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**100 Questions - 100 Answers  
About ESOPs**

**SHARE-PARTICIPATION FOUNDATION**

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## Introduction

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I would like to express my gratitude to the officials of the Ministry of Finance preparing the ESOP Law - *Dr Eva Hegedűs* and *Dr Gabor Dobrocsi* - for the opportunity to have useful discussions, and to *Dr Andras Nemes*, the official of the Ministry of Justice, the literary adviser of this booklet and the codifier of the ESOP Law, whose valuable comments and critical notes I took into consideration when correcting the first draft.

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The Author

## The Theoretical Background of the ESOP Law

The fundamental theory of the ESOP can be summarized in the following simplified way. The ESOP is a financial, financing and structural technique, which makes it possible for the employees of a company to become individual share owners in an organized way in the employer company, in a way that the repayment of the acquired credit or the purchase price instalments and the interest will not be covered from their wages but from the profit earned at the company, the collateral of the credit is not their personal assets but the assets of the company, and in the process of property acquisition the unilateral interest in wages is replaced by the joint interest in increasing the profit and the assets of the company.

The ESOP Law - approved by the Parliament on June 9, 1992 - has become well known in Hungary. The purchaser of a state property share was an ESOP in approximately 75 cases (up to October 1993), there are more than a hundred ESOP organizations registered, and the number of the companies and corporations where ESOP initiatives have been started is even larger. Accordingly the ESOP has proved a successful privatization program even if it was debated politically and technically while it was being prepared and it has not changed since the ESOP Law got in force.

Some people - openly or inwardly - reject this idea saying it is unnecessary for employees to have their own property shares because they are unable to represent a uniform and consistent ownership concept, fragments of property hinders the rational and harmonized control of the company, and they are afraid of the return of collectivism or the appearance of "third alternatives".

Others consider ESOPs economically irrational because the repayment of credit borrowed for property acquisition (in case of instalment payment the repayment of instalments) and the payment of interest distracts resources from development but for political reasons they accept and support this privatization technique believing that it is only transitory since employees will sell their property shares to people who offer cash as soon as possible.

Some others think ESOPs are the means of a management that is incapable to revive itself, has no concept therefore it is doomed to fail "to save themselves for the future". These people say this management is afraid that a new, outside owner would not take their services therefore they accept the establishment of an ESOP or occasionally they are supportive or even they initiate it.

There are people who accept that it can be reasonable for the company to establish employee ownership but not here and not now. It is a good technique for some well-developed market economies, where the owner and the management

realize themselves that employee ownership offers additional resources. In Hungary - they say - owners and managements have not had the opportunity to see the usefulness of share ownership and co-operative management so it is too early to establish ESOPs in Hungary. First the managers must gain a thorough knowledge of the conventional, hard management techniques that are built up starting from the upper levels. ESOPs and participation can come some time later when the conditions are fine for them.

It would be a simplification to say these opinions completely lack true statements. Obviously there is some truth to them since ESOPs were established in various ways and in specific conditions so some of them inevitably carry phenomena that seem to prove and actually do prove these opinions.

It is possible that some of these concerns occasionally get proved however a comprehensive judgement can be made only after having acquired profound experience. Making a comprehensive judgement is not justified on one hand because economic transformation including privatization shows contradictory results in almost every area, no matter we have in mind spontaneous privatization, the establishment of corporations on a large scale, buy-out on E-credit by entrepreneurs or the management or foreign investors. On the other hand it is not justified to make a quick judgement about ESOPs because the early experience of ESOPs in Hungary shows the same positive signs as the ESOPs in the USA or the United Kingdom.

There are several counter arguments against the opinions listed above. I will mention only some of them in brief here.

The broad experience in the United States shows that the employees as share holders are able to make decisions together, following the requirements of economic rationality if they are given the adequate amount and quality of information and they are continuously taught how to interpret this information. For this - among many other things - good communication within the company is needed. This many-sided, internal communication together with participation on the company level and a total quality management" brings additional profit.

It is true that uniform, quick and hard actions by the owners in the transformation of the company have less chance than in case of one owner but it is not impossible even if the ESOP Organization has the controlling majority shares. It is worth studying the cases in the United States where the ESOP Organization took uniform, quick and precise actions, in addition there are Hungarian examples as well. Experience also shows that efforts to cooperate and to make the changes broadly accepted during the transition of the company have several advantages, which are more profitable in the long run than a sudden change.

In an economy where the conditions of a market economy are predominant it is impossible to follow "third alternatives". Nobody in the USA considers ESOPs

either some sort of collectivist-socialist formation or a "third alternative" but a technique that revives the traditional capitalist economy and helps to create a broad layer with capital income and it is supported by both the Republicans and the Democrats. In recent years the trade unions, which are losing their support, have not had a negative attitude, in some cases they have even been supportive. In a market economy being in the process of getting established the Hungarian ESOPs cannot be too different from the ones in the USA.

It is true that the ESOP diverts sources from the company in order to pay off the credit and the interest but this loss of sources is less than in any cases of E-credit, for two reasons. On one hand the ESOP is allowed to use pre-tax profit to repay the credit and the interest, which makes the repaying liabilities less expensive for the company than in case of the regular E-credit where theoretically this repayment can be done using only after-tax profit. The ESOP may carry out the repayment using exclusively corporate profit - which increases the corporate tax income of the state counterbalancing the tax allowance given to ESOP-s - while in the case of the usual E-credit it is not necessarily the case.

Following their own interests of ownership acquisition most of the old and new generation of the Hungarian managers are able and willing to control the company they are entrusted with by the owners successfully even if one of the owners is the ESOP. If it was not the case, i.e. the Hungarian top managers were unable to meet the requirements of a market economy, it would be irrational to promote property acquisition by the management.

A management which is unable to manage the company according to the new economic- and market relations will fail. They will be removed by the employees, who, inevitably recognizing the economic necessities, will support or seek managers who are able to produce a program aimed at market- and financial success and a plan for productive cooperation for its accomplishment.

The majority of our managers are teachable, able and willing to learn new and effective techniques which are applied on a large scale in modern market economies. This ability and willingness are true not only in the case of traditional management styles (authoritarian, dictatorial, non-cooperative, etc.) but also in the cases of management styles enforcing the principles of Total Quality Management which is built up starting from the lower levels and based on team-work and cooperation. The learning of the latter is more unusual, tiresome and slower, but much more competitive than the traditional styles, not only, but first of all in the ESOP companies. Teachable managers will realize that, when the ESOP is the owner, this direction is worth taking. Why to believe that in Hungary traditional management techniques are the only way to the cooperative management style of the 90s?

I found it important to mention these arguments and counter-arguments in the introduction in order to indicate the reason why the next 100 questions and answers

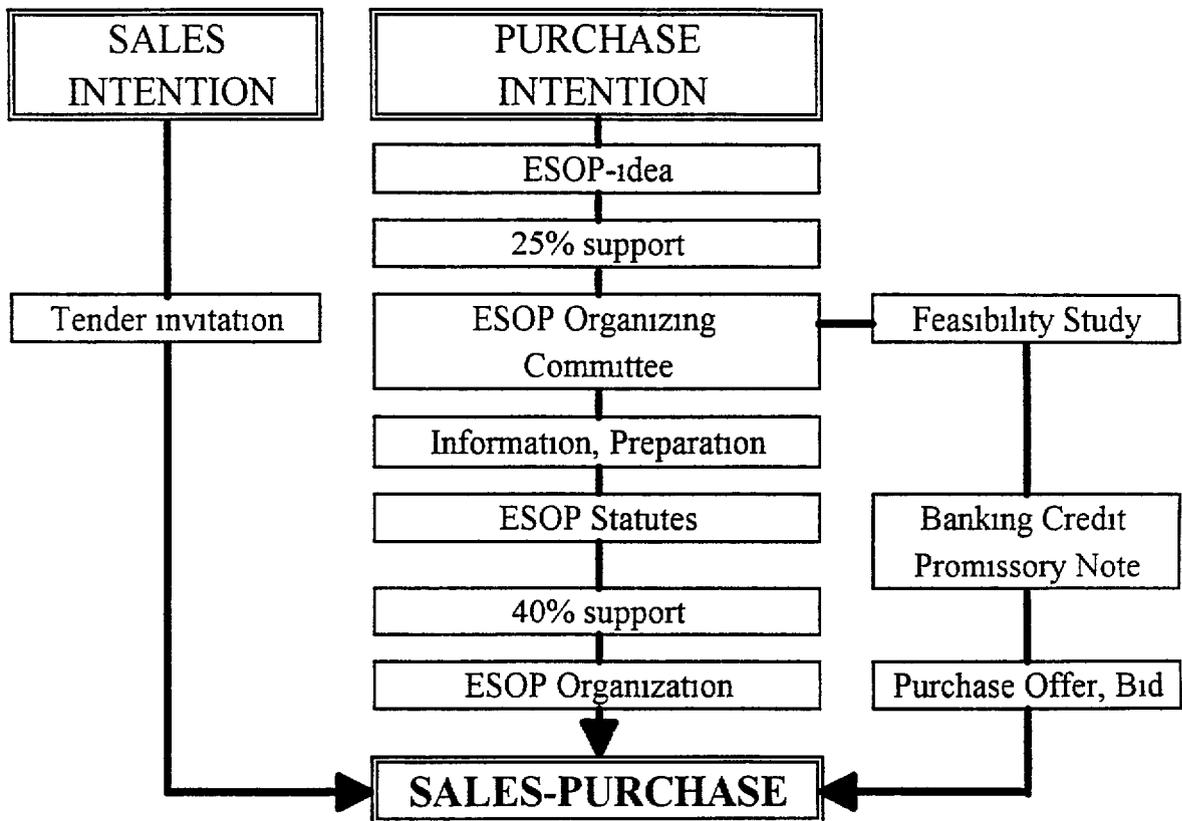
cover more than just the close interpretation of the ESOP law, providing an outlook to the internal relations of an ESOP and issues related to the management of ESOP companies

In the following I try to make the reader acquainted with the Law No XLIV of 1992 on the Employee Share Ownership Program in a language which is not technical but clear to anybody, in the form of questions and answers. However, I also think it is important that those wishing to get a closer knowledge of the legal terminology could find the relevant articles and sections of the Law. Therefore, the relevant parts of the ESOP law--the number of sections and articles-- are also included in the following form [ ( )]

Some of the answers given to simple questions have inevitably become complicated, so, as a compensation, I have tried to summarize the main phases of organizing an ESOP in a flow-chart shown on the following page

# Flow-chart of Organizing An ESOP

in the case of tender invitation



# List of Questions

## I General Principles Establishment of an ESOP organization

- 1 What can be the purpose of the establishment of the ESOP organization?
- 2 Why is it expedient for the owners and the management to accept and support the ESOP initiative?
- 3 At what companies/corporations can an ESOP be initiated?
- 4 Can the ESOP initiative be aimed at a separated organizational unit of a state company?
- 5 Can the ESOP initiative be aimed at the purchase of operating assets?
- 6 Who can initiate an ESOP?
- 7 What are the precondition of the establishment of the ESOP organizing committee?
- 8 In order to initiate the ESOP and establish its organizing committee is it necessary to have the approval or support of the management of the company (corporation)?
- 9 Is it possible to establish more than one ESOP organizing committee at the same company (corporation)?
- 10 What is the procedure for assigning the ESOP organizing committee?
- 11 What should be/must be the concrete tasks for which the ESOP organizing committee is authorized in the assignment letter?
- 12 What are the tasks to be carried out by the ESOP organizing committee during the preparation of the ESOP?
- 13 What can be the consequences if the managers of the company (the board of the corporation) do not support the establishment of the ESOP organizing committee, the activity of the committee or the establishment of the ESOP organization?
- 14 In case of a conflict as a result of the ESOP initiative and organizing activity are there any safe-guards against the dismissal of members of the organizing committee?
- 15 What preparations are needed before an ESOP organization can be established?
- 16 When may the founding assembly of an ESOP organization be summoned, and what are the conditions of the registration at the court?
- 17 What is that date from which on the ESOP organization is established from a legal point of view, that is, from which date on can it for example complete a sales contract or a credit agreement?
- 18 When should one ask the state assets management organization for consent to establish the ESOP organization, and in what cases, according to our experience, does the state assets management organization grant this consent?
- 19 Under what conditions does the State Property Agency approve the

establishment an ESOP organization?

## II Obtaining property, the tender

- 20 Does the ESOP organizing committee have any opportunity to make a purchase proposal to the state assets manager without a tender?
- 21 Is there a chance that the SPA will accept the purchase proposal of the ESOP organizing committee, and this way the ESOP organization will become a buyer without entering a tender?
- 22 Is it possible for the employees to obtain property in an ESOP organization even if the majority of the company's property shares had been sold already by the state assets organization?
- 23 Is it necessary to submit a bid even if the state assets manager had already sold the majority of the company's property shares?
- 24 What resources can the ESOP organization utilize in order to pay the purchase prize if it purchases property shares from a state assets management organization?
- 25 Can the ESOP organization make use of the preference offered by the state assets management organization against state assets according to the regulations of the Property Policy Guidelines?
- 26 Should the preference offered by the state assets management organization against state assets according to the regulations of the Property Policy Guidelines be used individually or through the ESOP organization?
- 27 Can any price reduction deriving from the regulations of the law other than the preference according to the regulations of the Property Policy Guidelines be used in case of a purchase through the ESOP?
- 28 What resources can ESOP use to pay the purchase price if it is not purchasing directly from the state assets managing company?
- 29 Can the ESOP get an ESOP credit even if the owner of the employment company is a state owned company or a company owned wholly or partially by the state, that is, the vendor is not the state assets manager?
- 30 Under what conditions can the state assets manager allow the ESOP organization instalment payment?
- 31 What is the minimum own cash requirement for the ESOP organization to obtain property share?
- 32 Is it sufficient if the ESOP organization possesses the minimum own resource stipulated in the law?
- 33 What regulations apply to the utilization of compensation coupons in an ESOP? Can the ESOP organization pay its own resource with compensation coupons?
- 34 Is the employer company entitled to pay the own resource on behalf of the ESOP Organization?
- 35 Who is authorized to complete the feasibility study ?What information should it contain?
- 36 Is the employer company is obliged to provide the necessary data for completion of the feasibility study?

- 37 Who is to finance the costs of completion of the feasibility study?
- 38 When - how many days before the tender - should the organizing committee submit a loan application to the bank(s)?
- 39 What should an ESOP loan application contain?
- 40 What are the documents needed for the evaluation of a loan application and for granting a loan promissory note?
- 41 What information does the credit promissory note contain?
- 42 What coverage may there be for obtaining the ESOP loan and company instalment payments? Who are the guarantors?
- 43 May the ESOP Organization obtain the guarantee provided by the Credit Guarantee Co on ESOP loan?
- 44 What obligations does an ESOP organization mean and what benefits result from an ESOP organization for the company where one has been established? Why would it be the interest of the other owners of the company to encourage such an initiative?

### **III Participants**

- 45 Who can participate in the ESOP during the preparatory period?
- 46 Who are eligible to participate in the ESOP, and who can be participants of the ESOP organization at the time of its establishment?
- 47 Do the eligible employees automatically become participants of the ESOP?
- 48 Can participation in the ESOP organization be denied an employee of the company who is eligible and who declared in writing his wish to become a participant?
- 49 Does an employee joining the organization after its establishment have any disadvantages?
- 50 Is it compulsory for all the employees of the company to become participants of the ESOP organization?
- 51 Can an employee remain participant of the ESOP organization if his employment terminates?
- 52 Are the participants of the ESOP organization responsible with their own income and/or private property for the liabilities of the organization?
- 53 Will the shares purchased through the ESOP become and remain in collective ownership or in private ownership? How will the property shares purchased by the ESOP organization be transferred into the ownership of the employees?

### **IV The Statutes and the General Assembly**

- 54 Why is the statutes of the ESOP organization important? Can the participants freely stipulate its regulations?
- 55 What the mandatory items of the statutes of the ESOP organization?
- 56 What is the role and scope of authority of the general assembly of the ESOP organization?
- 57 How often, when and how must the general assembly of the organization be

- summoned?
- 58 Can the general assembly be held in the form of a partial assembly, and in what cases should this form be used?
- 59 When does the general assembly have the quorum, and what are the regulations regarding its chairmanship?
- 60 May the statutes of the organization be amended?
- 61 What voting rights and how many votes do the participants have at the general assembly of the meeting?
- 62 Who is authorized to represent the Organization vis-a-vis third party, the Court and other authorities?
- 63 What rules govern the establishment of the executive body?
- 64 What is the scope of authority of the executive body and what is the duty of its members?
- 65 What responsibilities do the members of the administrative body have?
- 66 Is it expedient to establish a supervisory committee?
- 67 What are the rights and responsibilities of the participants?
- 68 What should be the rules concerning the allocation of the shares purchased by the ESOP with credit or with instalment payment be like?
- 69 What rights and responsibilities do those have, whose employment at the employer company terminates or who terminate their participation in the organization and remain employees of the company?
- 70 At what purchase price should the ESOP organization exercise its repurchase right? What should the schedule of the instalment payment of the repurchase price be?
- 71 What are the conditions for selling the repurchased property shares?
- 72 Who can exercise the voting rights for the shares (business shares) in the ownership of the participants at the employer company's general assembly (shareholders' meeting)?
- 73 Who can exercise the voting rights for the shares (business shares) in the ownership of the organization at the employer company's general assembly (shareholders' meeting)?
- 74 Who can the participant turn to if he suffers damage because of the activity of the ESOP organization or in case of an unlawful act?

## **V Ownership and transfer into ownership**

- 75 What is a share account? Does the Ltd business share need to be registered on a share account too?
- 76 What proprietary rights are connected to the shares obtained through ESOP?
- 77 What are the restrictions on the proprietary rights of those shares (business shares) which were transferred from the ownership of the organization into the ownership of the participant?
- 78 According to what rules are the property shares (shares or business shares) purchased by the payment of own resources - cash or compensation coupon - transferred into the ownership of the participants?
- 79 Can the participants freely dispose of the property shares (shares or business

- shares) purchased by individual payments through utilizing own resources, and what proprietary rights can they exercise free from any restriction?
- 80 When and with what conditions are those property share transferred into the ownership of the participants, which were purchased by the company with own resources, but which are not coming from the individual payments of the participants?
- 81 What happens to the shares purchased through the ESOP by the preference outlined by the Property Policy Guidelines? What are the regulations regarding transfer into ownership and proprietary rights, and what allocation rules can be used or are reasonable?
- 82 When and with regard to what statutory regulations can the shares purchased by the ESOP organization through a loan or as a result of an instalment payment agreement be transferred into the ownership of the participants?
- 83 What regulation can the statutes contain regarding the allocation of the shares, which, during the repayment period, get into the ownership of the participants?
- 84 Should we require an own resource payment from the participants who join the organization?
- 85 Do the participants have to pay tax and/or duty after the shares transferred into their ownership?
- 86 What tax allowance can the participant of the ESOP organization utilize for the amount, which was paid by himself to repay the debt of the organization either at the establishment of the ESOP or afterwards?
- 87 Why is it reasonable to retain a part of the shares (business shares) in the ownership of the ESOP organization even after they have been freed up for allocation during the repayment period?
- 88 What are the resources, with which the ESOP organization or the company may repurchase property shares?
- 89 Does the organization have a repurchase obligation?
- 90 May the ESOP participant sell, and to whom can he sell the property shares which were transferred into his ownership through the ESOP organization?
- 91 What factors influence the price of the property shares in the ownership of the participant?
- 92 Why and how should the ESOP organization establish an internal share market?
- 93 May the participants get dividends on the shares transferred into their ownership through the ESOP organization?

## **VI. Tax related and other questions**

- 94 From what resources can the ESOP organization repay its debt and interest, or in case of instalment payment, pay the instalments and interests?
- 95 With what conditions and restrictions may the employer company subsidize the repayment and interest payment obligation of the ESOP organization?
- 96 Is there a relationship between the amount of the subsidy exempt from tax that may be given to the organization and the proportion of the organization's

shares in the company?

- 97 In what extent may the organization receive subsidies exempt from tax if it does not purchase the property shares directly from the state assets manager?
- 98 Is there a tax allowance on the amounts paid by the company or by the participants in order to subsidize the repayment of the ESOP debt, if the ESOP organization did not purchase the property shares - neither directly or indirectly - from the state assets manager?
- 99 What can be written off among the operational costs of the ESOP organization, and what resource covers the costs of the organization?
- 100 For what period is the organization established, and when does it terminate? What happens to its property at the termination?

