Although the number of filings is monitored, data are not systematically kept on the nature and size of companies that enter reorganization or liquidation, or on the duration or ultimate disposition of the proceedings.
The strong pace of filings is expected to continue for several reasons. First, new banking and accounting laws are expected to put pressure on the banking system and make banks more vigilant on debt collection. Second, the new law is likely to make creditors more willing to initiate bankruptcy, both because liquidations should be faster and because the new law is more protective of creditors' rights. Third, enterprise managers are more likely to initiate bankruptcy under the new regime, because they are subject to penal sanctions if they willingly fail to do so when the enterprise is insolvent. Furthermore, they may be more willing to initiate bankruptcy because of the possibility of reorganization (and retention of their jobs) in lieu of liquidation.

This surge in cases demonstrates the difficulty of applying the traditional solution--judicial bankruptcy proceedings--to the systemic problems of enterprise insolvency in CEE countries. It is highly improbable that any judicial system--much less one with relatively little exposure to economic matters--could handle such a surge in caseload efficiently and effectively. As noted earlier, the judicial route works best at the margin, but other means may be needed to handle the large systemic problems, which could affect 30-50 percent of the economy.\textsuperscript{116} Not only are experienced judges in short supply, but so are qualified trustees. Especially in cases that involve large enterprises, liquidators have to act as corporate managers and financial managers in order to preserve the assets of the enterprise and, whenever viable, to encourage settlements between creditors and debtors. They also need to have legal expertise.\textsuperscript{117} The Ministry of Finance has recently increased the pool of liquidators by establishing objective criteria for eligibility and selecting 90 additional liquidators from among numerous applicants. That is, however, still a small number for the thousands of cases now being filed.

\textbf{Competition Law}

The structure and dominance of the public sector throughout Central and Eastern Europe is now proving to be an obstacle not only for the development of the private sector, but also for the improvement of the performance of the public sector itself. Large state-owned monopolies are able to impose unfair conditions on private firms, smaller public

\textsuperscript{116} For example, integrated programs of bank restructuring, enterprise restructuring, privatization, and liquidation of insolvent state-owned firms--primarily using non-judicial means--are now under discussion, for example, in Poland and Slovenia.

\textsuperscript{117} The government is authorized to establish a list of liquidators. Until recently the supply of liquidators was provided by six institutions, most of them consulting firms. However, under Government Decree No 165/1991, individuals can also be included in the list of liquidators. Such individuals need to have a degree in economics, finance or law. Organizations that employs such individuals may also be enlisted. Applications are judged by a committee appointed by the Minister of Finance and Minister of Justice.
firms, and consumers. In essence, private firms are free to thrive primarily in niches not dominated by the state sector. Because of their power over output and jobs, large state firms act as a powerful lobby to influence government decision making in fiscal, monetary, trade, and other areas. For this reason the breakup and privatization of state monopolies is essential not only to the growth of a private sector but more generally to the development of a stable market economy. Competition law can be an important tool to encourage such breakup and to prevent abusive monopolistic behavior. However, Hungary should move very carefully in applying its competition law in order to avoid overzealous enforcement and resulting bureaucratic dampening of healthy competition.

Hungary's new competition law is Act LXXXVI of 1990 on the Prohibition of Unfair Market Practices, which took effect on January 1, 1991. The law deals with the traditional areas of antimonopoly enforcement, including horizontal and vertical agreements among firms, abuse by a single firm of a dominant position, and merger control, and it sets up a specialized antimonopoly office, the Office of Economic Competition, to enforce these provisions (subject to review upon appeal by the Budapest district court). The law also covers unfair competition and prohibits such activities as misleading advertising or "unfair" acquisition and use of business secrets.

On the topic of horizontal agreements, the law explicitly forbids agreements among competitors concerning such things as price, market division, technological development, or exclusion of certain consumers or input suppliers (Para. 14). However, the approach is a "rule of reason" one rather than the "per se" ban on horizontal cartel arrangements, as there are numerous exceptions to the prohibition, both specific (such as agreements between parties with less than 10 percent of the market) and general (for example, if such agreements are "aimed at stopping abuses of economic superiority" or if "the advantages exceed the disadvantages") (Paras. 15-17). Thus the law provides a relatively weak restriction and gives the antimonopoly office and the courts wide discretion in reviewing cases. While this discretion might help the authorities concentrate scarce administrative resources on certain

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118 Hungary's concern with rules of competition actually began in the late 1960s, with its moves toward decentralized market socialism. As part of the reforms instituted under the New Economic Mechanism (1968), Hungary revitalized its original Act on Unfair Economic Competition (Act No. V on the Prohibition of Unfair Competition of 1923) through numerous governmental decrees. These rules were updated in 1984 with the adoption of Act No. IV on the Prohibition of Unfair Business Activities.

119 Claims concerning unfair competition can be brought only to the court, while those concerning freedom and fairness of competition or consumer fraud can be brought to either the court or the Office of Competition.

120 The merits of each case are considered on an individual basis under a "rule of reason" approach, while a "per se" approach forbids a particular practice under any circumstances.
cases, it weakens the general deterrence power of the law and could lead to long drawn-out arguments on what is or is not a limitation of competition. Hungary might want to consider strengthening the prohibition of horizontal cartel agreements by adopting a "per se" approach.\textsuperscript{121}

In the area of vertical agreements, a separate section of the law forbids abuse of a "dominant"\textsuperscript{122} position (Para. 20) and includes certain restrictions on vertical agreements. Para. 9 prohibits vertical tying arrangements regardless of the size of the firms involved. It is wise of Hungary to limit its scrutiny of vertical restrictions to those involving dominant firms, and the same rule should probably apply to tying arrangements. Economic analysis in the U.S. and Europe shows that many vertical restraints (such resale price maintenance, refusals to deal, discriminatory pricing, and tying of sales) may enhance efficiency under certain circumstances--typically when market structure is competitive and the firms imposing the restraints are not in a dominant position.\textsuperscript{123}

Also included in the section on dominant firms is any behavior that limits access to the market to new entrants.\textsuperscript{124} This is extremely important in the Hungarian context if new private firms are to gain access to inputs and distribution networks. However, the Hungarians must be careful not to interpret reasonable market behavior--such as buying in bulk, requiring up-front deposits from purchasers, or raising or lowering prices to consumers--as anticompetitive. In general enforcers should refrain from imposing direct price conditions, concentrating more on conditions of access to the market.

With regard to market structure, the Hungarian law empowers the antimonopoly office to review proposed mergers of large firms\textsuperscript{125} and block any that are deemed


\textsuperscript{122} A dominant firm is defined as one having over 30 percent market share.

\textsuperscript{123} As a result of this economic analysis, enforcement of U.S. antitrust law has softened in the 1980s, and the Department of Justice refuses to prosecute many cases it would have brought in earlier times. The OECD is also recommending that European jurisdictions relax their laws to look at each case of vertical restraint on a rule of reason rather than a per se basis. Opponents of the rule of reason approach argue that businesses need certainty above all, and that the rule of reason approach leaves too much uncertainty as to what is permitted and what is not, and therefore inhibits business activity.

\textsuperscript{124} Article 20.

\textsuperscript{125} Firms must prenotify the office if they jointly have a 30 percent market share or if their joint turnover in the previous year exceeded HF 10 billion. Article 23.
anticompetitive. As with horizontal agreements, there are exceptions to the rule; mergers need not be blocked, for example, if the advantages to competition exceed the disadvantages, or if the merger promotes penetration into foreign markets. Again, the agency is given almost unlimited discretion.

One important element missing from the law is authority of the antimonopoly office to order the break-up of large monopolistic firms. Such authority should exist, particularly in the case of state-owned enterprises being privatized. Such a link between antimonopoly policy and privatization exists in both Poland and Czechoslovakia and is a useful tool to inhibit the privatization of public monopolies into private ones (which are certainly much harder to control or break-up once in private hands).