# Questions and Answers

## I General Principles. Establishment of an ESOP organization

*1 What can be the purpose of the foundation of an ESOP organization?*

The ESOP Law provides a legal basis for the joint acquisition of assets of a Corporation or Limited Liability Company registered in Hungary (corporation in the followings) by a body of its employees. The role of the ESOP organization is to provide a legal framework for the transfer of the assets acquired jointly to the full ownership of the employees as private persons, according to the ratio of the repayment of the loan and the payment of the tranche of the purchase price.

The ESOP organization established by the employees on a voluntary basis, is a legal entity which comprises a self-government (a administrative and representative body elected by a secret ballot vote in the general assembly of the corporation and the general assembly of the organization [section 3 of paragraph 4] - administrative body in the followings) and registered participants.

One of the goals of the ESOP for the employees is the extension of their private property by means of acquiring property shares in the corporation (shares or business shares) which can be sold for cash after the successful completion of the repayment, when the property share can be sold at a price exceeding the original purchase price. This is a result of the profitability and attractiveness of the corporation.

The second goal is the acquisition of dividend profit on the property shares in full ownership of the participants after the completion of the repayment of the loan.

The third goal is participation at decisive forums of the shareholders for the future of the corporation, general assembly and shareholders' meeting.

*2 Why is it expedient for the shareholders and the management to accept, and furthermore, to support the ESOP initiative?*

The shareholders, as well as the managers of a corporation generally have some goals when accepting and supporting the establishment of an ESOP organization and its property acquisition scheme. The interest of the employees in the increase of the assets and the profit, instead or together with a wage increase, and their commitment to the market success of the corporation may be a long-term factor ensuring its profitability.

This interest is a driving force which has enabled the establishment of structures similar to the ESOP organizations at several thousands of corporations of middle or large size in several countries of the world. The interest represents however an indirect, dormant and not fully employed resource until it is knowingly directed and represented by the management by the use of methods of cost economy and quality improvement. These techniques require a new philosophy and commitment of the management to base them on the principle of participation. The results of the efforts can only be measured on a middle to long term.

### *3 At what companies/corporations can ESOP be initiated?*

An ESOP can be initiated at any companies (state company, subsidiary, company of certain legal entities [art 1 sect 6]) or at economic associations with the exclusion of financial and insurance institutions. The implementation - establishment and property acquisition - can only be made possible at Corporations and LTDs registered in Hungary.

### *4 Can an ESOP initiative be aimed at a separated unit of a state company?*

Yes, ESOP can be initiated at units (factories, plants) separated from state companies not yet transformed. The ESOP organizing committee can be established on the mandate of minimum 25 % of the employees of the unit (art 2 sect 1). In order to bring the initiative to a success, the state property manager (mainly the State Property Agency, SPA in the followings, or the State Asset Management [AV RT] or their consultants) transform the unit into a Corp or Ltd (Art 1 sect 5).

The transformation into an independent corporation is hindered by the following factors:

- The state property manager body may withdraw part of the assets of the state company. In this case, it becomes a cash payment guarantor and is responsible for the liabilities of the company (to the trade creditors and suppliers) in the extent of the ratio of the book value of the withdrawn assets and the book value of the total assets. In most of the cases, the purchase price is not collected in cash, therefore, the state asset management bodies are rarely partners for the establishment of a corporation from the withdrawn assets. The management body is most likely to act as a partner when there is no risk of bankruptcy, and no cash payment guarantee is expected.
- The manager body may either transform the state company into several corporations, or prefer to divide the corporation already transformed into several corporations in order to establish the ESOP. Time and cost needs are significant (preparation of the asset balance and the proposal for the distribution of assets, the sharing of the rights and liabilities, etc.), which may result in the hinderance of the transformation procedure.

- The manager body may make a decision at the general assembly (shareholder's meeting) whereas the parent company transforms one of its units into a corporation and realizes it wholly or partially in the framework of an ESOP. This decision can be made by other decision-making bodies of the parent company or the economic association if they have the right to act so. The legal regulations require a significant amount of cash for the establishment of a corporation, or, if the capital requirement is not significant for reasons of cash economy, the equity raise taking place with the issuing of fresh shares, the law prescribes a particular phasing: the equity raise can take place minimum one year later than the date of the establishment of the corporation (art 301 sect 3 of the Law VI of 1988). Time can therefore also be a hinderance to transformation.

- Corporate tax or personal income tax liability applicable to most of the cases mentioned above also hinder the transformation procedure, although experience demonstrates that ESOP initiative at units to gain independence can be successful. It seems therefore reasonable to try it. A modification in the legislation enables tax payment without an actual cash flow when the subscribed capital is raised with non-cash deposits.

#### *5 Can the ESOP initiative be aimed at the purchase of operating assets?*

No ESOP initiative can only be aimed at the acquisition of corporate property share, namely Corp share or Ltd business share. ESOP can be also initiated in the transformation of state company, subsidiary or the company of certain legal entities. In order to establish an ESOP, the organizing committee may request the withdrawal and transformation of the assets of state companies or their separated units (factory or plant) into a corporation by the management body.

The ESOP organization cannot acquire operating assets even if it incurred the liability to establish a corporation or in order to acquire shares in the corporation, assets were taken as contribution in kind to an already operating corporation.

#### *6 Who can initiate an ESOP?*

An ESOP can be initiated by anybody without the requirement of being employed at the company or corporation. Naturally, the success of the ESOP can largely be ensured if the group of initiators include one of the leaders of the workers, because the idea and the initiative are not exclusively enough for the ESOP, its preparation and the establishment of an organizing committee require the extensive support of the employees (art 2 sect 1).

#### *7 What are the preconditions of establishing an ESOP organizing committee?*

The establishment of an ESOP organizing committee, comprising 3 persons, requires a written mandate of minimum 25 percent of the total labor force employed at the company or corporation with assigning the acquisition of property share (art

2 sect 1 )

When the ESOP is initiated at a separated unit of a state company, the required minimum mandate is calculated on the basis of the number of workers employed at the unit

*8 In order to initiate ESOP and its organizing committee, is it necessary to hold the approval or support of the management of the company (corporation)?*

Not necessarily, although the support is highly recommended. The ESOP organizing committee can be established on the mandate of 25 percent of the workers (art 2 sect 1 ), but the unconcern or the opposition of the management may hinder the organization. The opposition may have several reasons

- on the basis of the business prospective of the company, they estimate the repayment of the loan and interest payment quasi impossible,
- a promising contact has been developed with external investor who will not admit ESOP as a co-investor,
- they strive for an exclusive MBO with E-credit or privatization leasing,
- they feel adversary to the organizers, etc

It is therefore highly recommended to gain the support of the management. Although they must provide data for the feasibility study (art 2 sect 4 ) and its cost are paid by the corporation (art 2 sect 4 ) supposing the ESOP organization is finally established, experience demonstrates that the work of the organizers may be significantly hindered if the management is reluctant to cooperate especially in cost matters. Besides, the convocation of the founding assembly of the ESOP organization requires the approval of the general assembly of the Corp (or partners' meeting in the case of Ltds), (art 3 sect 3 ), which is difficult to prepare without the support of the management.

Furthermore, the feasibility study, the credit application and the purchase proposal (art 2 sect 3 ) are based on the data of the minimum mid-term business strategy and plan held by the management. It is therefore important to have the support of the management and participate together in the tender. The second reason is that according to international experience, the success of an ESOP is based on a cooperation of the total body of employees and management of a corporation, which can be undermined by conflicting interests.

*9 Is it possible to establish more than one ESOP organizing committee at the same company?*

Although it is possible, it is not recommended, since it may result in a division of the workers endangering the success of the ESOP initiative, and the repayment of the loan in case the initiative was successful. It is advisable to conciliate conflicting interests before the organizing committees start their complex, time and money-consuming activity.

Theoretically it may occur (and it has actually occurred), that two organizing committees and subsequently, two organizations are established at the same company, unit, or corporation, as the first needs a 25 percent, and the second, a 40 percent support. Therefore theoretically, it is possible to have two separate organizations for the acquisition of separate asset share. One employer may join only one of the organizations (art 4 sect 4 )

*10 What is the procedure for assigning the ESOP organizing committee?*

The mandates have so far been prepared with a general formula

"We, the undersigned assess our intent to acquire assets from the corporation (transformed from the company, etc ) in the framework of ESOP. We mandate the following three members of the ESOP organizing committee to act in our name "

According to past experience, the mandate should assign all the duties in connection with the organization and implementation of the ESOP to the organizing committee which should be vested the legal competence, otherwise the committee can face a situation whereas it cannot carry out its duty or it has to apply for concrete authorization of the employer for every single action

*11 What should be/must be the concrete tasks for which the ESOP organizing committee is authorized in the assignment letter?*

First of all

- inform every employee of the corporation (company) about the ESOP in general, and coordinate with them regarding the concrete conditions of the credit and the sales-purchase transaction [Article 2 (1)],
- provide information about the preferences that can be used for the purpose of acquiring shares either individually or in the framework of the ESOP in accordance with the Property Policy Guidelines (hereinafter PPG),
- collect the letters of intent of purchase by individuals through the use of PPG preferences and keep the relevant individual payments on a deposit account,
- prepare a feasibility study to see if it is reasonable to buy from the corporation assets, to what extent and for what price,
- work out with the management of the corporation (company) how to cover the expenses related to the feasibility study [Article 2 (4)] If the company refused to pay advance for the expenses the ESOP organizing committee should be authorized (up to a certain amount) to collect payments - to be

- repaid later -to cover the preparation of the study from the employees,
- have the feasibility study countersigned by the Company, certifying that its contents are professionally valid [Article 2 (3)],
- having the feasibility study it should turn to the asset manager of the company to be privatized, in case of a company or corporate owner to the decision making body to inquire about the intention of selling the share It should also inquire whether the potential creditor banks are willing to give loans [Article 2 (1)],
- it should get a credit certificate from the bank and a certificate for the instalment payments from the State Trustee Organization (seller of the property) [Article 2 (1)],
- Collect the cash or compensation bonds,if they can be regarded as payment instruments,which is the requirement of the loan [Article 14 (1)],
- prepare the privatization tender document (selling bid), sign the related documents in the name of both the employers and employees, hand in the tender document in time to meet the deadline,
- prepare a draft for the ESOP Statutes [Article 4 (3)],
- get Company General Assembly's approval for the foundation of the ESOP organization [Article 3 (3)],
- summon and organize the founding meeting of the ESOP organization [Article 4 (3)]

*12 What are the tasks to be carried out by the ESOP Organizing Committee during the preparation of the ESOP?*

The ESOP Organizing Committee should have an overview of all the tasks assigned to it by at least 25% of the employees The Organizing Committee should be responsible for the following

- prepare a feasibility study to see if it is reasonable to buy from the company's assets and if yes, to what extent and for what price [Article 2 (3)],
- to have the company countersign the study, certifying that its contents are professionally valid [Article 2 (3)],
- having a feasibility study which satisfies the requirements of the SPA or more generally the vendor,the Committee should turn to the owner of the property share (the State Trustee Organization or to the decision making

body in case of a company) to find out about the intention of selling the share [Article 2 (1)],

- having a feasibility study, which satisfies the requirements of the banks, it should approach the banks to find out about their willingness to offer loan facilities. It should get a promissory note for the loan from the banks and one from the vendor for the instalment payment [Article 2 (1)],
- prepare the tender document for the privatization (offer for bid), sign the necessary related documents in name of the mandant and hand in the document (offer for bid) before the deadline,
- ensure the amount to cover the expenses related to the feasibility study, the loan application and the tender document. The corporation (company) should pay for the expenses related to the preparation of the study, if an ESOP organization is founded [Article 2 (4)]. If the company does not pay these expenses or does not pay the advance, the ESOP Organizing Committee can only rely on payments made by the employees,
- it should work out the terms of the sales agreement with those owners who intend to sell their property or part of their property to the ESOP organization. This agreement can only be regarded as an advance agreement, whether or not the ESOP will be founded. The agreement will include the price of the property, method of payment, date of payment, terms of potential instalment payment and secondary obligations which are conditions of the agreement [Article 2 (1)],
- inform all employees of the company on ESOP in general, get their agreement on taking credit and on terms of sale [Article 2 (1)],
- prepare a draft for the ESOP Statutes [Article 4 (3)],
- get Company General Assembly to approve the foundation of the ESOP organization [Article 3 (3)], and prepare related documents. The decision makers will usually ask for the feasibility study and a draft on the ESOP Statutes,
- summon and organize the founding meeting of the ESOP organization [Article 4 (3)]

*13 What can be the consequences if the managers of the company (the board of the corporation) do not support the establishment of the ESOP organizing committee, the activity of the committee, or the establishment of the ESOP organization?*

There are several ways through which the managers of the company can hinder the foundation of the ESOP Organization and the work of the ESOP Organizing Committee, such as not providing data timely for the feasibility study, refusing to countersign the study, threatening, dismissing members of the Organizing Committee, etc (the ESOP law does not deal with these cases, it does not include sanctions), but with enough devotedness an investment the handing in of the tender document can not be refused. Because it is not the management but the owner of the company whose approval is needed to form the ESOP organization. In case of privatization one has to turn to the trustee managing state property and the approval in case of a privatization tender and winning the tender can almost be taken as granted.

The situation is more complex if the owner of the property to be purchased by the employees within the frames of the ESOP program. This owner can be a state company or any other firm - it could be called mother company- which is only partly managed by the state. In these cases it is usually the board or the management of the mother company which has the decisive vote and not all parties are interested in indirect privatization and within this in selling property to ESOP.

In case of a conflict as a result of the ESOP initiative and organizing activity are there any safe-guards against the dismissal of members of the Organizing Committee?

The members of the ESOP Organizing Committee will only be protected in case of a conflict, if they are also members of the trade union or company board. In all other cases they can only appeal to court if the specific procedure is violates working rights.

What preparations are needed to establish an ESOP Organization?

In order to establish an ESOP organization a 3 member Organizing Committee should be appointed to carry out the preparatory tasks listed in answer 12, that is

- prepare the feasibility study [Article 2 (3)],
- ensure that the promissory note is written (crediting, instalment payment agreement),
- ensure that the owner of the property share will be ready to sell the property to the ESOP Organization [Article 2 (1)],

- ensure that the General Assembly (members meeting) of the Employer Company agrees to the foundation of the organization [Article 3, (3)],
- prepare the draft of the Statutes,
- ensure that at least 40% of the employees of the company at the founding general assembly agrees to the Statutes [Article 4, (3)] and,
- announces the founding of the organization [Article 4 (3)], and
- votes the members of the executive body through a secret ballot [Article 4 (3) and Article 8 (1)],
- finally the court registration needs to be settled [Article 5 (1)]

*14 In case of a conflict as a result of the ESOP initiative and organizing activity are there any safe-guards against the dismissal of members of the organizing committee?*

In case of a conflict the members of the organizing committee may be protected only if they are trade union officers or factory council officers at the same time. If these two do not apply they may defend their own interests at court in the case of a non-fair procedure according to the labor law.

*15 What preparations are needed before an ESOP organization can be established?*

In order to establish the ESOP Organization first of all it is necessary to assign a three-member organizing committee so that this committee can do all the preparatory tasks which were mentioned in question 12, 1 e

- a feasibility study should be prepared [Article 2 section (3)]
- promissory note for credit or instalment payment
- the owner of the property share to be purchased should be willing to sell that property share to the ESOP organization [Article 2 section (1)]
- the general assembly of the employer company should agree on the establishment of the of the organization [Article 3 section (3)]
- the draft statutes should be prepared
- the statutes of the organization should be approved by at least 40% of the employees of the employer company at the founding general assembly of the ESOP organization [Article 4 section (3)]
- the establishment of the organization should be announced [Article 4 section (3)]
- the members of the board of the organization should be elected by way of secret ballot and,
- they should apply for the organization's registration at court [Article 5 section (1)]

*16 When may the founding assembly of an ESOP organization be summoned, and what are the conditions of registration at court?*

The founding general assembly can be summoned if based on the feasibility study the promissory note (loan agreement, instalment payment agreement) is ready and if the owner of the property is ready to sale the property share to the ESOP organization within the framework of a tender or outside it The organizing committee can only summon the founding assembly if the general assembly of the employer company agrees to it

The organization is founded if at least 40% of the company's employees proclaims the foundation of the ESOP organization and approves the Statutes of the organization, appoints the Executive Body of the organization and finally it must apply for registration at court

The Organization will be registered by the competent county court or by the capital court (hereinafter Court) [Article 6 (1)] The court will decide on the registration in case of non-legal action immediately Several documents are needed for the registration According to law and because of practical reasons the following documents should be enclosed with the application

- minutes of the founding meeting [Article 5 (1)],
- attendance sheet, certifying that at least 40% agreed to the foundation the sheet should also contain the names of the representatives of the organization,
- the Statutes approved at the founding meeting [Article 5 (1)],
- an authentic copy certifying the registration of the organization by the employer company,
- a declaration of approval from the company [article 3 (3)],
- names of members of the executive Body (the name of the representative of the organization, which should also be indicated in the Statutes) and the specimen signatures and
- the minutes of the first meeting of the executive body which should include the name of the chairman of the executive body (if according to the statutes the head of the executive body is the representative of the organization) [Article 9]

*17 What is that date from which on the ESOP organization is established from a legal point of view, that is, from which date on can it for example complete a sales contract or a credit agreement?*

The Court decides on the registration out of turn and by not means of a legal action [6 § (2)] The Court may not refuse registration if founders met the requirements of the law on ESOP [5 § (2)] It is advisable to notice that the organization can be regarded as legal entity only from the date of registration [5 § (2)], which means that the registration is not retrospective In other words, registration is not effective as of the date of the founding meeting

What is arising from this? The elected executive directors may not act on behalf of the organization Upon establishment of the Organization, the Organizing Committee ceases to exist The interval between the founding meeting and the registration - what can exceed 30 days in case of a supplementary requirement - involves the risk for the already founded ESOP Organization, if its representative has to make a legal statement, or sign contracts

This is the reason why the earliest possible establishment is in the interest of the Organization and the State Trustee Organization, coordinating the sale of state-owned property, and this is why it is reasonable for the State Trustee Organization, being the owner, to assent to the earliest possible establishment

*18 When should one ask the state assets management organization for consent to establish the ESOP organization, and in what cases, according to our experience, does the state assets management organization grant this consent?*

It is advisable to demand an assent as soon as the ESOP Organizing Committee has fulfilled all the requirements for an assent by the State Trustee Organization in the process of preparation of the establishment of an ESOP Organization

The easiest solution would be if the State Trustee Organization (and now for simplification let me mention only one the SPA), as the majority owner, at the early stage of the privatization, would demand only minimal requirements from the ESOP and would fulfil its demand for an assent, as this is the essential precondition to summon the initial founding meeting of the ESOP Organization which is to become a legal entity upon registration [5 § (2)] and [6 § (1)], in order to be entitled to sign agreements and contracts for the benefit of the members of the Organization

According to the present practice, the SPA approves the establishment of an ESOP Organization in case of an ordinary general assembly on rare occasions Generally it assents after and upon submission of a tender by the ESOP Organization Committee for the ownership of the part of, or full all of the property shares owned by the SPA in the Organization, or maybe after or upon winning that tender

However this practice have its risks for either the tendering ESOP Organization or -

to a certain extent - for the SPA

On one hand, the assent upon submission of the tender but mainly upon winning that tender leaves only a limited period of time to summon the initial founding meeting of the ESOP Organization and for the following registration, and to conclude a contract of sale and a credit contract within a short deadline (occasionally 30 days) as stipulated in the tender

However the Court decides on the registration out of turn by not means of legal action [Article 6 (2)], which occasionally lasts for even 30 days Besides, the summons of the initial founding meeting of the ESOP Organization - and especially, since before the announcement, the contributing resolution of the regular or extraordinary general assembly has to be possessed - what can also take several weeks or even two months (Note The summons of the general assembly of a company limited by shares has to be announced 30 days prior to its initial day )

On the other hand, the legal status of the ESOP Organization Committee at the time of submission of the tender or after submission, in case of winning it, is not firm enough to enforce such contractual obligations against it, which can be enforced against the elected executive body of the ESOP Organization The ESOP Organization Committee is entitled only to conclude a preliminary agreement, in case of the ESOP Organization gets established, if its coordination obligation with the assignor employees [2 § (1)] is legally difficult to be fulfilled Moreover, the ESOP Organization has no representative during the interval between the establishment of the ESOP Organization and the registration, since by setting up the ESOP Organization, the ESOP Organization Committee ceases to exist [4 § (3)] and the elected executive body gets authorized for representation of the Organization upon registration of the Court

There are several arguments against giving an assent

1 The assent has its effects on the Company, like, the Company is responsible as a guarantor for repaying the credit and for completion of the instalment payments of the credit, obtained by ESOP Organization to purchase property shares [14 § (6)] provided that the ESOP Organization can obtain credit for the purchase of the asset, which was offered for sale, or can conclude a contract on payment by instalments, since credit can be obtained and a contract on payment by instalments can be concluded only upon the SPA's intend to sell a part of its property share

If the SPA does not intend to sell a part of its property share - whether because the ESOP will be the winner of the tender or because the tender-winner outsider investor does not approve the SPA, as a minority co-investor or because of any other reason prevents the ESOP purchase - the only loss will be that effort and work which was invested into the organization of the ESOP initiative, and the Company will not be liable as a guarantor

2 The ESOP Organization can be used as a mean of pressure over the SPA, to enforce it to sell its property share, it intends to put on sale, to the ESOP Organization. As questions 20 - 22 detail the obligatory existence of outside bidders let me make the remark that in a situation in which the quality of the bid is important, it is in vain to quote pressure

3 The third argument intends to eliminate the possibility of giving an assent prior to winning the tender, by claiming that it would put pressure on the tender-winner outsider investor in that case, if the already existing ESOP Organization intends to purchase a part of the rest of the state owned property share, and the SPA would want to sell it to the ESOP Organization within the framework of or outside of the tender. The guarantor obligation of the Company for repaying the credit or completion of the instalment payments of the credit, to be obtained by the ESOP Organization [14 § (6)] will be effective and the right of pre-emption of members (shareholders) may not be exercised with regard to the property shares offered for the Organization [3 § (4)]. In this case, the outsider investor - with respect of the information on the establishment of the ESOP Organization - can present it with knowing that accidentally the co-owner is the ESOP Organization

If the party, which intends to obtain majority ownership aims to prevent that the ESOP Organization be the co-owner, it is possible for it to come to an agreement with the SPA, and involve in the Contract of Sale or in connecting Supplementary Contract that the SPA will not offer any part of its remaining property share to the ESOP Organization

With respect to all of these, the SPA - maintaining the current procedure of giving assent - in the tendering procedure for the ESOP Organizations allows 60 days instead of the standard 30 days for the obligation to conclude a contract

*19 Under what conditions does the State Property Agency approve the establishment an ESOP organization?*

The SPA, as the majority owner of a Company, at an ordinary or extraordinary general assembly gives its assent to the establishment of an ESOP Organization, provided the legal ESOP Organization Committee submits

- a all the documents proving that it bears the legal assignment of 25% of the employees,
- b a detailed feasibility study which meets the current SPA requirements, and involves a description of the proportion of the property shares it intends to purchase, furthermore the sources of payment, and repayment and a broad business plan,
- c those resolutions of the proposed deed of association, enabling the SPA to determine whether or not the ESOP, in fact, means a management buyout. In other words, it details on,

- d terms and conditions of participation (whether it is substantive law, whether it is related to the length of employment or to the signature of a letter of intent, whether the conditions for participation of management and the employees are equal or not),
- e principles of distributing the property shares (whether it stipulates privileges or the distribution is deformed by the fact, that it is related to the - in some cases actually legally stipulated 2% - minimum payment of the own resource and larger proportion of the payment is executed by some managers or not),
- f the principle of exercising voting rights (whether or not it is related to the payment of own resource or the general assembly of the ESOP Organization is securing management dominance)

## II. Obtaining property, the tender

*20 Does the ESOP organizing committee have any opportunity to make a purchase proposal to the state asset manager without a tender?*

The ESOP organizing committee has the right, as anybody else, to submit a purchase proposal to the State Trustee Organisation. With this proposal the ESOP organizing committee only indicates its intention of purchase for the property shares, and this indication must be accepted by the State Trustee Organization. But the acceptance of the indication does not mean the acceptance of the offer. The so called "Tender Procedure Order" mandatory for the SPA and for its counsellors regulate, that state assets sales may only be affected by a public tender. In case of the SPA and its counsellors acquittal can only be granted by the Board of Directors of the SPA should it be a closed, i.e. invitation for tender based on competitive offer invitations, or a sale without a tender.

*21 Is there a chance that the SPA will accept the purchase proposal of the ESOP organizing committee, and the ESOP organization will become a buyer without entering a tender?*

The SPA has the right to sell state assets to the ESOP organisation according to Article 76 section (4) paragraph a) of the 1992 LIV Law concerning the sale, utilization and protection of the assets by the SPA, which assets are temporarily in the ownership of the state. This paragraph says

(4) The regulations of (1) need not be applied

- a) if the State Property Agency sells state assets to employees in the extent regulated in the Guidelines and according to the stipulations of the 1992 XLIV Act on the Employee Share Ownership Plan Above this extent the employees may acquire state property in a similar way to other external investors

Guidelines means here the Resolution of the Parliament named Property Policy Guidelines The (1) paragraph mentioned in the quotation is the following

Article 76 (1) The sale management, rent and the assignment of all these are made through tenders

SPA in its practice formed according to the "Tender Procedure Order" used this opportunity only in special cases - after the approval of the Board of Directors However this does not completely rule out the possibility of such a request, as there may be a change in the practice of the SPA, and rarely though, but there have been exception It is not probable that the SPA or its counsellors accept the purchase offer of the ESOP organizing committee for the majority of property shares without a tender, even if the purchase price and other purchase conditions should be acceptable Thus the ESOP organizing committee must be prepared for a tender

Tenders are not invited in the case, when the SPA or its counsellor has sold a company's majority shares, and the remaining minority property shares - and by the force of the above mentioned law - are sold to the ESOP organisation without a tender Besides the corresponding sale and purchase intention the acceptance of the ESOP organisation as partner by the majority share owner is of course also needed The acceptance or rejection of an offer may have several reasons These reasons are listed and explained in the answer to question 44

*22 Is it possible for the employees to obtain property in an ESOP organization even if the majority of the company's property shares had been sold already by the state assets organization?*

Of course there is a possibility for this, especially if the mode and direction of the sale of the property shares in the ownership of the State Trustee Organisation has not been defined yet by a decision or agreement

It may occur, that the State Trustee Organisation saves the minority share property or a part of it for the conversion to compensation coupons, for the Small Investor Share Purchase Program, in case of agriculture or food industry for the purchase to producers, for the preferential sale to employees according to the Property Policy Guidelines or for other purposes

It may occur, that the majority investor stipulates or gets a purchase opportunity, so

called option in the sales contract or in its supplementary agreement for the reserved but for the reserved and not purchasable property shares. In such a case - if the ESOP organisation has not been formed previously - an ESOP is only possible if the majority investor renounces its option in favor of the ESOP organizing committee.

A further obstacle in the way of the ESOP obtaining property - even if the State Trustee Organization would readily accept the purchase offer of the organizing committee - is when the investors who had already obtained property are entitled to the right of first refusal. In case of an incorporation this is guaranteed by a special agreement, in case of an Ltd the partners - the members of the Ltd - this is stipulated by the regulations of the corporation law. In case of such an event, any other owner besides the State Trustee Organisation may accept the purchase offer of the organizing committee and, if he is willing, he may be the buyer instead of the ESOP at the same price.

The investor with majority ownership may prevent the success of an ESOP initiative in other ways too. As the majority owner he has or may have decisive vote, and may control the general assembly (in case of an LTD the shareholders meeting) of the employer company whether to approve the forming of the ESOP organization or not [Article 3 section (3)]. This resolution of the general assembly (shareholders meeting) requiring majority vote is only probable, if the company's majority owners (others than the State Trustee Organisation) have an interest in the implementation of an ESOP or at least they are not antagonistic to it.

That is why it is important when the owners (members of the company) approve the foundation of an ESOP organisation. If for example the State Trustee Organisation as majority owner approves the foundation of the ESOP organization at the company's general assembly (shareholders meeting) before selling the majority of property shares [Article 3 section (3)], than the members of the company (shareholders) may not exercise their right of first refusal - based on the regulations of the corporation law or a contract (eg statutes of the company) - with regard to the property shares offered to the Organisation [Article 3 section (4)]. This means that the State Trustee Organisation may sell the property shares in his ownership to the ESOP organisation after selling his majority ownership, even if any of the partner owners should be entitled to the right of first refusal. But the condition of this is the approval of the foundation of the ESOP organisation before the sale of the majority property. Is it possible for the majority owner to prevent the ESOP from becoming owner although the organisation has been established? (See question 18.)

From the point of view of the other owners (members) of the company the implementation of an ESOP - besides the several, mostly medium and long term positive effects - may have drawbacks too, which make the owners antagonistic towards the ESOP initiative. This topic is handled in detail in question 44.

*23 Is it necessary to submit a tender bid even if the state asset manager had already sold the majority of the company's property shares?*

Not in every case. If the State Trustee Organization has property shares to purchase as mentioned in question 22 or above those factors, then it is worth to submit an ESOP purchase proposal to the State Trustee Organization, which can accept it without a tender. Besides the authorization of the law [1992 LIV Act Article 76 section (4)] the State Trustee Organization has this opportunity, because at the sale of the majority of the shares the purchase price rate is established, and to this the ESOP organizing committee may tailor its own proposal. The purchase price proposal has to be duly deliberated, as the investors mostly pay a higher price for the majority property as for the minority. This criteria must be understood by the ESOP organizing committee when drawing up their bid and at the later price negotiations.

*24 What resources can the ESOP organization utilize in order to pay the purchase price in case of purchasing property shares from a State Trustee Organization?*

As the ESOP organization cannot undertake any business action it cannot have any own financial resources. Thus it can pay with the cash payments and/or compensation coupons given by the participants as own resource, or with money from other external financial resources given by non-participants. These external resources may be

- the preferential bank loans provided for the purchase of property shares in the possession of the state (let us call this loan ESOP loan hereafter), the interest rate of which is always equal to the interest rate of the E-loan [Article 15 section (1)],
- the State Trustee Organization as vendor, who may permit instalment payment [Article 14 section (1)],
- the preference given by the State Trustee Organization following the current regulations of the Property Policy Guidelines at the expense of the state assets,
- the employer company itself,
- the bank loan of banks

The interest of the ESOP loan - following the currently valid interest rate of the E-loan - is 3%, for which the commercial banks may charge a maximum interest margin of 4%. The term of the ESOP loan is 15 years, from which the first 3 years period is a grace period ([Article 14 section (5)] of the ESOP Law was amended by the 1993 XLIII Act which came in force on 12 May, 1993). During the grace period the repayment of the loan does not have to be fulfilled, but interest payment must be performed.

Of course the ESOP organization may receive resources in the form of donations from anybody.

*25 Can the ESOP organization make use of the preference offered by the state assets management organization against state assets according to the regulations of the Property Policy Guidelines?*

Yes, the allowance, supporting employee ownership, can be obtained by the ESOP, in a form of price rebate. The Asset Policy Principles (hereafter referred to as APP) for 1992 come to existence as a Parliament Resolution No. 71/1992. The APP for 1992 was not in effect as of January 1, 1993 (and the APP for 1993 was not approved by the Parliament until the draft had been finished) but its resolutions are applied by the State Trustee Organization. The adjusted APP has been presented by the Government to the Parliament, but these adjustments do not effect employee allowances. The APP mentions the ESOP twice under Point 5.

It states that

Forms of allowances for employees and companies established by them, furthermore for ESOP Organizations, are treated by the Trustee organizations on the basis of the same principle and regard the different allowances as a whole.

It also states that

the Trustee Organization of the state is authorized to grant price rebate and to allow payment by instalments allowance to employees up to the 50% of the sale price. In case of payment by instalments of the reduced price - except of a sale within the framework of ESOP which is subject to the new Law on ESOP - interest is payable. The rate of interest is equivalent with the interest rate of the privatization loan ("E-loan"). For settling the payment of the reduced price, privatization loan ("E-loan") can also be used.

The allowance, in general, as per the current practice, can be granted in the event of the privatization of the employer company. The following statements characterize the above mentioned allowance with respect to the maximum amount and the limits:

1. the amount does not exceed 10% of the own resource, but in most cases 10% of the price paid by the employee, projected to the total registered capital (this is the price, the investor would be required to pay if he'd buy the whole company), or rather the amount which equals to the one person's 12-month gross salary. The lower amount gives the basis of determination.

2. if 10% of the own resource (in practice, the smaller amount, namely the price projected to the total registered capital, is regarded) do not reach the 12-month gross salary - with a justified request - the state trustee organization may increase the allowance compared to the own resource (to the price projected to the total registered capital) from 10% to 15%.

3 If within the framework of the "allowance purchase program - as its was stated before that the beneficiary of the allowance can also be the ESOP Organization - not all of the employees participate. The amount of the allowance has to be determined with respect of the number or with respect of the participating employees, in proportion with the total number of employees (If only 60% of the employees intend to participate in the ESOP, the allowance can only be 60% of the above calculated )

4 The allowance can be granted at a later date for those too, who have not requested it at the beginning

The ESOP Organization (and the ESOP Organization Committee, if the Organization is not yet established) is entitled to require in its tender or bid either that the calculated amount of the allowances be deducted from price, offered in the tender or bid of the ESOP, (or agreed in price talks), or may also request, that the portion of the shares, representing equivalent value with the acquired allowance, immediately after signature of the Contract of Sale be registered as the property of the Organization without providing the counter value

*26 Should the preference offered by the state assets management organization against state assets according to the regulations of the Property Policy Guidelines be used individually or through the ESOP organization?*

As a general advice, it can be said that employees in the interest of an earlier acquisition of ownership rights, which are free from restrictions, should endeavor to utilize the allowances, individually, if they meet those requirements individually which govern the payment of the reduced purchase price, and which are stipulated in the APP

1 the calculated price, which can be diminished by up to 50% of the price paid by the investor, can be paid off in instalments within 3 years, with such a method, that upon signature of the Contract of Sale, 25% of the reduced price is payable in cash and,

2 the interest rate on the remaining sum will equal to the interest rate on the privatization loan ("E loan"),

3 or for the settlement of the reduced price, privatization loan ("E loan") can be requested individually,

4 the reduced price can be settled with compensation bonds, as the SPA according to its current practice - accepts compensation bonds

As an alternative possibility, after transformation or privatization, the allowance can be utilized for the purchase of employee shares on reduced price (the price reduction can be up to 90% of the face value) provided that for this sufficient funds

are available and the State Trustee Organization decides to issue employee shares and chooses the increase of the capital on the account of those sufficient funds

The increase of the capital, in case of companies, which were transformed in accordance with Act 12 of 1988 into self-governing enterprises (governed by the Company Board, the General Assembly, and the Delegates' Meeting), can be financed from that 20%, which is returnable by the State trustee organization to the enterprise. In this case, employee shares should be issued. Depending on the actual method of transformation or privatization, there are several versions for this (which are not always beneficial for employees), but present chapter does not go into details

Besides the advantages of utilization of allowances in the form of purchasing employee shares (e.g. the price can be 10% of the face value), there are disadvantages - which are also beyond the scope of this chapter

*27 May any price reduction deriving from the regulations of the law other than the preference according to the regulations of the Property Policy Guidelines be used in case of a purchase through the ESOP?*

As a general rule No, it may not

Before laws on privatization (Acts LIII, LIV and LV of 1992) came into force on August 27 1992, the effective Law on Transformation [Act XII of 1989, Article 21, section (1)] stipulated that the State trustee organization is obliged to transmit 20% of the income resulting from the privatization of the property shares of the given company to the enterprise, provided that the enterprise was transformed into an enterprise from a self-governing company. This amount should form the base for the obligation that the enterprise is compelled to issue employee shares parallel with the increase of the capital

This latter step can only be executed by companies limited by shares, as law prescribes. Since the source for transmission of 20% of the purchase price - in the event of purchase with "existence Loan" - does not exist, that practice took shape, that the buyer, being the majority owner of the enterprise, waives the amount and endeavors to assert a part of it as price allowance

The obligation of the State trustee organization for the transmission of this amount, unfortunately does not exist, because the above mentioned resolution of the Law on Transformation should not apply to ESOP [3 §]. The word "should not apply" does not mean "does not apply", so the enterprise is allowed to endeavor to attain the transmission of the 20% of the income. The State trustee organization probably will only be ready to do so upon the amount in question appears in cash as income from privatization

28 *What resources can ESOP use to pay the purchase price if it is not purchasing directly from the state assets managing company?*

The ESOP-loan with favorable interest rate and maturity can only be applied for, if the ESOP Organization executes the purchase directly from the State trustee organization. Otherwise, the price and terms of payment entirely depend upon the agreement between the seller and the ESOP Organization, namely, whether the seller

- allows payment by instalments and if yes, with what grace period,
- requires own resource and if yes, in what proportion and with what allowances,
- in case of payment by instalments, what securities should be provided

Upon payment in ready cash, in general only bank loan can be required with standard conditions

If the seller of the property share of the employer enterprise is a state owned company or an enterprise with majority ownership of State trustee organization in it, then the State trustee organization as the owner - has its interest in this indirect privatization, decentralization - can influence the decision of the enterprise (company) via the governing bodies. In the event of an indirect purchase, it is therefore reasonable not only to see the enterprise (company) but the previous majority owner - the State trustee organization.

29 *Can an ESOP Organization obtain loan if the owner of the employer company is a state owned company or a partially or fully state owned enterprise, in other words the seller is not the state asset manager?*

No, it can not get. As the Law on ESOP prescribes -- similarly to the Existence Loan - the condition for obtaining the ESOP loan on favorable terms is that the part of the purchase price paid off from the granted loan on favorable terms, should directly appear at the State trustee organization. This income has to be fully utilized to diminish the state debt [15 § (1)]

30 *Under what conditions can the state assets manager allow the ESOP organization instalment payment?*

With respect of payment by instalments the Law on ESOP has its resolutions but the State trustee organization might also have its rules. Upon sale of the property share owned by the State trustee organization by instalments, the interest rate - except of the interest margin -, applied, equals to the interest rate on the ESOP Loan (see Question 24) [15 § (1)]. There is no rule governing the interest margin on the ESOP Loan. It is solely dependent on the agreement between the parties. This interest margin, however, remains under the 4% (as prescribed in the government resolution) interest margin on the Existence Loan.

The precondition of payment by instalments is that the ESOP Organization must have its own financial resource. Maturity and the grace period are the same as for the ESOP Loan. The guarantor obligation of the Organization (see Questions 44 and 52), the right of pledge (see Question 77) and the obligation to payment by instalments of the dividend (see Question 77) is applicable in case of payment by instalments.

A detailed list on conditions of payment by instalments (e.g., the necessary guarantees) and preprinted forms are being edited by the State Property Agency and the State Asset Management Co. Ltd. and hopefully will be available in the near future.

Revenue of the State trustee organization from payment by instalments has not to be spent on diminishing state debts.

At this point, word of the Law on ESOP seems to be contradictory so that it requires qualification. [15 § (2)] of the Law on ESOP stipulates "The conditions of sale on payment by instalments of the property shares owned by the State Trustee Organization are the same as the ones stated in section (1) except of the interest margin." Consequently, there is a clear reference to interest. This is what [15 § (1)] stipulates "The interest rate of the credit provided for the purchase of the property shares of the State Trustee Organization must always equal to the interest rate of the privatization loan (E - Loan).

Furthermore section (1) goes on "The State trustee organization must spend all its proceeds financed by credit facilities on diminishing state debt." This can be explained so that the State trustee organization must spend all revenue from payment by instalments on diminishing state debt. As [15 § (1)] clearly mentions "proceeds financed by credit facilities" and the reference in section (2) to section (1) mentions interest, I personally agree with the interpretation, which says that revenue of the State trustee organization from payment by instalments not be spent on diminishing state debts.

This interpretation is important, because the decision of the State trustee organization can probably be favorably modified if it can expect revenue in cash - even if it is received in instalments.