Interpreting and applying the new Hungarian law effectively is an enormous challenge, particularly given the discretion granted enforcement authorities in the law itself and the broader set of problems with antimonopoly legislation in general. The enforcement office will need to tread lightly at first. As well as handling individual complaints, it should concentrate on its other important missions: educating the public about the distortions caused by monopoly behavior and lobbying the government and Parliament to minimize barriers to international trade—the most powerful antimonopoly force of all.

**Judicial Institutions**

As in other CEE countries, the judiciary did not play an active role in the commercial sector during the socialist period, and it is not well-equipped to take on the sudden expansion in activity in commercial and related areas that has emerged from the rapid economic reforms of the past few years. In order to accommodate private sector activities, the judicial infrastructure will need to be upgraded through training, staffing, and equipment.

**Court Structure**

There are four types of courts in the Hungarian judicial system: the Supreme Court, county courts, local courts, and special courts. Nationwide there are about 2000 judges,

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126 Article 24.

127 The structure of the judiciary is defined by the current Constitution; Act IV of 1972 on the judiciary; Act LXXX of 1990 on the Establishment of Local Courts; Act XXXII of 1989 on the Establishment of the Constitutional Court; Act III of 1952 on the Code of Civil Procedure; and Act I of 1973 on Criminal Procedure, as amended. Law Decree 23 of 1989 and Executive Decree of the Minister of Justice govern courts of registration and registration of companies. The 1989 amendment to the Constitution introduced into this system a Constitutional Court (as discussed above), but it is not formally part of the judicial structure.
with about 200 unfilled positions. Most cases are brought initially in the local courts, of which there are 102. They are courts of general jurisdiction and hear criminal, civil, and commercial cases. Although the local courts are not divided into chambers, judges do tend to specialize, meaning that in practice cases are heard by judges with some experience in the area. Hungary has a fairly unified court system with few separate specialized courts, except for the Labor Court, the Court of Registration, the Court of Arbitration attached to the Hungarian Chamber of Commerce, and the Military Court.

Appeals from the local courts are to the county courts. There are nineteen county courts in Hungary, as well as the municipal court, which serves the Budapest metropolitan area. This level is divided into three branches: civil, commercial, and criminal. The Budapest municipal court has a separate labor chamber. A county court may act as the court of first instance when the amount in controversy exceeds HUF 3 million—typically disputes between state-owned enterprises—or in claims related to intellectual property, libel, slander, damages caused by state officials, and certain other matters. In such cases, appeal may be made to the Supreme Court. The Supreme Court also guides lower courts by issuing advisory opinions. This judicial guidance role is stipulated in the Constitution.

Changes in court organization began in 1989. In 1990 a new law on the promotion and compensation of judges came into effect. Self-governing Judicial Councils were established to appoint court officials and to handle internal disciplinary cases. The latest amendment, Act LXVII of 1991, increases the role of Judicial Councils in court financial decisions and in selection and appointment of judges. The amendment also separates budget and administration of the Supreme Court from the Ministry of Justice, unlike local and county courts which remain subordinated to the Ministry.

The Hungarian judicial system suffers from a shortage of well-qualified judges, particularly in newly-emerging commercial areas. Judges are appointed for life by the Hungarian President and may be removed only for cause. They do not enjoy

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128 Until 1972, all inter-enterprise disputes were heard by "economic arbitration tribunals," which settled supply and delivery agreements according to the state plan. These tribunals were abolished in the 1970s, and inter-enterprise disputes have since been heard by the commercial chambers of the county courts.

129 Ch. I, sec. 47.

130 One area under active discussion involves overhaul of the court structure: whether a four level court system should be introduced or a modification of the current system is adequate, and whether the Ministry of Justice or the self-governing Judicial Councils should be the guarantor of the lawfulness of court procedures.