*31 What is the minimum own cash requirement for the ESOP organization to obtain property share?*

As the ESOP Loan stipulates, a precondition of payment by instalments a qualification for ESOP Loan is that the ESOP Organization must have its own financial resource. The amount of own financial resource depends on the value of the total price of the property share, purchased by an ESOP Organization, divided by the number of participants. If this per head average is under HUF 5 million, the

proportion of the own financial resource is 2% If the average exceeds HUF 5 million per participants, the proportion of the own financial resource is HUF 100 000 -, plus a 15 % of the amount over HUF 5 million (in accordance with [14 § (4)] of the ESOP Loan and the Act XLII of 1993 that adjusted the above referred [14 § (4)] on May 12 1993 )

The amount of own financial resource, payable by the Organization is determined by the per head value of the price of the property share [14 § (4)] and price - stripes The calculation is easy in case of the amount is under HUF 5 million Then the amount of own financial resource will equal with 2% of the total purchase price [14 § (4)] regardless the number of participants in the Organization

If this price is equal with or over HUF 5 million - and this will hopefully occur on rare occasions - the proportion of the own financial resource will have to be HUF 100 000 - + 15 % of the amount over HUF 5 million (in accordance with [14 § (4)] of the ESOP Loan and the Act XLII of 1993 that adjusted the above referred [14 § (4)] on May 12 1993 )

The result of adding the sums up then multiplied by the number of participants in the Organization gives the total amount of own financial resource The reason for this is that the only way to get the total amount of own financial resource if the amount calculated on the basis of price - stripe projected to the whole Organization As the Law on ESOP describes "The amount of own resource - taken as a function of the purchase price of the property per participant - is to be determined by the projection to the property share purchased by the Organization [14 § (4)]

*32 Is it sufficient if the ESOP organization possesses the minimum own resource stipulated in the law?*

The amount of own financial resource discussed under Question 31 is the precondition of obtaining credit and paying by instalments However, the ESOP Organization may be required to pay a larger sum - a sum defined in percentage of the purchase price - in order to submit an acceptable bid or to have the chance for winning the tender

The state trustee organizations usually demand deposit in cash that might as well exceed 2% of the proposed purchase price If the Trustee organization is not satisfied by the ESOP Organization places the deposit at the bank, which is to grant credit but requests to have the deposit be placed with its own account, the bidder also has to place the amount, which is the precondition of the bank for qualification for credit, with the bank

An additional difficulty for the bidding ESOP Organization is if the employer company belongs into the category of the first, second or third phase of the simplified privatization (self - privatization) Should this occur, the practice and provisions of the overall contract between the State Property Agency and the

advisor, the advisor is entitled to practice its right to demand the fee paid by the State Property Agency for its services, be paid as cost of privatization in cash

This is the reason why tenders on self-privatization determine the amount that is payable as cost of privatization in cash, and what proportion of this is considered as deposit. Cost of privatization generally exceeds the amount of own financial resource that is, as the relevant law stipulates, required as the precondition of credit to be granted and payment by instalments and which can be paid with compensation bond. The cost of privatization -- assuming that the ESOP Organization intends to bid and won the tender -- has to be obtained in cash from whatever resource possible.

A main feature of ESOP is that own resource should not be provided personally by participants but on ESOP Organization level. It is the Organization that has to have it presented and paid. This amount, nevertheless, has to be collected by the participating individuals if it can not be financed from any other fund, usually in the form of advance payment by the company.

This is why, the deed of association of the ESOP Organization may prescribe personal (individual) contribution obligation as a condition of entitlement for a quota from the dividable property shares but not as a condition of participation (see points 46 - 49). This contribution per person, sometimes can be so high, - as a result of the deposit and cost of privatization, as discussed earlier - that it can not be financed without external assistance, support.

However, the Law on ESOP allows that support be provided by external natural person or legal entity - or by the organization itself - for the ESOP Organization. Other rules govern the division and ownership of property shares paid from this support and others govern rules on property shares, which are paid from payment by individuals [18 § (6)] (See Question 34 for more details.)

*33 What regulations apply to the utilization of compensation coupons in an ESOP?  
Can the ESOP organization pay its own resource with compensation coupons?*

If the sale is conducted by the State trustee organization, compensation coupons are to be considered at par value - which means par value plus interest in accordance with the law on compensation - and regarded as own financial resource, when obtaining credit and instalment payment facilities. This means that own financial resource, payable by the ESOP Organization - as discussed under Question 31 - can be provided by the participants in compensation coupons, which are received by them either from the state, or from members of their family or purchased on the secondary market.

Furthermore, the ESOP Organization, as well as the ESOP Organization Committee is also entitled to purchase compensation coupons, financed from own resource contributions of participants in cash. However the best timing to execute this is

upon winning the tender

An ESOP Organization is allowed to apply compensation coupons as described above, as own resource. Nevertheless a tender may have disadvantageous requirements - e.g. the prescription that deposit and/or cost of privatization is payable in cash. In other cases, tenders often require the settlement of the purchase price in compensation coupons as a precondition for winning the tender. It is always the content of the tender, which is to be taken into consideration if compensation coupons wanted to be used.

*34 Is the employer company entitled to pay the own resource on behalf of the ESOP Organization?*

The Law on ESOP allows that support be provided by external natural person or legal entity - or by the organization itself - for the ESOP Organization. If it can not be fully accomplished, the equivalent of the property shares remaining in ownership of the Organization must be registered on the share accounts in the same proportion [18 § (6)]

A part of, or all of the own resource can be advanced by the employer company to the ESOP Organization. Then a balance should be reached after use of the amount, upon establishment of the ESOP Organization. The amount in advance and settling the balance is important for the following reason: should the employer company provide more support to the ESOP Organization that is over the non-taxable limit [26 § (4), (5)], it will be obliged to pay revenue tax on the support. The sum that is paid in advance is considered as a loan, and so that, the same rules govern the purchase of property shares financed from it, as govern the purchase from loan or payment by instalments. (See Question 93)

If the support for the own resource is financed on the account of profit reserve of the organization in the form of ultimate asset transfer, participants are obliged to make provisions in the deed of association of the ESOP Organization freely on the ownership and possession of property shares purchased from this source. Property shares purchased from this source should remain constantly in the ownership of the ESOP Organization to enable it to exercise its right of pre-emption, which can be financed from the dividend of these property shares. (See Questions 69 -70)

*35 Who is authorized to complete the feasibility study? What information should it contain?*

The ESOP Organization Committee has to have the feasibility study prepared [18 § (6)]. This means that the study has to be completed by someone else but the ESOP Organization, possessing a commission by it. The person, completing the study can be an independent external expert or advisor or even an employee of the organization. What is important, is that the study should be professional and answer all those questions, prescribed by the law, required by the bank granting the credit,

as well as are relevant and important from the essence of success of the ESOP

The feasibility study has to contain - based on the agreement between the seller and the creditor (or if such agreement does not exist, then based on the would - be content of it) the following information

- the extend of ownership,
- in case of a company limited by shares the face value of the shares, which enable to realize the program,
- whether the financial position of the company, profitability and the expected profit will make repayment of the credit, or execution of payment by instalments and the interest possible,
- what kind of market (business) strategy and business plan is the guarantee for instalment payment

The feasibility study should not be done exclusively for the appointees of the ESOP Organization Committee, in other words for at least 25% of the employees

A version of it has to be provided to the owner(s) of the employer company, whose contribution at the general assembly is required as a condition of establishment of the ESOP Organization. As these owners are the seller, whose interest is to increase the purchase price, the version of the feasibility study provided to them should merely show whether the program can be realized or not, but not the detailed calculation on profitability and the itemized business plan

However, the bank, granting the credit, should be furnished with these latter documents and calculations, furthermore with the list of orders, data on turnover and several other pieces of information. It provides the reason, why different versions of the feasibility study should be prepared

*36 Is the employer company is obliged to provide the necessary data for completion of the feasibility study?*

The company is obliged to provide the required data for the preparation of the study [2 § (4)] However should it not happen, the crucial questions are, what remedy to resort to and when? Due to the slow proceedings of the Court, the action to protest at interest defense organizations and at the representatives of the owner(s) is the most expedient

*37 Who is to finance the costs of completion of the feasibility study?*

Upon establishment of the Organization, the expenses connected to the preparation of the feasibility study will be born by the Company [2 § (4)] This means that the company is obliged to pay upon establishment of the Organization. That is of certain that the company is allowed to cover these expenses in advance, at its own initiative. Should this not happen, participants of the ESOP have to finance it from

then pocket

*38 When - how many days before the tender - should the organizing committee submit a loan application to the bank(s)?*

After the establishment of the ESOP Organization Committee, upon preparation of the first version of the feasibility study the application has to be submitted as soon as possible. Different banks demand different information to evaluate an application and usually, there is a long discussion process prior to judgment. Banks have to make their decision within 30 days but if the guarantee by the Credit Guarantee Ltd is requested, this period will be 15 days longer.

The law on ESOP prescribes "if during the process of sale of assets by the State trustee organization, there exists the possibility for the utilization of an Existence Loan" and allows payment by instalments" the deadline for the application for the sale of assets may not be less than 35 days" [2 § (2)]. The State Property Agency prescribes a 45-day-deadline - because of the period in which the credit guarantee can be obtained. Credit application evaluation has to be within the 45-day-deadline. This is the reason to enter into connection with the bank urgently.

*39 What information should the application for ESOP Loan contain?*

First of all, the ESOP Organization Committee has to prove that it was commissioned in accordance with the law (If the ESOP Organization has already have its founding meeting, all the documents and the judge's order verifying it has to be submitted )

In addition to this

- the Organization Committee has to have a feasibility study prepared. Its professional substantiates and the reality for repayment of the ESOP Loan has to be verified by the signature of the executive body of the Company. The study has to give information on assumable revenues of the ESOP Organization that would make repayment of the loan and the interest of this loan possible.

- In the event of evaluation outside of the framework of the tender, the agreement with the State trustee organization on the conditions of sale of the property shares has to be attached.

- There are several banks, which require a written statement, in which they request Organization Committee to undertake joint and several liability for any future liabilities of the Organization - over the granted mortgage and organizational guarantees, stipulated in the Law on ESOP - and the list of mortgage the Committee offers.

- The Organization committee has to submit all documents relating to the establishment of the Company, (or of the separated structural organization) to the financial position, and to the management of the Company (e.g., documents of title, buyers, suppliers, loans) which are to be provided by the State trustee organization or its representative

*40 What are the documents needed for the evaluation of a loan application and for granting a loan promissory note?*

Commercial banks request the following documents to be provided by an ESOP Organization Committee, on the basis of the procedure of evaluation of applications for "Existence Loan" and for payment by instalments - which was approved by the Ministry of Finance, The State Property Agency, the Hungarian National Bank, the Association of Banks and the "OKFI" The list - which may vary from bank to bank - is the following

- A written commission of the ESOP Organization Committee, the resolution of the Court proving registration of the ESOP Organization (or the Minute of the Founding Meeting proving that at least 40% of the employees of the company approved the establishment and the overall rules and regulations governing the Organization)
- In the event of evaluation outside of the framework of the tender, the agreement with the State trustee organization that states the price (or other conditions of sale of the property and auxiliary services, if any)
- The feasibility study, approved and signed by the executive body of the Company (or by the separated organizational units)

The study has to contain a business plan (covering the period up until the maturity of the loan but for at least for 3 years), including development of production profiles, lay-off necessary investments and operational conditions. If needed, it should 1) contain a plan for crisis management, 2) evaluate future market conditions (demand, supplies, competition), 3) prepare a cash-flow statement in order to demonstrate that the future financial position will enable the repayment of credit and the interest, 4) and the purchase price and ownership proportion of the program

#### Documents in relation with transformation

- a detailed asset evaluation and the extract of the balance sheet at transformation,
- a certified copy of the Deed of Association of the Company,
- a certified copy of the resolution on registration by the Court

All the relevant documents with respect of operation of the company

- a certified balance sheet based on the last trail balance as well as balance sheets for the previous 3 years,
- accounts payable and receivable (bad debts on a separate list),
- inventory of fixed assets,
- a statement of invested assets (ownership title documents),
- copies of effective financial contracts, credit contracts, financial contracts of assets received, and copies of other obligations, (e g bill guarantees)

Guarantees securing the credit, documents on possible guarantees

- a written statement on undertaking guarantor activity of the Organization, in case of a company has not yet been transformed or in case of separated structural units are becoming independent, the commission of the State trustee organization allowing the statement be made if the Organization gets established,
- possible bank guarantee contracts (drafts),
- a request to the Credit Guarantee Co to undertake guarantee of payment at first call,
- documents of title,
- securities, guarantees of payment at first call

Other documents to be provided as requested in accordance with the internal regulations of the bank

With respect of the written statement on undertaking guarantor activity a note has to be made the Organization - if gets established - is liable as stipulated by the Law on ESOP as a guarantor for all liabilities of the ESOP Organization, if there are no other guarantees exceeding the value of the mortgage on the property shares (e g the guarantee of the Credit Guarantee Ltd ) So there would be no need for such a guarantor obligation upon establishment of the Organization

#### *41 What information does the credit promissory note contain?*

The credit promissory note is a promissory note made out by a financial institution to the bidder of a tender that is invited by (or of a sales offer made by) the State trustee organization for the purchase of property shares of an asset, it intends to sell

The credit promissory note contains

- information on the bidder, applying for a loan,
- name and description of the property share (stock, business share) for which the financial institution is willing to grant credit,
- the maximum purchase price, should the actual price exceed this agreed

maximum level, credit and payment by instalments facilities can not be utilized (This can also be agreed and accepted under a separate agreement ),

- a certificate, acknowledging the payment of the own resource,
- other conditions (e g on guarantees) of the financial institution in connection with the credit

If a formerly state owned Company intends to transform or if - upon request by the Organizational committee - the State trustee organization intends to transform the separated structural unit into an Organization, the financial institution will only issue a conditional promissory note This means, that obligations under the promissory note are binding if a statement for undertaking guarantor activity of the new organization (contribution to establish the ESOP Organization and a document proving the registration of the ESOP Organization Committee) is available and all the requirements - as stipulated on the promissory note are fulfilled

*42 What coverage may there be for obtaining the ESOP loan and company instalment payments? Who are the guarantors?*

The financial institution, granting credit or payment by instalments for the purchase of property shares and the State trustee organization allowing payment by instalments is entitled to assert the right of mortgage over the property shares, regardless of the fact whether the purchased property shares, are still owned by the Organization or by participants Mortgage on property shares of pensioners or of successors who passed away in the meantime, will be abolished If there are no other securities beside mortgage, the Organization will be liable for all the loans, obtained by the ESOP Organization and for payment by instalments

On the list of securities, the guarantee by the Credit Guarantee Ltd is on the top, which - within certain limits (detailed under Question 43) - can be regarded as joint and several liability

However, a number of financial institutions are not satisfied by the mortgage on the property shares of the ESOP Organization or of participants - guaranteed by the Law on ESOP - (which is sometimes accompanied by caution money) or by the guarantee of the Credit Guarantee Ltd , but for qualification for the loan demand the joint and several liability of the Organization, and mortgage being registered on real estate,

The Organization is liable for all liabilities of the Organization to the extend of all assets and equities Participants of the Organization are not liable for such liabilities with their private property - except of those property shares and the dividend on them) which were bought by the Organization for credit or for payment by instalments and of which ownership was transferred to participants for payment by instalments

*43 May the ESOP Organization obtain the guarantee provided by the Credit Guarantee Co on ESOP loan?*

That is of certain that the ESOP Organization can obtain the guarantee of the Credit Guarantee Ltd on ESOP loan from the Credit Guarantee Co which offers joint and several liability for loans granted by 25 banks and specialized financial institutions and 40 saving associations. The guarantee must not exceed 80% of the amount of credit plus interest and charges, as stipulated in the contract, or HUF 100 million. The restriction on the number of full time employed staff, which must not be more than 300 - at the time, when the credit is granted - does not apply for ESOP Organizations.

Services of the Credit Guarantee Co can be requested by an ESOP Organization in case of lack of funds at the time of application for credit and processing this application by the bank. This fact will be verified by the financial institution. Credit guarantee request forms are available at the relevant 65 financial institutions.

The form consists of two parts:

Part 1 - the qualification of the overall credit undertaking - is filled in by the financial institution,

Part 2 - statement of client - is filled in by the Organization. The latter part basically deals with the application for services and it is an acknowledgment of fees and charges payable, furthermore a statement on qualification for the conditions stated by the rules and regulations of the Credit Guarantee Co.

The decision on qualification for credit guarantee is made within 15 working days. The charge, payable, is 1% of the amount of guarantee. In case of disqualification the Credit Guarantee Co returns the half of the 1% to the applicant. The condition to start the qualification process is to enclose the copy of the document of the bank transfer to the request form. The Ltd evaluates the risks of the credit guarantee, with special attention to market conditions, liquidity, professional experience of the management, available sources for operation.

This is the reason, why it is advisable to detail in the business plan - besides introduction of the opportunities for repayment of the ESOP loan - sources for development and financing current assets. A condition of undertaking the guarantee by the ESOP Organization is that the Organization be the guarantor - as stipulated by the Law on ESOP and discussed under Question 44 - and the attachment of the draft of the articles of association or the approved articles of association.

A favorable decision on the credit guarantee request is likely to be made, if

- the operation of the Company is balanced (and the financial institution ranked it as first class debtor,

- the required amount of guarantee does not reach 80% (but remains around 50 -60%),
- the value of securities required by the financial institution or offered by the Organization reach the amount of the loan and are easy to mobilize, so that provide opportunity for the Ltd to minimize its loss in case of joint and several liability is has to be utilized,
- the amount of own resource exceed the legally prescribed minimum amount
- the management is also among the participants

*++ What obligations does an ESOP organization mean and what benefits result from an ESOP organization for the company where one has been established? Why would it be the interest of the other owners of the company to encourage such an initiative?*

The part of the public, which is generally sensible for negative preconceptions even if it is not aware of the domestic and foreign practice of the ESOP, by reading the Law on ESOP might get convinced that the ESOP Organization by obtaining a part of the property shares can only negatively influence the company Why?

- 1 Once the employer company contributed to the establishment of the ESOP Organization, it will be responsible as a guarantor for repaying the credit and for competition of the payment by instalment [2 § (4)] Certain banks are not satisfied by this undertaking guarantor activity and the ban on alienation and the right of pledge - guaranteed by the Law on ESOP [19 § (1)], but demand guarantee of payment at first call, mortgage, and depositing the property shares obtained by the utilization of the loan or sometimes by the own resource Joint and several liability and mortgage will narrow the space for action, which will make financing and liquidity difficult to achieve However this statement is not only valid for the ESOP but for all cases, in which property was purchased mainly by the utilization of loan (E loan)
- 2 The second argument is that the in spite of the authorization of the Organization to transmit funds from before - tax profit to the ESOP [26 § (4) - (5)] but this amount diminished funds available for development and dividend after taxation This virtually causes damage for the other owners but the ESOP, which is allowed to pay instalments from the non--taxed donation, whereas the Organization is still obliged for joint and several liability

- 3 By the fact that the ESOP-Organization becomes an owner, which has not only insight into the business deals of the Organization and able to defend its interest as an owner, but, it is able to put pressure by its participants, who might be the employees

An argument against these declarations can be that employees, who have direct interest in the success of the business, in the increase of the assets of the Organization and who are - to achieve all of these - ready keep back their demand for wage increase - represent such a value for the management and for the other owners, which will worth facing the disadvantages, outlined above

Funds transferred, before taxation, for competition of repayment and payment by instalments obligations are more favorable for the Organization with respect of cash - flow than should these amounts be paid exclusively from dividend Methods, to balance the advantage of the ESOP Organization with regard to the fact that it acquires a sum from the after - tax - profit to can be found (the issue of special stocks, dividend preferences etc ) However, the emphasis is on the mutual interest of the of the employees, notwithstanding compensations, which targets the success of the company

Interest of the employees, indeed, prevails only in favorable conditions and indirectly if the cooperation of the owner - employee is provoked by the structure of the whole (or parts of the) Organization However this demands a deliberate structure-building and -operational conception, furthermore practice of the management, which is accomplished slowly

Well it is advisable for the management of an Organization, which is partly owned by the ESOP, to take into account that the ESOP is not only a way for employees to obtain property, and not only a burden for the management but also a mean for the venture to be successful, and the utilization of this source solely depends on them

### **III. Participants**

#### *45 Who can participate in the ESOP during the preparatory period?*

During the preparatory phase of the ESOP everybody who is employed at a joint-stock company, a limited liability company (below as Company) or a state owned company registered in Hungary may participate [Article 1 section (1) and Article 1 section (5)] Exceptions are the financial institutes and the insurance companies, to which the ESOP law does not apply [Article 1 section (6)] The employment required for participation does not mean occupation as well, that is, it also includes those who are serving in the army and who are on a maternity leave But those are excluded, who have a mandate contract with the company or who have any other

connection (a legal connection with the purpose of fulfilling some work) with the company

If at least 25% of the above mentioned employees decide to obtain property shares in the employer company, or in the company formed of a state owned company or of one of its separate organizational units through the ESOP, they may appoint - or, if they wish to give a legal form to the initiative, they must appoint - a three member ESOP organizing committee for the preparatory tasks

The preparatory phase ends with the founding assembly of the ESOP organization, which all the employees of the company may attend. The support of 40% of the employees is needed for the establishment of the organization [Article 4 section (3)] But if an employee wants to participate in the ESOP, that is, he wants to become a participant of the ESOP organization, his vote in the question of the establishment of the ESOP organization is not enough. These conditions are treated in the answer to question 46

*46 Who are eligible to participate in the ESOP, and who can be the participant of the ESOP organization at the time of its establishment?*

An employee is eligible to participate in the ESOP, i.e. become a participant of the ESOP organization if the company employs him at least in half of the official working hours, and he has been employed at least for six months - including the service period at the company's legal predecessor. The statutes of the ESOP organization may stipulate a longer service period than six months as a condition of eligibility, but this period may not be longer than five years [Article 1 section (2)] Thus it is important that all the employees of the company should have the opportunity to look at the draft statutes, and to express their opinion about its contents, make proposals for amendments to the organizing committee of the ESOP at the founding assembly or even before that

*47 Do the eligible participants automatically become participants of the organization?*

To become a participant of the ESOP organization it is not sufficient to be eligible. A written statement about the willingness of the eligible to participate in the ESOP needs to be submitted to the organizing committee prior to the establishment of the organization or to the board of the organization after the establishment of the organization [Article 1 section (3)] Those employees, who are eligible to participate in the ESOP according to the accepted statutes, can waive their right only by a written statement [Article 1 section (2)]

*48 Can participation in the ESOP organization be denied an employee of the company who is eligible and who declared in writing his wish to become a participant?*

Participation cannot be denied from an employee, whose service period at the company reaches the time stipulated in the statutes, which had been accepted by the general assembly of the ESOP organization as the condition for eligibility, and who declared in writing his wish to participate [Article 1 section (1)-(2)] The ESOP organization can stipulate conditions in its Statutes, regarding who out of the eligible persons and in what extent may participate from the shares, after they have been released and ready to be allocated These stipulations are also valid for participants joining the organization after its establishment and for those, who were members right from the start

*49 Does an employee joining the organization after its establishment have any disadvantages?*

Joining the organization must be allowed, it is - as we could see in question 48 - the subjective right of the employee At the same time the law allows the possibility that participants joining the organization later may have certain disadvantages at the distribution of the property, i.e., participants, who paid the cash payment at the foundation of the organization may have proportionate advantages Although the ESOP law does not directly stipulate, that employees joining the organization later must receive a portion of the shares already paid off and thus freed up for allocation, the spirit and context of the law implies it The only aim and meaning of participation is to acquire property, and the basis of this may not be the amount of the own resource payment - a relatively small amount compared to the property purchased by the organization It should be rather the proportion of contribution to the profit, as the employer company's profit is mostly the only source for the fulfilment of the instalment obligations

The stipulations of the ESOP Law regarding the allocation of the property shares (see the answer to question 68 ) may include many conditions, but one should not forget the experience of foreign countries, which says, that if the majority of the employees are not participating in the organization and/or are not getting shares from the property, than there may be conflict among the different employee groups, which will affect the operation of the company, hinder its market success, and the commitment to its profitability (see question 44 ) Therefore such conditions are reasonable, regarding joining and allocation, which encourage the employees to join the organization and thus to become owners of the company

*50 Is it compulsory for all the employees of the company to become participants of the ESOP organization?*

Of course not but it is advisable First of all it is advisable because participation in the ESOP organization enables the acquisition of such property (shares or business

shares) and dividend-income, which non-participants do not get, which they may obtain under much less beneficial conditions. But participation is not only the employee's interest. The company should also aim at all its employees eligible becoming member of the ESOP. The interest to increase the company's property and revenue (the participants), and the interest only in compensation (non-participants) may result in such tension between employee groups, which damages the cooperation within the company.

*51 Can an employee remain participant of the ESOP organization if his employment terminates?*

No. Upon termination of employment, the Employee loses his right to participate in the ESOP [Article 1 section (4)]. This does not mean, that the employee loses everything in his ownership he obtained through the ESOP. He loses the right to acquire further shares after his termination. Upon termination the organization must settle accounts with the participant according to the ESOP Law and the Statutes of the organization.

*52 Are the participants of the ESOP organization responsible with their own income and/or private property for the liabilities of the organization?*

No, the participants are not responsible for the liabilities of the organization with their own property, as the organization is responsible for it with its entire property [Article 13]. This property is usually the value of the shares purchased by a loan or with instalment payment by the organization. So that the banks should, in spite of this give credit, and the vendors allow instalment payment, the law stipulates the mandatory warranty of the company in case of the establishment of an ESOP and if there are no guaranties other than the pledge (eg the guarantee of the Credit Guarantee Inc.)

Should there be lack of sufficient profit, the participants, in spite of the warranty (or the immediate paying guaranty and mortgage on individual real estates, assets of the company required by the bank), may be forced to make a decision in order to keep the company existing either they donate own resource payments to help the ESOP organization's instalment and interest payment, or they decide the termination of the organization to protect the company, which is their place of employment. In the latter case the banks are paid with the released and not yet released shares (business shares).

The decision of the participant to donate money for the instalment and interest payment from his own private income, may only be a voluntary decision. It is wise to include a regulation in the statutes or make a decision at the general assembly, which encourages the participants to make such a donation.

The interests of the creditor bank and, in case of instalment payment, the State Trustee Organization are protected by the right of pledge and alienation prohibition, which applies to the paid off and allocated property shares in the ownership of the

participants as well [Article 14 section (2) and Article 19 section (1)] Thus the participant is only responsible with the shares already paid off, allocated and transferred into his ownership [Article 13 and Article 19 section (1)], and with the dividend on these shares [Article 14 section (3)]

*53 Will the shares purchased through the ESOP become and remain in collective ownership or in private ownership? How will the property shares purchased by the ESOP organization be transferred into the ownership of the employees?*

The whole background theory of the ESOP Law is based on the concept, that the property purchased by the ESOP organization which had been established by the company's employees - and which organization is proceeding in its own name as an independent subject, but in the interest and favor of the participants as beneficiaries during the entire process of obtaining property -, should not remain collective property, but become as soon as possible the private property of individuals with all proprietary rights. It is a basic principle, that the shares, which can be credited to the share accounts of the participants or transferred into their ownership during the process of paying the purchase price or the instalment payments, should be allocated among the participants at the general assembly according to the statutes. The rules of the allocation are stipulated by the participants themselves within the frame of the ESOP Law.

The participants may, of course, decide to keep together part of the shares (business shares) which can be allocated to them, as a collective, but any time allocable property if it is reasonable. They have the exclusive decision making right. The main aim is to give property and connected rights to the participants as private entities. But depending on the resources utilized for the purchase of the shares and the repayment of the credit or the instalment payment there are different rules applying for the allocation and the proprietary rights. These are stipulated by the ESOP Law and the statutes of the ESOP organization. As you will see in the answers to questions 76 to 83 there are mandatory regulations stipulated by law regarding these questions, and there are regulations which may be decided by the statutes of the organisation or as a resolution of the general assembly of the ESOP.

#### **IV. The Statutes and the General Assembly**

*54 Why are the statutes of the ESOP organization important? Can the participants freely stipulate its regulations?*

The Statutes is the most important document of the ESOP organizations, it can be considered as a constitution. Article 9 of the ESOP Law enlists all items which the Statutes have to regulate but in many aspects it allows free interpretation of the

regulations This freedom, however, often makes the participants feel that they have a right to develop solutions, which do not coincide with the Statutes, but which is would not be in line with international practice It is not at all sure that all those solutions which are legal are useful and helpful for the ESOP organization/and or the employer company there are of course several alternatives, which are not against the law most probably local interests and pressure groups will decide the most appropriate ones

*55 What are the mandatory requirements of the ESOP Statutes?*

The Statutes of the Organization must specify the following

- a) name, objective, domicile of the Organization, and the name of the Company whose property shares were purchased by the Organization,
- b) name of the organization's representative,
- c) the mode of summoning the general assembly, its quorum, the procedure in case the general assembly does not reach its quorum, the mode and conditions of exercising voting rights,
- d) the number of members of the Executive Body, the mode of their election, their scope of authority, and the duration of their activity,
- e) the manner and amount of payments effected by the participants,
- f) the mode of transferring the property shares from the ownership of the Organization to the ownership of the participants, and the principle of their allocation,
- g) the rules for repurchasing the property shares which are already in possession of the participants, and the mode of exercising the right of first refusal in case of their sale,
- h) the mode of announcing decisions,
- i) the regulations concerning the affiliation of Employees with the Organization after its establishment,
- j) rights and responsibilities of the participants,
- k) the rules of alienating (selling) the property shares remaining in possession of the Organization after repayment of the credits and instalments,
- l) the principles of distribution of assets in case the Organization ceases to exist,

m) any thing which the participants which to regulate in the Statutes

*56 What is the role and scope of authority of the ESOP general assembly?*

The supreme body of the Organization is the general assembly, which consists of all the participants of the Organization

The following belongs to the exclusive scope of authority of the general assembly

- Establishment and modification of the Statutes,
- Determination of the annual budget,
- Election and recall of the Executive Body, and determination of the salary of its members,
- Approval of the annual report of the Executive Body,
- Determination of the extent of property shares transferred into the possession of the participants,
- Decision about the approval of the conditions of taking credit and of instalment payment and about everything which Statutes remit to the exclusive scope of authority of the general assembly

The above items are those which according to the law belong to the exclusive scope of authority of the organization. Apart from these the Statutes can give several other responsibilities to the organization such as

- determination of the roles and responsibilities of the Executive Body,
- approval of the Organization's basic regulations,
- appointment and approval of a Steering Committee,
- decision on selling or retaining shares repurchased by the Organization,
- giving orders to the representative of the organization how to exercise voting rights on the employer's assembly (what decision to take concerning the different agenda items),

*57 How often, when and how must the general assembly of the organization be summoned?*

The general assembly must be summoned as needed, but at least once a year. The general assembly must also be summoned if the court so orders or if one-third of the

members - or a smaller number of them specified in the Statutes - wishes to summon it while pointing out the reason and objective. The administrative body of the organization summons the general assembly is summoned by sending out written invitations. The invitation letter should contain the date, location and the agenda of the assembly. In addition to the original agenda indicated new agenda items can be discussed if all participants are present and agree unanimously.

The Statutes should also determine cases, when the Executive Body is obliged to summon the general assembly, for instance,

- if court, or the ESOP law in force or the Statutes require the Executive Body to summon it,
- if the organization cannot meet its payment obligations, or if this would endanger the employing organization,
- if one-third of the members or a smaller number of them specified in the Statutes) wishes to summon it while pointing out the reason and objective,
- if the Steering Committee formed in line with the Statutes initiates it,
- if the number or mix of the Executive Body, due to some changes is not in line with the Law or the Statutes,

It is advisable to give the invitation personally or by mail - and ask for a written evidence of receipt. The letter should be sent timely to allow enough time to summon the general assembly. If the employer is a limited liability company, the deadlines will be shorter to allow for a potential repetition of the meeting of the general assembly (within 15 days). Apart from the sending the invitation letter other channels of communication could also be used (billboard, newspaper of the organization, or company).

*58 Can the general assembly be held in the form of a partial assembly, and in what cases should this form be used?*

The general assembly, apart from the first general assembly, may be held in the form of a partial general assembly in the way regulated in the Statutes. Partial general assemblies may be held in those large companies with many outlets where it would be difficult for a significant number of staff to take part in the meeting. Regulations regulating the partial general assemblies should be in line with the general assembly regulations and should allow that partial general assemblies be held parallel. The quorum should be counted separately. The Statutes should exclude the possibility of adding on further items on the agenda within the frames of the partial assembly.

*59 When does the general assembly have the quorum and what are the regulations regarding its chairmanship?*

The general assembly has the quorum, if the majority of its participants or the representatives of its participants is in attendance. The authorized person can be a member of the organization or any one else. The authorization should be registered officially.

If the general assembly does not have the quorum a new general assembly has to be summoned. Concerning the agenda items, the new assembly will have the quorum, independently of the number of participants. The new general assembly should be summoned for a date (min 5 max 10 days).

In the general assembly participants will vote either personally or through an authorized person. The resolutions of the general assembly have to be voted openly with simple majority. According to the law members of the executive body (the selected members, since not more than one-third of the members of the executive body could be delegated by the employer company), the general assembly will vote through a secret ballot. The statutes can also demand secret balloting in other issues as well.

The Statutes can require instead of simple voting majority a two third or three quarter majority in all questions. This can be for instance an item modifying the Statutes or a decision to terminate operations of the organization after repayment, before all the shares are handed over to the participants, etc.

*60 May the statutes of the organization be amended?*

It is presumable that there will be several occasions during the operation, in which the modification of the articles of association will be required. Adjustment of the articles of association -- as their completion -- is in the exclusive power of the general assembly. An adjustment, if approved by the general assembly, has to be announced to the Court of registration within 30 days after the general assembly meeting. The Court is entitled to refuse registration, if the adjustment is inconsistent with the relevant law.

*61 What voting rights and how many votes do the participants have at the general assembly of the meeting?*

It is wise to stipulate -- as a principle -- in the articles of association, that all participants of the general assembly are entitled to vote and a minimum of one number of vote is due to everybody. However, regarding the number of votes of participants the articles of association may include several versions. This offers the chance to make a selection on the basis of expedience, since the Law on ESOP does not give a method for it. Here is a list -- with explanation -- of some of these alternatives. On the basis of international experiences, the first three seem to be the most advantageous.

1 Participants of a general assembly are given one vote on each issue on the agenda. This is not the best option, because it ignores the proportion of ownership, namely, that as a result of payment of the own resource, (and later, at payment by instalments and at distributing the property shares) miscellaneous amount of property shares can be owned by different participants. Since a part of the decisions of the general assembly directly effects shares, owned by participants, such an alternative which gives one vote for each attendant is not advisable.

2 At the general assembly meeting the executive body calculates the total number of shares that have been transferred to the participants of the ESOP and the number of those shares, which could be transferred -- if all conditions are unaltered (number of participants and their composition, etc.) -- to participants. The numbers of votes equal to the total number of shares.

This solution employs the principle that the number and composition of the ESOP organization are changing. It considers the potential to obtain those property shares, which are still owned by the Organization but their distribution depends on the rule of allocation.

Parallel with the right of vote associated with shares owned by participants, the executive body takes the right of vote associated with shares that are owned by the organization, into account in such a manner -- in the process of determination of the number of votes due to each participant -- that it applies the rule of the relevant resolution of the articles of association.

This means that they regard these shares, as if they were to be distributed to the participants at the time of the general assembly is taking place. This is, nevertheless, a theoretical distribution because that is absolutely not sure that these figures will apply at the end of payment by instalments.

3 At the general assembly meeting in case of vote on internal affairs of the Organization (e.g., the modification of the articles of association, election of the members of the executive body) applicants should have only one vote. Should other questions arise the determination of the total number of votes should be as follows: The number of votes, already transferred within the framework of the ESOP to the participants, should be added to the number of shares, which could be transferred -- if all conditions are unaltered (number of participants and their composition, etc.) -- to participants. The number of votes equals to the total number of shares.

This alternative merges the above two ones, therefore constitute the best and most flexible way of operation -- as international experiences show -- despite the perception that complex registration and combination methods should be applied. However this method is easy to follow by using a computer software. Except of questions in which vote follows the rule of "one participant -- one vote" principle there might be a need for ballots, which should be handed over upon the participants are signing the attendance sheet. Though authorization is also have to be taken into account.

4 Attendants are given the right of vote in accordance with the executed payment of own resource

This selection -- even if it is applied sometimes -- is legally inadequate, because it means that those who join the Organization after its establishment, would have no right of vote. Should the number of votes at the general assembly be connected to the face value of the property shares of the participants, this would assume a fix number of participants within the 10-year repayment period (if there is no change in the number of participants compared to the time of establishment of the ESOP, and if there is no change in other conditions and further distribution would be based on in accordance with the executed payment of own resource

This is however, impossible, since there can be several reasons, why the employment of an employee ceases (Note participants of the Organization have to be employed by the employer company) Application of this alternative would sooner or later concentrate the right of vote in the hand of a small group

5 Attendants are given the right of vote in accordance with the number of property shares transmitted to members of the ESOP

This option is -- even if it is applied sometimes -- legally inadequate too, because it means that a number of participants would have no right of vote. The reason for this is that this alternative considers exclusively those shares, which had been given to participants, but not those which are still owned by the Organization

This alternative means preference for those old members of the Organization, who had already have the chance to obtain shares (by the payment of own resource and executing payment by instalments) and disclose those new members from making a decision over the affairs, who have not been given shares by the Organization

*62 Who is authorized to represent the Organization vis-a-vis third party, the Court and other authorities?*

The name of the representative of the Organization is included in the articles of association. Adjustment of the articles of association is an exclusive right of the general assembly. This explains the fact that the representative of the Organization can be elected by general assembly from among the members of the executive body, or -- in accordance with a resolution of the article of association -- it can be the president of the executive body, provided that the president is also a member of the Organization.

*63 What rules govern the establishment of the executive body?*

A member of the executive body can be any natural person, who is not forbid to be active in public matters. They can be elected or delegated. At least two-third of the members are voted for by ballot, and maximum one-third is delegated by the employer company. Minimum the half of the number of members should be elected from participants. Members are elected for a determined period of time, but this time frame should not be the same for all of the members, in order to avoid the need to elect the whole executive body at once and to secure that there are always

experienced members in the body

The executive body can have, together with the elected representatives of participants and the delegated representatives of the employer organization, not-participating elected members. For instance, the bank, granting the credit, may require to appoint a not-participating person. However, that is of certain that these candidates should be elected by ballot voting.

It is the responsibility of the of the executive body to keep track of any change in the constitution of the executive body, and to take the necessary steps if any proportional change violates the disciplines of the ESOP.

*64 What is the scope of authority of the executive body and what is the duty of its members?*

A resolution on powers and duties of the executive body has -- or advised -- to be included in the articles of association (and in the operational statutes, if any). Here are some of the most important ones:

The executive body should

- should set up the operational organization of the ESOP Organization and conduct its operation,
- prepare and conclude contracts of sale, contract of credit, contract of payment by instalments and other relevant contracts,
- keep record of the income of the Organization, prepare the books and all statutory reports, listed in the Accounting principles (Balance Sheet ),
- organize and call the general assembly of the Organization if it is mandatory in accordance with relevant resolutions of the articles of association, or when it is needed. The executive body should conduct the meeting consistently with rules and resolutions of the articles of association, furthermore, announce its resolutions,
- declare the resolutions of the general assembly in the form of an announcement in order to inform all participants and give opportunity to apply his right -- guaranteed in the Law on ESOP -- to appeal against unlawful resolutions,
- guarantee the right of inspection of minutes of the general assembly and that attendants are free to make copies of it, at their own expense,
- inform those employees of the employer company who got entitled, in accordance with the articles of association, to participate in the meeting and ask them to declare their intention to participate,

- keep record of the participants of the Organization,
- monitor the share-accounts and inform participants on the face value and rate of shares on the share-accounts,
- prepare and announce the budget for the general assembly,
- prepare the annual report on the performance and of the Organization of on the its own performance,
- organize and coordinate repurchase of shares and their sale (on the integral shock market),
- outline its own proceedings,
- prepare and announce the operational statute of the Organization to the general assembly,
- continuously apprise participants of the Organization on the deals of the employer company, provided that this information is not strictly confidential

*65 What responsibilities do members of the executive body have?*

Members of the executive body are responsible to the extent of their own property -- which correspond with resolutions of the civil code for illegally caused damage. They are relieved from this obligation if they prove that in the given circumstance, they acted as they would have been expected to act. It is worth paying attention to this important resolution, because, often tremendous value of asset is being managed by the executive body. Members of the body, the participants, might as well assert their ownership rights -- to the extent of their full private property too. This is the reason why it is wise to share the responsibility of decisions -- parallel with sufficient information -- with the (owner) participants of the general assembly.

*66 Is it reasonable to set up a supervisory Committee?*

The general assembly is authorized -- with respect to the relevant resolutions of the articles of association -- to set up a supervisory board to help and control the work of the executive body. It is sagacious to include details on the size of such a board, election of its members, authority and its activity, partly into the articles of association and partly into the operational statute.

*67 What are the rights and responsibilities of the participants?*

Duties and obligations of participants have to be recorded in the articles of association in consistence with Para 9 of the Law on ESOP, but it should be dealt

in details under this question Here are some of the most important ones

- participation, right of vote at the general assembly, appeal on Court against unlawful resolutions,
- demand to have a share-account be opened,
- taking shares into possession, for which a participant paid from the utilization of his own resource and executing all rights, - without limitation - attached to shares (right of vote, right for dividend, and right of sale),
- parallel with executing payment by instalments, participants are entitled to receive those shares, which got divided in compliance with regulations of the articles of association and the decision of the general assembly, -- provided that these are already included on the share-account and restrictions under [14 § (3)] and [19 § (1)] of Law on ESOP are met,
- parallel with executing payment by instalments and obtaining the shares, participants are entitled to assert their right of vote,
- execution of rights attached to shares and power of disposal to the extent of shares listed on the share-account or shares received in case of retirement death and termination of employment,
- execution of right of pre-emption of shares (in the order, which is determined by the Law on ESOP), which were repurchased by the Organization,
- demand the final settlement upon the Organization ceases to exist,
- the participant is liable -- to the extend of shares (deposit, restriction on sale) acquired by payment by instalments or financed from dividend -- for the existing liabilities of the Organization, as prescribe in the Law on ESOP Participants are not liable to the extend of their own property -- beyond what has been said above -- for the liability of the Organization

*68 What should be the rules concerning the allocation of the shares purchased by the ESOP with credit or with instalment payment be like?*

This question is not governed by the Law on ESOP This is solely dependent upon the agreement of participants (See [9 § f] of the articles of association and [7 § (2)e] of resolution of the general assembly ) Theoretically, all rules can be applied, which are voted for by the majority of the participants (or of the proportion , prescribed by articles of association

However international experiences reveal some general principles, which are reasonable to be kept in focus when the articles of association or resolutions of the general assembly are being drawn up. It is recommended to consider the fact that the ESOP is an Organization that (as a community) produces the fund to be divided to facilitate payment by instalment of individuals. This leads to private property. This private property is not only valuable for individuals but for the Organization, because it will result in interest of medium and long term profit.