131 Ch. X, sec. 48.
particularly high status or pay, and over half work on a part-time basis. Over the past few years their workload has more than doubled, due to the registration of new private companies, the rapid rise in the number of commercial disputes, the rash of new compensation claims, and growing criminal activity. In order to alleviate the judiciary of this increased work load, the Ministry of Justice sought unsuccessfully to reestablish the administrative courts—which had been abolished under the socialist regime—in order to adjudicate alleged violations of citizens’ rights by the state.

An area needing particular attention is debt collection. Of the total number of 700,000 law suits filed nationwide last year (a 60 percent increase from the previous year), two-thirds of those cases involved uncollectable debts. Streamlining debt collection, perhaps by allowing private debt collection in uncontested cases or reducing procedural requirements in judicial cases, could relieve much of the current strain on the courts.

Arbitration could be a useful alternative to court procedures as a means to resolve commercial disputes among private parties. As in other CEE countries, the Hungarian Chamber of Commerce has an arbitration chamber that specialized during the socialist period in the settlement of international trade disputes. The 1988 Act on Business Organization gives this court jurisdiction for disputes arising out of a company’s organizational documents, if the parties agree. A broader mandate and proper technical support could help this body develop into a viable alternative means for dispute resolution. A new draft arbitration law now under consideration would give access to the Chamber’s arbitration chamber to anyone doing business in Hungary.

The Legal Profession

Law-Decree 4 of 1983 on the Legal Profession broke the close ranks of the "legal working groups" and allowed company attorneys to compete in dealing with economic organizations. Act XXII of 1991 amended the 1983 law to give Hungarians attorneys the right to establish law offices (with two attorney minimums) or individual practices. Attorney working groups have to transform themselves to Law Offices. Admission to the Bar requires a law degree, professional exam, Hungarian citizenship, permanent domicile in Hungary, a clean record, and liability insurance. Practicing attorneys may not take up other employment, although they may join companies’ boards. Currently there are about 1200 practicing lawyers in Budapest. Foreign lawyers can open representative offices and provide legal assistance on foreign legal matters, but may not practice Hungarian law.

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132 See Ostas, supra note 106, at 9.
Conclusion

Hungary has been on the forefront of CEE countries in reforming its legal framework to promote private sector development. It was among the first to make major changes in its Constitution and Civil Code to promote free enterprise and put private property on the same legal footing as state-owned property. It moved quickly to establish a Constitutional Court to protect these legal rights; its Court has extremely broad jurisdiction, and has proven very active in reviewing economic as well as social legislation. With regard to formerly nationalized property, it is the only CEE country to eschew widespread restitution in-kind, opting instead for a coupon scheme that is likely to cause significantly less uncertainty and disruption in property markets. It has basic legislation in place to protect intellectual property and to provide a clear and flexible framework for the setting up of domestic or foreign-owned firms. Finally, new and relatively modern antimonopoly and bankruptcy laws went into effect at the beginning of 1991 and 1992, respectively.

Despite these achievements, however, numerous legal and institutional challenges remain. The most difficult area (apart from company privatization, which is not discussed here) remains real property. The development of efficient land markets continues to suffer from an inaccurate land registry, an underdeveloped legal and institutional framework for collateral, the near impossibility of eviction in cases of nonpayment of mortgage loans or rent, and an outdated and incomplete zoning and regulatory structure. Further substantive scrutiny is also called for in other areas of law, most notably in the areas of bankruptcy and competition.

Finally, the challenge of implementing all of this new legislation is daunting, particularly given the country’s limited experience with market principles and institutions. Both the specialized institutions (such as those charged with implementing intellectual property and antimonopoly laws and with registering companies) and the regular courts are in danger of being overwhelmed with the burgeoning caseload. A prime example is bankruptcy, where some 7000 new cases were filed in the first 4 months of 1992 alone. Another is antimonopoly law, where the broad legislative mandate and the relative inexperience of the regulators could create the potential for counterproductive results. In addition to training and technical assistance, Hungary should work to provide widespread dissemination of the rulings of the Office of Competition and the courts more generally, both to educate the public and to promote public accountability and oversight.
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