Consequently, contribution to total production (profit) should be the basis for division.

In an ESOP Organization the source of interest payment and of payment by instalment is the profit of the Organization, which -- to 20% of the before-tax profit [26 § (4)-(5)] -- can be utilized without tax-obligation as a dividend due to the owner. This is the reason, why the contribution to total production (profit) should be the measure for division. However, it is evident that there is no exact measure for this, though a certain combination of the wage and the time, spent at the company, could give a relatively good basis. Wages at a prospering company in the market should evaluate performance.

When considering the time spent at the company -- what could be a basis of division for a certain proportion of the total number of shares -- working experience, and personal connections (which can be used in the interest of the company) could be honored. When considering the time spent at the company, effort to increase the assets of the company gets acknowledged too.

Furthermore, it is reasonable to divide a certain (small) part of the property shares among participants on the right of being a participant, because, in this way a chance is given to those employees, who were not able to take part in the process of profit making -- due to reasons, beyond their control.

There are countries, in which (e.g., the USA) the Law on ESOP stipulates so called "rules of honors" with respect of division of shares. This prevents certain groups from acquiring too big "slices of the cake" (as a result of the allotment, the proportion of the smallest and the biggest shares can not be bigger than the proportion of the lowest and highest wage on a per year basis, or another rule managers or employees with high wages together can not receive more than one third of the divided property shares. Etc.)

The primary basis for division should not be the own resource, (ESOP loan own resource of the payment by instalments) paid upon establishment of the ESOP.

Even if these payments, which enable the ESOP Organization to submit a bid for the tender, places enormous burden to the participants, it is fair to honor -- to a certain extent -- this action. The way of appreciation can be e.g., the distribution of 10 - 20% of the dividable shares of a year on the basis of those payments.

It is extremely unfair to distribute property shares on the basis of initial payment, if it did not exceed the minimally required 2% of the purchase price. Such actions violate e.g., the "rules of honors" of the British and of the United States Law on ESOP. There are two reasons for it:

1. The first one is that in return of minimal cash, in a situation, which is free for individual risk disregarding contribution to total production (profit) guarantees multiplied equity to the participant (as payment by instalments is executed from the non-taxed contribution of the Organization and from the dividend, guaranteed by the guarantor activity of the Organization).

2. Secondly, this principle promises that the participant will receive 10 times the initial investment, though this is true, if the participant is a member of the Organization and an employee of the company until the maturity of payment by instalments' obligation.

In this way, the dividable property would be concentrated in the hands of a smaller and smaller group provided that until the maturity of the obligation more and more employees leave the company.

Further, necessary voluntary payments during payment by instalments should be honored.

Should there be a need for additional payment during payment by instalments due to difficulties, voluntary individual payments might be required to maintain the ESOP process. This is, of course, settled by donating property shares with equivalent value of the payment. However it is reasonable to honor to a higher extent this sacrifice by e.g., a certain proportion of property shares might be donated or registered on the share-account on a "one for two" basis.

*69 What rights and responsibilities do those have, whose employment at the employer company terminates or who terminate their participation in the organization and remain employees of the company?*

Upon termination of employment, the employee loses the right to participate in the ESOP [1 § (4)] but certain rights and obligation will supersede, depending on the cause of termination.

A retiring employee, and the perpetuate of one who passed away, is entitled to get those shares (business shares), which were purchased by the Organization on payment by instalments or by the utilization of loan and got into the property of the participant by repayment. These property shares will be freed from the restriction on sale right of pledge and administration right of the Organization, which normally expire upon full completion of payment by instalments. Nevertheless, the organization will -- until the end of the repayment period -- maintain its right of pre-emption [19 § (3)], which is governed by the provisions of the Civil Code.

There is a need for further explanation of the Law on ESOP Property shares, mentioned in the paragraph above raise the question of whether a retiring employee, and the perpetuate of one who passed away, are entitled to receive dividend? In my reading, yes he/she is, because administration right of the Organization and all the other restrictive resolutions cease to exist in the event of retirement and death

However a counter-argument can be the words of [14 § (3)], which says "The profit (dividend) of the property shares purchased by utilizing credit or payment by instalment is to be spent on repayment of the current debt. This is the guiding principle in the process of repaying instalments

In any other cases, if the employment / participation is terminated, during the repayment period for any other reason, the Organization is entitled to repurchase the shares already owned by the participant within 6 months from the termination. The ex-participant is obliged to allow repurchase of property shares at a certain value, defined in the articles of association. In case the participant unlawfully discontinues his/her employment, or the employer initiates termination by a special notice, the Organization may pay the purchase price in instalments within five years [19 § (3)]. In other cases of termination of the participation -- which include termination of participation, whereas the employment is not terminated -- the Organization is entitled to pay the purchase price in instalments within two years [19 § (3)].

If the Organization does not exercise its right of redemption, the ex-participant is not entitled either to sale the property shares, he / she obtained in the process of repayment, because, until fulfilling the obligation of repayment, shares are under restriction of sale, right of pledge and are being managed by the Organization [19 § (1)].

There is a need for further explanation of the Law on ESOP Property shares, mentioned in the paragraph above raise the question of whether an ex-participant is entitled to receive dividend? In my reading, no, he /she is not because administration right of the Organization still in effect, even if it does not influence rights arising from stock ownership. Anyhow, [19 § (3)] of the Law on ESOP (as quoted before) provide feedback for my explanation

*70. At what purchase price should the ESOP organization exercise its repurchase right? What should the schedule of the instalment payment of the repurchase price be?*

As the Law on ESOP stipulates, the repurchase price has to be defined for the Organization, which intends to utilize its right of redemption, in the articles of association. This can not be less than half the market price. However, it would need special consideration whether it is clever to fix this value for the entire period, or not. The reason for this, is that as the end of the repayment period is coming closer - with the promising expiration of the right of pledge, restriction on sale, shares will

be more valuable than before. Consequently, repurchase price should be determined in such a manner to allow floating.

When deciding the purchase price, which should be lower than the market value, the fact should be taken into account, that the Organization is not authorized to perform other activities but what is stipulated in the law. Accordingly, the Organization is not entitled to sell the repurchased property shares for higher value, because this would be considered as business activity.

It is extremely important to be very thoughtful when this point, but especially a paragraph on undertaking repurchase obligation, are being included into the articles of association, due to lack of funds of the Organization. It should be considered that the repurchase price be set lower in case the participant unlawfully discontinues his employment or the employer terminates the employment by a special notice, than in case of the termination is a result of another reason, (except of retirement and death).

However it is justified to prescribe in the articles of association that the repurchase price is settled in fixed proportions (e.g., same amount in each year). The Organization might as well undertake interest payment but as there are no relevant resolutions in the Law on ESOP contractual obligations will be binding in such cases.

*71 What are the conditions for selling the repurchased property shares?*

It is not requested to sell repurchased property shares. However, if the organization intends to sell them (see question 69), employees of the company (non-participants), participants and the members (shareholders) of the employer company -- in this order -- have the right of pre-emption.

Nevertheless, restriction of sale, right of pledge (of financial institutions granting credit asset management organizations, allowing payment by instalments) and the administration right of the Organization on repurchased property shares will not be liberated until the Organization has liability or payment by instalment is fully accomplished [14 § (2)].

Furthermore, the relevant resolution of the Law on ESOP has to be met, which states that the profit (dividend) of the property shares purchased by the utilization of credit or payment by instalment facilities -- and repurchased property shares are also in this group -- has to be spent on repayment of current debts [14 § (3)].

The articles of association should set forth the determination of timing of sale of repurchased property shares, the applicable method for appraisal of purchase rate, the priority order of groups that are entitled to buy such shares, management of over subscription and payment and repayment of deposit.

*72 Who can exercise the voting rights for the shares (business shares) in the ownership of the participants at the employer company's general assembly (shareholders' meeting)?*

The right of vote, represented by property shares purchased by the utilization of own source and property (business) shares obtained from the Organization by repayment of the credit, are due to participants at the general assembly. The reason for this is that even if property shares, which remained in the ownership of the Organization will remain under the administration of the Organization until the repayment of the credit or completion of payment by instalments, will not effect the shareholder rights derived from the legal relations of corporate membership [19 § (1)] in other words, right of vote that is determined by Act VI of 1988 on Economic corporation.

The articles of association must not restrict this right but participants have the right to authorize the representative of the Organization for the occasion of the general assembly.

*73 Who can exercise the voting rights for the shares (business shares) in the ownership of the organization at the employer company's general assembly (shareholders' meeting)?*

The articles of association may contain resolution only on exercising the right of vote which is represented by property shares -- purchased by the Organization by utilization of credit and payment by instalments facilities -- that have not yet been transferred into the ownership of participants. This right is generally practiced by a member of the executive body who is gets authorized in accordance with the resolution of the articles of association. The representative must not act according to his/her own reactions but the preliminary resolution of the general assembly.

However it is justified that the articles of association should require that the agenda of the general assembly of the employer company be discussed first on the members' meeting (general assembly) of the organization. Here a resolution has to be accomplished determining the common approach of the Organization, which is to be stuck to. This safeguard has to be applied, due to the responsibility of the Organization towards its members.

With respect of what has been said above, the representative of the Organization is not entitled to approve new items to be included in the agenda, announced prior to the meeting. It should also be compulsory to require the public announcement of the resolutions of the general assembly of the employer company.

With respect to exercising the right of vote, the articles of association might, as well determine that participants -- according to the application of the principles on DIVIS 3.1 -- can also be authorized [19 §]

*74 Who can the participant turn to if he suffers damage because of the activity of the ESOP organization or in case of an unlawful act?*

A participant, in case of complaint and if an action suspicious to be unlawful, can turn to -- as the last chance -- to Court. However, the first step, to make is to complain at the executive body, or at the maturing general assembly. If there is no remedy the participant is entitled to summon an extraordinary general assembly by pointing out to the reason and objective, if he / she is supported by at least one third of the participants [7 § (3)]

Any decision of the general assembly or of the executive body, which violates the Law may be challenged at the Court by any participant within 30 days after a participant gets aware of it [10 § (1)]

Challenging the resolution may not interfere with this implementation, however in a justified case the Court may suspend the implementation of the resolution [10 § (2)]

In case of an action suspicious to be unlawful, can turn to the Prosecution, which controls the association from the legal point of view. In case of the operation according to legal resolutions can not be guaranteed, the prosecutor may appeal to Court [11 §]

The Court -- regardless of whether a participant directly or via a Prosecutor initiates legal proceeding -- may

- terminate (abolish) a resolution, which violates law and may order a new resolution to be constructed,
- summon the general assembly in order to restore lawful operation,
- suspend the operation of the Organization and may order a supervisor to guarantee lawful operation

## **V. Ownership and transfer into ownership**

*75 What is a share-account? Should a business share of a limited liability company be registered on the share account?*

The ESOP Organization opens a share account for all participants to register the value (and the face value) of property shares obtained by the participant. For simplification, the term "share account" will be used in connection with limited liability companies (ltd). The executive body keeps an exact record of property shares acquired by participants within the framework of the ESOP. This account

has several sub-accounts, because a participant may possess property shares that are to be treated separately

The executive body has to keep a separate list for those property (business) shares that were

- received by the participant in exchange for own resource but are deposited voluntarily at the disposal of the ESOP Organization for administration,
- paid for but it was not possible to transmit the ownership of the property share, because the amount does not reach the value of one property share, or -- in case of a ltd -- the minimum level of one business share (HUF 100,000), or can not be fully divided by 10,000. Consequently, the balance has to be kept registered, until it is not completed to reach the value of one property share, or -- in case of a ltd -- of the minimum level of one business share (HUF 100,000), or the ownership of parts of property shares with a face value of 10,000 -- attached to property shares, which have already been handed over, can not be transmitted. However, this property is already not free from restrictions,
- divided and the ownership of which was transmitted by the general assembly of the ESOP Organization to participants as a result of repayment of the loan or payments by installments. Rules, which are discussed under Question 82, govern transmission of ownership. Therefore, it can also occur, that transmission of ownership is not accomplished or not fully accomplished (a balance remains)
- not handed over, because the ESOP Organization was not able to do so (These are property [business] shares that were divided as a result of payment by installment) These will be registered as a balance until it gets completed at the next round of payments by instalments, to become suitable to be handed over

In addition to what has been listed above, cash payments are also have to be administrated, which are executed by newcomers in the ESOP Organization in order to create the financial basis of the Organization to complete its right of pre-emption to repurchase those shares which belonged to participants whose employment gets terminated thus they intend to sell their shares. Therefore two share-accounts are reasonable to be opened: one for the administration of property shares (face value and type of shares) which were handed over by the Organization, and one for the administration of amounts paid for the benefit of the employee (own resource, dividend), but property shares have not yet been given in exchange for them

76 *What kinds of ownership rights do property shares, acquired within the framework of ESOP, represent?*

The ownership of a property share of a company generally represents two types of rights. Exercising these rights are restricted by the ESOP Organization, the Law on ESOP and the articles of association of the ESOP Organization or a separate contract. These rights are

- rights of property (right for dividend, right to receive a part of the net value of assets upon the Organization ceases to exist and the right of sale),
- rights at the general assembly (right of vote, right of inspection, right to file a motion -- in general minority rights)

The operation of the ESOP can be characterized well by the process that at the beginning property shares get into the possession of the Organization. Property rights of shares can be restricted to lower or greater extent, depending on the sources, which had been utilized, to obtain those shares. After the beginning, property shares can either get into the property of participants or remain in the possession of the Organization. Restriction of property rights gets abolished in certain cases (retirement or death of a participant) before full completion of payment by installments.

This principle is in effect regardless the fact whether the Organization purchased directly from the state trustee organization or not. Inasmuch as in cases which the Organization has *not* purchased directly from the state trustee organization, the interested parties are allowed to depart from certain rules of the Law on ESOP [14 § (1) and (4)--(6)] as stated in [21 §]. Should this occur the need for further explanation of the Law on ESOP arises.

Let's examine the possible sources of the ESOP Organization, which can be applied to get the ownership right of property shares from the state trustee organization. This provides the basis to distinguish the different types of property shares that differ from each other in the method of division, transfer of ownership, and execution of property rights.

The sources are

- own resource of participants (regardless of the origin, which might be for saving, loan, compensation coupon if the latter one can be used for this purpose),
- own resource of non-participants (cash or compensation coupon if the latter one can be used for this purpose). This generally means an advance payment of the employer,
- application of allowances of the Asset Policy Guidelines (APG) for the settlement of the purchase price of property shares, if the allowance is not considered as a factor to decrease the price but as a free equity transfer,
- ESOP loan or agreement on payment by installments

*77 What restrictions apply over ownership rights of property (business) shares, which are transferred from the property of the ESOP Organization to the property of participants?*

The rule is that the property shares which are transferred from the possession of the Organization to the possession of participants may not be alienated, until repayment of the debt and installments. The creditor banking institution or in case of payment by installments the state trustee organization, has the right of pledge on the above mentioned shares [19 § (1)]. This resolution, however does not apply to shares, purchased by the utilization of own resources [19 § (5)], but does apply -- according to the Law on ESOP -- to property shares, obtained free of charge by utilization of the preferences of the APG.

Property shares transferred from the possession of the Organization to the possession of participants -- except of those, which were purchased for the own resource -- will remain in the administration of the Organization until repayment of the debt or installments. This, however, does not affect shareholder (membership) rights [19 § (1)] and the right of vote.

Types of property shares, described under Questions 75 and 76, are completely different according to the stipulation of the Law on ESOP on right for dividend. The rule is that the profit (dividend) on the property shares, purchased by the utilization of credit or installment payment, is to be spent on repayment of current debts [14 § (3)]. This is the principle for property shares transferred to the ownership of participants in the process of repaying the installments [14 § (3)].

This leads to the fact that dividend of the property shares, which were *not* purchased by utilization of credit or payment by installments facilities, can be used openly. The method of use is solely dependent on independent or collective decision of the participants. Participants can use the dividend of the property shares, purchased by utilization of credit or payment by installments facilities, openly, if the dividend is not necessary to be spent on repayment of current debts, independently from the fact whether the property (business) share, earning the profit (dividend) is in the possession of the Organization or, as a result of competition of payment by installments, it is in the possession of the participant.

*78 What rules govern the transfer of ownership of property (business) shares, which are purchased from own resource -- cash or compensation coupons -- of participants from the possession of the ESOP to the property of participants?*

Property shares, purchased within the framework of the ESOP first get to the property of the ESOP Organization, since the ESOP Organization is the contracting party in the sale. Property shares, purchased by the utilization of own resource must immediately be transferred by the Organization into the ownership of the participants in proportion to individual payments [18 § (6)]. However, in some

cases, property shares purchased by the utilization of own resource get directly to the possession of participants

Nevertheless, it is not certain, that the face value of the transferable property share, reaches the face value of one property share, or its integral multiple, or -- in case of an ltd -- the minimum level of one business share (HUF 100,000), or if it is higher, it might not be fully divided by 10 000. As property shares can only be transferred into the ownership of the participant, if the sum total, indicated on the share account equals the par value of shares, or, in case of business shares, if it is in accordance with relevant provisions regarding equity rate of business shares (namely that it can not be less than HUF 100,000-- or it has to be fully dividable by 10,000 [18 § (3)]

If it cannot be fully accomplished, the equivalent of the property shares will have to remain registered on the share account [18 § (6)]. This remaining part can get into the possession of the participant upon completion of the value, in accordance with what has been said above. However, general restrictions on exercising property rights will remain.

Thus, it is reasonable to purchase property shares by utilization of the dividend of property shares, which were originally purchased from own resource. The law on economic corporations allows that one share (business share) be owned by more than one owner. As a result of restrictions that apply to ownership rights of the Organization, the worst solution is to leave the balance of own resources on the share-account in the possession of the Organization.

*9. Are participants allowed to dispose openly of property (business) shares, which are purchased from own resource? What ownership rights can they assert?*

The rule on property shares, purchased by the utilization of own resource must be transferred by the Organization into the ownership of the participants in proportion to individual payments immediately [18 § (6)].

Participants are allowed to dispose openly of these property (business) shares, because the restriction on alienation [19 § (1)] does not apply to those property shares whose ownership right has been transferred. Consequently, the creditor banking institution or in case of payment by installments the state trustee organization, does not have the right of pledge either [19 § (5)].

Dividend of these property shares is allowed to be disposed of openly by participants who are also allowed to assert their right of vote freely and individually or via their authorized representative (who might as well be a representative of the ESOP Organization).

*80 What rules govern the transfer of ownership of property shares, which were purchased from own resource of the ESOP Organization but not from the own resource of the participants?*

If the own resource or a part of it was not paid by the participants individually then the transfer of ownership is governed by the statutes. The relevant paragraphs are which deal with transfer of ownership of shares, financed from funds from external natural or legal person. In this case, ownership rights are not restricted at all.

The ownership of these property shares might, as well, be transferred immediately upon acquisition by the ESOP. Restriction on alienation, the right of pledge and the right of the Organization for administration does not apply in this case. This own resource can be paid or advanced to the ESOP Organization on the account of profit reserve of the employer company. The balance can be settled later upon establishment of the Organization and utilization of the fund in the form of dividend and a sum, which can be transferred tax-free to the account of the company.

Property shares, purchased this way, should be kept at the disposal of the Organization in order to make the Organization capable to utilize dividend for exercising its right of pre-emption and redemption. (See Question 69). The reason for this is that the Organization will face difficulties to make funds for it.

Should the article of association allow division (distribution) of such property shares and division (distribution) is actually executed, the Organization will face several tax payment obligations.

*81 What should happen with property shares, which were purchased by utilization of allowances offered by the Property Policy Guidelines within the framework of ESOP? What are the applicable rules governing ownership transfer, exercise of ownership rights, division principles?*

It has been mentioned under Question 25 that the allowance offered in the PPG can also be used within the framework of the ESOP. This can also be accomplished in such a manner that the state trustee organization does not deduct the allowance from the purchase price of the tender, but transfers the right of ownership of certain proportion of property shares free of charge into the possession of the ESOP Organization. The ownership of these shares (business shares) might as well be distributed among participants. The Law on ESOP has no specific regulation. However, these property shares, or a part of them, can be possessed by the Organization too.

The general assembly of the ESOP Organization or the statutes is free to make or set forth a decision on division. Nevertheless, it is more reasonable, if division is based on performance in the past. Whereas the division of shares purchased for credit or payment by installments should be connected to contribution of profit, which is the source of instalment and interest payment.

The restriction of alienation, the right of pledge, the administration right of the ESOP Organization until full repayment of the credit [19 § (1)] is relevant to property shares, purchased by utilization of allowances offered by the Property Policy Guidelines and the ownership of such shares is transferred into the possession of participants -- provided that the PPG allowance is not considered as utilization of own resource [19 § (5)] However, the owner is entitled to receive dividend and practice his/her right of vote

Moreover, if these shares are not transferred to the possession of participants, but remain at the disposal of the Organization, then the ESOP Organization -- as I interpret the Law on ESOP -- is entitled to dispose over them, without any restriction It can either sell them (in compliance with relevant stipulations of the Law on ESOP or of the statutes)

The Organization is not allowed to sell only those property shares which were purchased by utilization of credit or installment payment --except for transformation to participants -- and the right of pledge of the creditor financial institution--or in case of installment payment that of the state trustee organization--is valid over only these shares [14 § (2)] Thus, it is reasonable that PPG allowance be granted in the form of transfer of property shares free of charge, and the PPG allowance used within the framework of the ESOP be considered as own resource

*82 What rules govern the transfer of ownership of property shares, which are purchased from credit, obtained by the ESOP Organization or as a result of concluding a contract on payment by installments?*

The most important principle of the ESOP is that property shares, obtained by the ESOP organization are transferred into the ownership of the Organization and the Organization will transfer them to the ownership of its participants, according to the conditions of the statutes This ownership transfer is executed in two stages

- 1 *Stage One* The executive body of the Organization opens a share account to the participants [18 § (1)], on which the value and the face value of the property shares transferred into the possession of the participants should be indicated The total amount in the share accounts of the participants (the value of the total property shares transferred or included in the account) may not exceed the par value of the paid-off property shares [18 § (2)] In other words, only those property shares can be indicated on the share account -- whether they were purchased for credit or for payment by installments -- which has been paid off
- 2 *Stage Two* Property shares, indicated on the share account, will be transferred into the ownership of the participant, provided the face value indicated on the share account reaches a certain sum that equals the par value of shares, or, in case of business shares, if it is in accordance with relevant

provisions regarding equity rate of business shares (namely that it can not be less than HUF 100,000-- or it has to be fully dividable by 10,000)

The remainder is kept by the executive body on a share account or its sub-account until it reaches the value of one property share and after completion the shares are given into possession (See Question 75 for more details )

The Law on ESOP does not require that the ownership of property shares purchased by the ESOP Organization be transferred -- except for property shares purchased for own resource -- but allows the statutes to determine the period of time and other conditions to keep the property shares in the possession of the Organization [18 § (5)] This way, the statutes have to determine the method of division of property shares in the possession of the Organization (See also Question 87 )

*83 What provisions may the articles of association set forth with respect of actual hand out of property shares to participants who had been given the right of ownership of property shares during the period of payment by installments?*

Property (business) shares, purchased by utilization of payment by installments or credit facilities, will remain at the disposal of the Organization, until full repayment of the credit or fulfillment of installments obligations The administration right of the ESOP Organization over property (business) shares transferred into the ownership of the participant ceases upon retirement or death of the participant

However, participants may include in the statutes that property (business) shares, purchased by utilization of payment by installments or credit facilities, will remain at the disposal of the Organization, after full repayment of the credit or fulfillment of installment payment obligations except for property [business] shares, owned by participants whose employment is terminated ) Should this happen, the ESOP Organization has to issue a document certifying their own property (business) shares Unless such provision is included in the statutes, property shares have to be given into the possession of participants after full repayment of the credit or fulfillment of installment payment obligations

*84 Is it advisable to require own resource contribution of participants?*

Such provision may not be included in the statutes (see Questions 46 -- 49) Nonetheless, it can be advisable to attract own resource by mentioning own resource contribution as a factor taken into account during the division of property shares, especially, if participants of the ESOP Organization have to pay considerable amount of cash to purchase initial property shares

Should this happen, those participants, who join the ESOP Organization later -- potentially also those who were employed by the company when the ESOP Organization was established but for a certain reason did not want to join, -- have the advantage of not having to share the burden (own resource contribution, retention

money etc ) This is a very important component, even if those, who contributed with their own resource, are compensated immediately by receiving property shares (free from restrictions), because own resource contribution places a great burden and risk (of changes in the rate) to individuals

Upon becoming eligible, becoming a participant is a natural enjoyment of right Thus precondition and provisions to become a participant may not be prescribed by the organization (See Questions 46 --49 ) However, it can be advisable to attract own resource by mentioning own resource contribution as a factor taken into account during the division of property shares

To attract own resource might also be advantageous from the point that during the first years of the repayment period of the credit or the instalment payment usually there are only a few property shares which can be reallocated Later, the number of property shares, which can be purchased, will increase, and those, who join the ESOP Organization later, would have bigger advantage, unless a provision on prioritizing purchase of those, who contributed with their own resource, is stipulated

Own resource contribution can be eased by credit or instalment payment facilities The amount paid, can guarantee that the contributor gets property shares, since by using this money, the ESOP Organization will be able to exercise its right of pre-emption and repurchase property shares owned by participants whose employment is terminated and offer them to the contributors after having offered them to non-participant employees who have priority [19 § (4)]

*85 Are participants obliged to pay tax / duty on property shares, upon they get into their ownership?*

The acquisition of property shares from the ESOP Organization is free of tax or duty [18 § (4)] and they have no tax or duty obligation after the amounts credited on their share account [18 § (3)], until they do not alienate the shares which are free from restriction on alienation [19 § (1)], [26 § (1)] Upon sale, personal income tax is payable in consistence with the effective law

*86 What tax allowance can be demanded by a participant of an ESOP Organization after payment to the ESOP Organization upon establishment and during its operation, if this payment was executed from his/her after-tax income?*

A participant of an ESOP Organization may deduct from its assessable income -- but only up to 30% of the assessable income --the payments executed in the current year (own resource payment), according to the provisions of the effective personal income tax law

87 *What is it reasonable to leave a part of the property shares at the disposal of the ESOP Organization, even if they could be handed over to participants, during the period of payment by installments?*

In many countries ESOP is applied in order to widen ownership and to encourage employees. Their experiences indicate that owners of Organizations -- also participants of ESOP Organizations -- should also think about this question. Participants appreciate property (business) shares, if they are provided dividend on a regular basis, and if they can be sold for a good or reasonable value if necessary. However, the Law on ESOP provides this opportunity before full repayment of the credit or instalment payment obligations only when participation is terminated, in the case of participants who retire or successors only in a way limited by repurchase right while in other cases only if the Organization is able and ready to practice its repurchase right. Nevertheless participants are entitled to exercise their right of vote but it will hardly satisfy an average employee.

Again it is more important, that shares provide dividend on a regular basis and they can be sold. The crucial point of ESOP is that it creates the long term interest in the form of interest in high dividend through prosperity on the market, increase of assets -- against short term interest of wage increase. Thus, this is the way to encourage employees to cut expenses and increase quality, and this is the benefit of the management and for the other owners.

This encouragement is the reason, why property obtained within the framework of the ESOP should remain in the possession of employees and why funds and methods are created to enable participants to purchase shares from one another and enable the ESOP Organization to repurchase shares from employees leaving the company or from those who want to sell them and enable the Organization to offer them to new employees of the company (US laws provide significant tax preferences for the repurchase).

The Law on ESOP does not allow to use as an income the dividend paid on shares which have already been transferred into the property of participants, even if that dividend is not essential to meet the instalment payment obligation of the current year. Parallel with this, the law forbids the ESOP Organization to use the dividend received by the Organization for repurchase during the instalment payment period.

However upon completion of the payment obligation, repurchase on a price stated by an independent auditor or by the stock exchange becomes an extremely important instrument to regulate the market. This helps to keep the employees' ownership at a certain level and prevents that property shares get into the ownership of "persona non grata" and also creates and maintains confidence in property and shares. However repurchase has a great disadvantage it diminishes before-tax profit and -- if no allowances are granted -- after-tax profit too.

Companies and ESOP Organizations are trying to compensate this disadvantage by not giving the ownership of redeemed shares to employees by keeping a

considerable proportion (even 50%) in their own possession even after completion of payment obligation Shares, which are not reallocated, do not have to be repurchased, their dividend can produce the basis for redemption, furthermore, a "part of votes" can be kept together Dividend on shares, which have not been used for redemption, will be distributed among participants

*88 What kind of sources can be utilized by companies and ESOP Organizations to execute repurchase of property shares?*

Organizations have very limited sources to execute their rights of pre-emption and redemption discussed in Question 69 First of all, the question arises whether the company is entitled to support -- without paying tax -- redemption The company is allowed to transfer funds up to 20% of the before-tax profit [26 § (4)], -- without paying tax -- to the ESOP Organization, during the period of meeting the instalment payment obligation [26 § (5)], to help the Organization to realize its basic target (See Question 95 for more details on legal regulations regarding transfer of funds) If there is no tax allowance, redemption of shares can only be financed from the companies' after-tax profit or the Organizations' dividend

The ESOP Organization is entitled to utilize without limitations (also for repurchase) the dividend of shares purchased for credit or for installments and owned by the Organization only after the instalment payment or credit payment obligations are fulfilled As repurchase is more difficult before this obligation is met (a large proportion of property shares can be repaid in the last 1-2 years), it is desirable to constitute the relevant item of the statutes in such a manner that a large proportion of property shares remain in the property of the Organization after full repayment of instalments The Organization should possess them at least until -- as a result of modification of the relevant law creates tax allowance for such funds -- it is allowed to utilize this dividend for redemption and offer these shares with allowance for new employees

During the instalment or credit repayment period, individual payments by participants and the establishment of an internal share market might contribute to solve the problem of redemption

*89 Is it obligatory for the Organization to repurchase shares?*

No it is not Nevertheless, the establishment of methods of redemption and creation of funds is in the interest of both the company and the ESOP Organization, but undertaking this obligation require careful consideration because creation of funds puts a heavy burden to the Organization and to the participants (See also Questions 84 and 87 for details on trust and positive undertaking)

*90 Is the participant allowed to sell property shares received within the framework of ESOP? If yes who can be the buyer?*

The sales opportunities and the potential buyers are determined by the way and time when those property shares were transferred into the ownership of the participants, since different rules apply to property shares which were financed from own resources of the participants, from own resources deriving from the after-tax income of non-participants and to property shares purchased by means of credit or instalment payment. Certain property shares possessed by the participants may be free from restrictions, (those financed from own resources of the participants), which can be freely sold, while others (financed from credit and instalment payment) may only be repurchased by the organization. Pensioners and successors of participants who died are in a special situation because they are allowed to sell all their shares obtained within the framework of the ESOP organization openly. The only restriction for these shares is that the organization has the right of first refusal during the repayment period.

*91 What factors affect the price of property shares owned by the participants?*

First of all the rate of the property share, which can be exactly determined if the shares are publicly traded -- in case of share-holding companies introduced on the stock exchange. In other cases, an independent auditor can be asked to determine the price on the basis of the audited balance sheet or other information. However, the price can be affected to a great extent by regulations of the Law on ESOP or by the statutes with respect to restrictions of sale or exercising membership rights. As a result of these elements, an external price (stock exchange or outside the stock exchange) and an internal price (within the organization) is formulated which, unfortunately will be lower until full repayment of the credit.

*92 Why and how is it reasonable to create an internal stock market?*

As discussed in Questions 2, 44 and 87, it is in the interest of the company and of the ESOP Organization to encourage and maintain better performance in order to achieve trust in the ownership of the company as well as successful operation. A very important element of the above task is to offer a chance for the employee, being also an owner of property (business) share, to sell his/her shares, in case his/her employment is terminated or in the case of necessity.

Despite the fact that the Organization has the right of pre-emption and redemption, it nevertheless has sources to practice these rights. Thus stipulations of the Law of ESOP almost exclude the establishment of internal stock market and put obstacles to operation. However, it is extremely important to establish internal market -- beside redemption and possible sale on the stock exchange -- where employees are free to buy shares from one another in a regulated way for a price that is defined by an independent expert.

Regulation could mean that in case of demand, priority should be given to non-participants, whereas supply would be coordinated by priority to those participants whose employment was terminated and to those who intend to sell their shares because of financial trouble. The creator and coordinator of the internal market could reasonably be the ESOP Organization. The performance of this duty could also justify the existence of the Organization after fulfillment of the repayment obligation.

*33 Are participants entitled to dividend from the ESOP Organization on their property shares in their possession?*

Yes, they are, but not on all of their property shares. Participants are entitled for dividend from the ESOP Organization on their property shares in their possession only if the Organization purchased the shares from the participants' own contribution. But dividend cannot be paid in the rest of the cases before fulfillment of the repayment obligation.

The reason for this is that the Law on ESOP prescribes that repayment should be completed as soon as possible. Thus the law forbids open utilization of dividend of property shares--which were purchased for credit or payment by installment--until the obligation of repayment is met. This dividend may entirely be used for repayment, regardless the fact, whether it is possessed by the Organization or by participants [19 § (1)] and regardless whether, upon execution of current year's obligation, the remaining part of the dividend of property shares purchased for credit or instalment payment is needed for or not.

Consequently, participants, in compliance with the statutes or the decision of the general assembly, during the instalment payment are entitled receive the ownership of shares purchased by the Organization for credit or for instalment payment but they are not vested -- because of the restriction of sale, right of pledge, and the Organization's right of management [19 § (1)] -- not entitled to dividend as income, and only have the right of vote (no other ownership rights). However, there would be a desperate need (from the point of participants and the company) for a positive encouragement that would be expressed by payment of the remaining part (which is not needed for repayment) of the dividend on property shares to participants.

According to the stipulations of the Law on ESOP, participants are entitled to dividend only if the repayment is accomplished. This may take at least 8-10 years, in exceptional cases 5 years. Even in cases in which there would be no need for the remaining part of the dividend in addition to the sum which is transferred tax-free to the ESOP Organization, the restriction of the law on distributing the dividend would diminish the positive encouragement for better performance. This way better performance is not enjoyed by the employees but by the creditor bank and by the state trustee organization which allows instalment payment in the form of a shorter repayment period. This can also be an important objective but employees satisfaction is of greater significance.

As far as dividend distribution is concerned, pensioners and successors of those who die are exceptions because they have the right to dispose of their shares openly [19 § (2)] while respecting the Organization's right of pre-emption

## VI Tax related and other questions

*94 What resources are available for the ESOP Organization for the repayment of the credit and the interest or, in the case of payment by installments, to pay the installments and the interest?*

The main source of meeting the credit and interests repayment obligations of the ESOP Organization is the dividend of property shares purchased by means of credit or instalment payment. Dividend of these shares can exclusively be utilized for repayment [14 § (3)] regardless the fact that these shares are possessed by the Organization or its members

In addition of the above source, the ESOP Organization may receive tax-free donations from the company -- as discussed under Question 95. If these sources plus volunteer contributions of participants are still not sufficient to meet the repayment obligation of the current year then the company -- acting as a guarantor -- has to finance the difference on the account of its after tax-profit (profit reserve)

As mentioned, participants with their volunteer contributions may also support the Organization to meet its repayment obligation during the repayment period. They get tax allowance i.e. the effective amount of payment can be deducted from the total personal income, but up to 30% of the income

Of course, the Organization is allowed to accept donation-like supports from any other source, but there is a slight chance for it

*95 What conditions and restrictions apply for the company to provide support for the ESOP Organization to help to execute repayment of credit and interest?*

The employer company is allowed to give donation (support) to the ESOP Organization -- in order to help realize its final target, and to fulfill its credit repayment obligation. The amount transferred is deductible from the before-tax profit if the ESOP is connected to the privatization of a fully or partially state-owned company [26 § (4)]

If state-owned and non-state-owned property shares are purchased jointly by the same ESOP organization then, when calculating the taxable income, only that proportion of the support can be deducted which is equal to the state-owned

proportion of the property shares [26 § (4)]

If the ESOP Organization buys the property shares of a fully or partly state-owned company then, when calculating the taxable income, that proportion of the support can be deducted which is equal to the state-owned proportion of the property shares [26 § (4)]

However, when calculating the assessable income, only 20% of the modified amount transferred to an ESOP organization, can be taken into account (See the Corporate tax law for calculating the adjustments Act LXXXVI of 1991, [4 § (3)] for deductions and [4 § (3)] for increase )

*96 Is the amount of support, which can be transferred tax-free to the ESOP Organization, dependent on the proportion of ownership of the Organization in the company?*

As discussed in Question 95, the company is entitled to deduct from its taxable income the amount transferred to the ESOP Organization to help to execute its repayment obligation but up to 20% of its pre-tax profit. This 20% which can be transferred tax free, is not connected to the proportion of the property shares, purchased by the ESOP from the state trustee organization. In other words if the ESOP Organization owns 10% of the property shares, the company is allowed to transfer tax-free 20% of its pre-tax profit. Or even if an ESOP Organization owns 60% of the property shares, the company is not allowed to transfer tax free more than 20% of its pre-tax profit.

*97 To what extent is an ESOP Organization entitled to receive tax free support, if the purchase was not directly made from the state trustee organization?*

The items of the Law on ESOP regarding the corporate tax allowance to a company which supports an ESOP Organization [26 § (4)-(5)] does not go into details regarding the extent of the allowance if the ESOP organization buys the shares not directly from the state trustee organization, but buys the property shares of a company which is owned by another firm which is state-owned or at least partially owned by the state trustee organization.

The main aspect in the interpretation should be the proportion of the purchase price or instalment payment received by the state trustee organization. Concerning tax allowances, there might be 4 cases to be distinguished based upon whether the state trustee organization has direct or indirect interest in the company from which the ESOP organization acquires property shares, and also based upon the fact whether the ESOP organizations purchases non-state-owned property share with direct or indirect state ownership share.

*Explanation for tables 1-4*

- STO property of the state trustee organization ⇒ 
- OP other (not state-owned) property ⇒ 
- ESOP property of the ESOP ⇒ 
- Seller Corporation's property ⇒ 

Case 1

When the sale was realized, the company in which the ESOP Organization obtained ownership was fully or partly owned by the state trustee organization and the Organization purchased the shares directly from the state trustee organization. In this case the ESOP Law supports the interpretation according to which, at the time of calculating the tax base the company is entitled to reduce its pre-tax profit with the amount transferred to the ESOP Organization, until the amount exceeds 20% of the result before the adjusted taxation (See Question 95 )

Figure 1 a

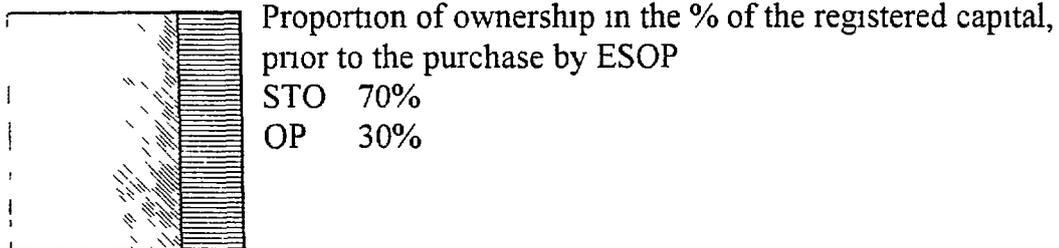
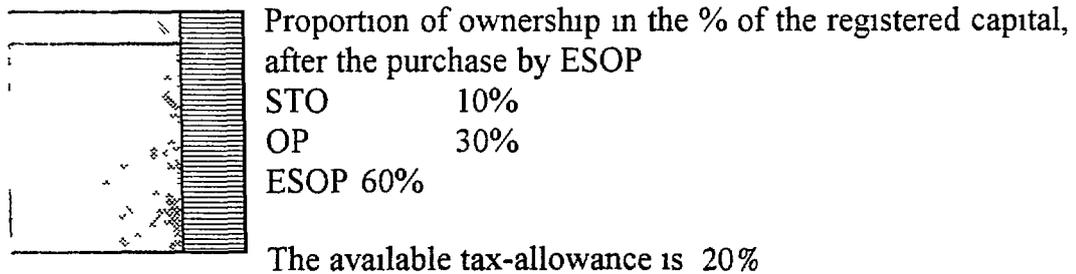


Figure 1 b



Case 2

The ESOP Organization purchased property shares, which at the time of sale were partly in the ownership of the state trustee organization (state-owned property share) partly owned by somebody else (non-state-owned property share). In such cases the ESOP Law [26 § (4)-(5)] supports the interpretation according to which, at the time of calculating the tax base, the company is entitled to reduce its pre-tax profit with the amount transferred to the ESOP Organization, until the amount exceeds the proportion of 20% of the adjusted pre-tax result corresponding to the proportion purchased from the state trustee organization by the ESOP organization.

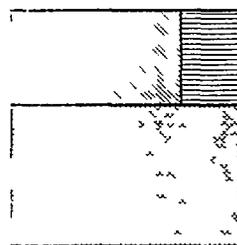
Figure 2'a



Proportion of ownership in the % of the registered capital, prior to the purchase by ESOP

STO 70%  
OP 30%

Figure 2'b



Proportion of ownership in the % of the registered capital, after the purchase of ESOP

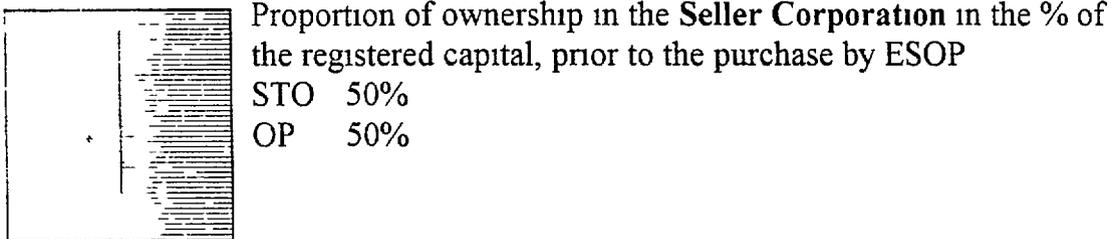
STO 28%  
OP 12%  
ESOP 60% (42% was purchased from STO and 12% from OT)

The available tax-allowance is  $20\% \times [42\% \cdot 60\%] = 20\% \cdot 0.7 = 14\%$

Case 2

The ESOP Organization purchased property shares of an employer company which was fully or partly state-owned, or owned by an enterprise in which the state trustee organization had interest at the time of the sale. In such cases the ESOP organization may also be supported by the employer company with tax-free grant during the repayment period. In such cases -- based on Art 26 sections 4-5 of the ESOP Law -- at the time of calculating the tax base, the company is entitled to reduce its pre-tax profit with the amount transferred to the ESOP Organization, until the amount exceeds the proportion of 20% of the adjusted pre-tax result corresponding to the proportion of state-owned share in the company selling property shares (this may only be 100%)

Figure 3



A corporation, 70% owned by the Seller Corporation

Figure 3/a

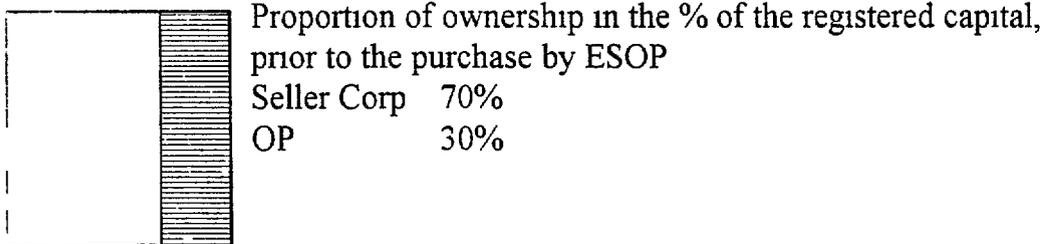
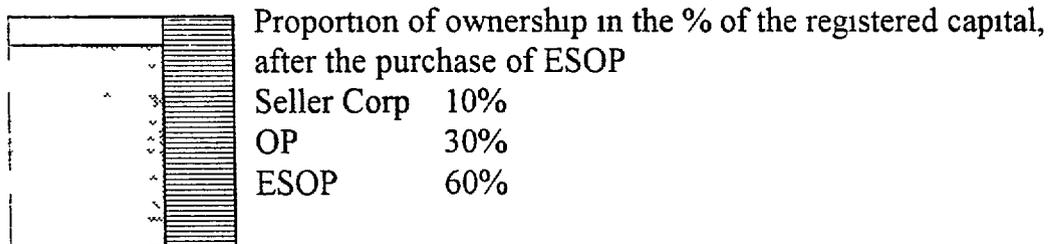


Figure 3 b



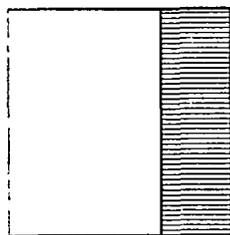
The available tax-allowance is

$$20\% \times [\text{Property share of the state in the Corp}] = 20\% \times 0.5 = 10\%$$

Case 4

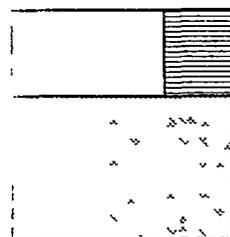
This is basically a combination of Cases 2 and 3. The ESOP Organization purchased property shares a part of which was sold by a company in which some state trustee organization owned a part and another part of which (non-state-owned) was sold by somebody else. In such cases -- based on Art 26 sections 4-5 of the ESOP Law -- at the time of calculating the tax base, the company is entitled to reduce its pre-tax profit with the amount transferred to the ESOP Organization, until the amount exceeds the proportion of 20% of the adjusted pre-tax result corresponding to the product of multiplication (1) of the ownership proportion of the company as on seller and (2) of the proportion in which the partially state-owned company receives a part of the purchase price.

Figure 4/a



Proportion of ownership in the % of the registered capital, prior to the purchase by ESOP  
 Seller Corp 70%  
 OP 30%

Figure 4/b



Proportion of ownership in the % of the registered capital, after the purchase by ESOP  
 Seller Corp 28%  
 OP 12%  
 ESOP 60% (42% was purchased from Seller Corp and 18% from OP)

The available tax-allowance is  $20\% * 0.5 * [42\% + 60\%] = 20\% * 0.5 * 0.7 = 7\%$

*98. Is an ESOP Organization is entitled to tax allowance provided that the ESOP Organization has not executed the purchase -- neither directly nor indirectly -- from the state trustee organization?*

A definite no is the answer. The reason is that the Law on ESOP prescribes that the condition for deducting the (limited) amount transferred to the ESOP organization when calculating the assessable income is that the transaction is connected to the privatization of a fully or partly state-owned company and to the sales of the property shares in their ownership.

In the case of so called "non-privatization ESOPs", corporate tax allowance can not be utilized. However, participants can deduct their own resource contribution from their assessable income up to 30% (together with other deductions) of their assessable income.

*99 What costs can be accounted for as operational costs of the ESOP Organization, and what sources are available to cover these costs?*

Only those costs can be accounted for as operational costs which are directly related to the objectives of the organization. These include costs related to establishment and operation of the ESOP Organization (e.g., wage, social security contribution, material expenditure, fees to experts, etc.) These costs -- just like repayment of credit or execution of instalment payment -- are covered from the income of the organization. (It was discussed under Question 95 that transfers can be made based on the pre-tax profit of the company, however restrictions apply.) The income of the Organization includes remittances by the company, payments made by participants and other natural persons and legal entities, dividends on property shares owned by the organization and income from sale of property shares [16 § (3)]

However costs related to the operational body of the organization, can not be financed from dividends of property shares owned by the organization because that full has to be spent on repaying current debts. Dividend on shares is not a direct income of the organization but it is received by the organization. It is due to the participants on the shares which were transferred into their ownership during the repayment period but it also has to be spent on repaying current debts [16 § (3)]

*100 For what period is the Organization established, and when does it cease to exist? What will happen to its property?*

The Organization is always established for a defined period of time, but it can be terminated any time by decision of the general assembly or Court. Assuming that the Organization has transferred all the ownership of shares to its participants, or the employer company ceases to exist without legal successor, the executive body is obliged to summon a general assembly within 30 days, which has to pass a resolution on the termination of the organization and the division of the rest of the property. Nevertheless, it is not necessary to terminate the Organization upon fulfillment of repayment obligation. Participants may decide so that property shares acquired by the Organization will remain in the possession of the Organization -- until the end of the period, determined in the statutes.

Should the Organization not be able to realize its main purpose, and should the implementation of the termination be unsuccessful, the state trustee organization which facilitated the instalment payment or the creditor bank have to turn to court. The court will decide on immediate termination of the Organization and will inform the Public Prosecutor about it.

The Organization may be terminated as a result of such decision of its participants -- upon initiative of the majority -- before the ownership of all property shares is transferred. Should such decision be made, it can be executed upon signing an

agreement by the company, the creditor bank or by the state trustee organization which facilitated payments by installments and upon settling the final balance with participants

When the Organization is terminated, there might be several alternatives for division of the property. It can be divided

- among participants in proportion to the shares owned by them,
- among participants in proportion to the shares owned by them and to those shares which could potentially be owned by them in accordance with relevant provisions of the statutes,
- among participants, pensioners, and successors of those participants, who died in proportion to the shares owned by them

# ATTACHEMENT

## **Act XLIV of 1992 on the Employee Stock Ownership Plan\***

For accelerating privatization and in order to promote that the employees can acquire - in addition to previous forms of property acquisition - ownership share in the economic association employing them, depending on their decision, in organized form and in a preferential system, Parliament enacts the following Act

### **General Provisions**

#### **Article 1**

(1) The shares [business quotas (hereinafter property share)] of a company limited by shares or limited liability company (hereinafter company) incorporated in Hungary can be acquired by the persons employed by the company as beneficiaries (hereinafter employees) in the framework of the Employee Stock Ownership Plan (hereinafter ESOP) in the way regulated by this Act

(2) An employee employed for at least half of the legal worktime, and has been employed by the company for at least six months, is entitled to participate in ESOP including the employment with the legal predecessor of the company. The statutes of the ESOP organization (hereinafter organization) can stipulate a longer time as condition of eligibility, but this shall not exceed 5 years. The employees entitled to participation can waive their entitlement only in writing.

(3) Employees, who comply with the conditions defined in section (2) and announce their intention to participate in writing to the organizing committee [Article 2 section (1)], or, after the institution of the organization, to the administrative and representative body (hereinafter executive body) can participate in the ESOP.

(4) Upon the termination of the employment the employee's right of participation in the ESOP terminates as well.

(5) ESOP can also be started in the course of the transformation of state-owned enterprises, of subsidiaries or of companies owned by certain legal entities. Upon the request of the organizing committee, the state trustee organization can withdraw the property of a separated organizational unit of the state-owned enterprise and transform it into a company with the purpose of starting ESOP there. In these cases the rights to which the company is entitled under this Act are exercised by the property administering organ which participates as founder in the transformation process.

(6) The financial institutions and insurance institutions do not come under the force of this Act.

## Article 2

(1) If at least 25% of the employees want to acquire property share in the framework of ESOP, they shall entrust in writing for this purpose an organizing committee consisting of 3 persons. If the property of the separated organizational unit of the state-owned enterprise is withdrawn by the property administering organ with the purpose of starting ESOP, the basis for the calculation of the 25% ratio of participation shall be the number of the employees employed at the separated organizational unit. The organizing committee agrees, in the name of the mandators and in consensus with them - with those owners who want to sell their property shares to the organization to be founded by the employees - for the case of the formation of the organization - on the conditions of the sale, especially on the service to be performed and the compensation, in case of payment by instalments, on its conditions as well as on the collateral obligations guaranteeing the contract.

(2) If in the case of sale by the state trustee organization there is a possibility to have recourse to the Existence Loan, the term of the property sale tender shall not be shorter than 35 days. This rule shall also apply if the state trustee organization grants payment by instalment.

(3) The organizing committee shall prepare a feasibility study (hereinafter study) on the possibility of fulfilling the agreement referred to in section (1). This shall indicate whether under the conditions defined in the agreement the financial situation of the company allows the amortization of the selling price and interests of the property share the employees wish to acquire, and the degrees of property share and face values of shares at which the programme can be realized. The study shall be countersigned by the company certifying that its contents are technically correct.

(4) The company shall supply the data required for the preparation of the study. In case an organization is formed, the costs arising in connection with the preparation of the study are borne by the company.

## Article 3

(1) In possession of the study the organizing committee may have recourse to a financial institution with loan application or can make an offer for payment by instalments to the owner selling the property share.

(2) As a result of the credit review, the financial institution can issue a loan promise and the owner as seller can make a declaration, according to which he shall accept the offer to pay by instalments in case an organization is formed.

(3) The statutory meeting of the organization shall be called by the organizing committee. In addition to what has been laid down above, this also requires that the shareholders' meeting (members' meeting) of the company consents to the formation of the organization in accordance with the content of Act VI of 1988 on economic associations (Companies Act, hereinafter CA), and the articles of association (the statutes) of the company.

(-) In case of consent the right of pre-emption due to the members (shareholders) of the company (on the basis of CA) or the articles of association (the statutes of the company) cannot be exercised with regard to the property share offered to the organisation.

## **The Formation of the ESOP Organization**

### **Article 4**

(1) The organization is a legal entity with self-government and registered participants created voluntarily by the employees for the purpose of acquiring property share in the company employing them. The statutes cannot deviate from the purpose defined in this section.

(2) The property share acquired by the organization becomes the property of the organization which shall deliver it into the property of the participants according to the conditions set forth in this Act and in the statutes.

(3) For the formation of an organization it is necessary that at least 40% of the employees of the company declares the formation of the organization at the statutory meeting, they adopt its statutes in accordance with the requirements set forth in this Act (Article 9) and elect its administrative and representative body (hereinafter executive body). The organizing committee ceases to exist after the formation of an organization.

(4) One employer can participate only in one organization at the same time.

### **Article 5**

(1) After the formation of an organization its court registration has to be applied for. The minutes of the statutory meeting, the statutes of the organization and the declaration of consent of the company [Article 3, section (3)] shall be attached to the application.

(2) The registration of the organization cannot be refused if the founders have complied with the conditions set forth in this Act. The organization becomes a legal entity by the registration.

### **Article 6**

(1) The organization shall be registered by the relevant County Court or the Budapest Court (hereinafter together Court) having jurisdiction over its seat.

(2) The Court decides on the registration out of turn, in non-contradictory procedure. The Court sends the resolution on the registration to the attorney's office.

(3) The change of the data of the statutes shall be reported to the Court within 30 days after the change has taken place.

## **The Functioning of the ESOP Organization**

### **Article 7**

(1) The supreme organ of the organization is the general assembly consisting of all the participants.

(2) The following are within the exclusive competence of the general assembly:

- a) the adoption and the amendment of the statutes,
  - b) the definition of the annual budget,
  - c) the election and revocation of the executive body, the determination of the remuneration of its members,
  - d) the acceptance of the annual report of the executive body,
  - e) determinate the measure of the property share to be transferred into the property of the participants,
  - f) decision on the acceptance of the conditions of raising a loan and/or of payment by instalments and on all matters which are referred by the statutes to the exclusive competence of the general assembly
- (3) The general assembly shall be convened as necessary, but at least once a year. The general assembly shall also be convened if this is ordered by the Court or if this is the wish of one-third (or smaller proportion as defined in the statutes) of the participants indicating the reason and the purpose for the convention
- (4) The general assembly meeting can also be held in the form of an incomplete session in the way defined by the statutes

### **Article 8**

- (1) The members of the executive body shall be elected by the general assembly by secret ballot for a definite period
- (2) The executive body represents the organization through its member named in the statutes vis-a-vis third parties as well as in court, and before other authorities. The executive body elects its president from among its members by itself
- (3) Unless the statutes provide otherwise, each member of the executive body is entitled to management of the organization
- (4) Any person, who is not prohibited to participate in public affairs, can be a member of the executive body of the organization. At least half of the members shall be elected from among the participants of the organization. At most one third of the executive body can be delegated by the company
- (5) The members of the executive body are responsible for their activity according to the general provisions of Civil Law

### **Article 9**

The following shall be defined in the statutes of the organization

- a) its name, purpose, seat, and the name of the company whose property share will be purchased by the organization,
- b) name of the representative of the organization,
- c) the way of summoning the general assembly, its quorum and the procedure in case of the lack of quorum, the conditions and way of exercising the right to vote
- d) the number of the members of the executive body, the way of their election, their sphere of competence and the term of their functioning,
- e) the way and degree of the contributions paid by the participants,

- f) the way the property share owned by the organization is transferred into the property of the participants, the principles of its distribution,
- g) the rules of re-purchase of the property share that has been transferred into the property of the participants, and in case of their sale, the way of exercising the right of pre-emption,
- h) the way the resolutions are published,
- i) the rules of joining by the employees after the foundation of the organization,
- j) the rights and obligations of the participants,
- k) the rules of the alienation of the property share remaining in the property of the organization after the full amortization of the loan and the interests,
- l) the principles for the division of the property in case the organization ceases to exist,
- m) anything that the participants wish to regulate in the statutes

#### **Article 10**

(1) Any illegal resolution on the part of the general assembly or the executive body of the organization can be challenged by any participant in court within 30 days from obtaining knowledge thereof

(2) Challenging of the resolution does not hinder the implementation of the resolution in justified cases, however, the Court can suspend the implementation of the resolution

#### **Article 11**

The Attorney's Office exercises supervision of legality over the organization according to the rules of its government. If the legality of functioning cannot otherwise be ensured, the attorney may have recourse to the Court

#### **Article 12**

On the basis of the statement of claim by the participant and the attorney, the Court

- a) can repeal the illegal resolution of the organization and can order, if necessary, the adoption of a new resolution,
- b) can convene the general assembly for the restitution of legality of functioning,
- c) if the legality of the functioning of the organization cannot otherwise be ensured, it can suspend its activities and appoint a supervising commissioner for its control

#### **Article 13**

The whole property of the organization is a guarantee against its debts. With the exception of the content of Article 19, section (1), the participants are not liable for the debts of the organization with their own property

## Article 14

(1) The organization purchases the property share offered for sale through a loan or payment by instalments, as well as by using its own financial resources in accordance with section (4). In case of sale by the state trustee organization the indemnity bill shall be taken into account at face value, as own financial resource necessary for the loan or for the payment by instalments.

(2) With the exception of transfer to the participants, the organization cannot alienate the property share acquired by loan or by payment by instalments until the termination of the amortization, the lending financial institution, or, in case of payment by instalments, the state trustee organization have right of pledge thereon.

(3) The profit (dividends) due for the property share purchased by using loan or payment by instalments shall be spent on the amortization of the existing debt. This provision shall also apply to the property shares transferred into the property of the participants in the course of the amortization.

(4) A condition of granting a loan and payment by instalments is that the organization should have its own financial resources. The measure of the own resource is defined as follows, as a function of the average purchasing price falling on a participant:

The average bands of purchasing price falling on one participant	Basis of own resources	% of the part within the band
0 - 5 million HF	0 HF plus	2%
Above 5 million HF	100 000 HF plus	15%

The ratio of the own resources in accordance with the above shall be established by projecting it on the property share purchased by the organization.

(5) The term of the loan and of the payment by instalments is maximum 15 years from which at most three years can be the grace period<sup>1</sup>.

(6) The company is responsible as guarantor for the repayment of the loan, or for the performance of the payment by instalments in default of other securities offered in addition to the right of pledge defined in Article 14, section (2) and in Article 19, section (1).

(7) Article 38, section (3) and Article 39, section (2) of Act LXIX of 1991 on financial institutions and the activities of financial institutions shall not apply with respect to this Act.

## Article 15

(1) The interest on the loan granted for the purchase of the property share owned by the state trustee organization shall be identical with the prevailing interest conditions of the Existence Loan. The revenues of the state trustee organization financed by the preferential loan scheme shall be spent wholly on the reduction of

<sup>1</sup> These first two sections amended were announced on May 4 1993

the state debt

(2) The conditions of the sale of the property share owned by the state trustee organization in the framework of payment by instalments are identical with those described in section (1), with the exception of the interest margin

#### Article 16

(1) In addition to those described in Articles 14 and 19, the organization cannot engage in any other economic activity

(2) From the point of view of reporting and book-keeping, the rules of accountancy relating to other organizations shall apply to the organization

(3) The receipts of the organization include the sum remitted by the company, the payments of the participants, other natural persons and legal entities as well as the dividends (proceeds) due on the property share owned by the organization, furthermore, the receipts resulting from the alienation of the property share

(4) The organization can only charge the disbursements directly connected with and necessary for the realization of the aims of the organization to its operational costs

#### Article 17

In accordance with the statutes, the organization shall exercise its membership rights derived from the ownership of the property share through its representative. Other persons, too, can be entrusted with exercising the voting right in the way defined by the statutes

#### Article 18

(1) The executive body shall open a share account for the participants on which the value of the property share transferred into the property of the participants shall be indicated

(2) The aggregate sum on the share accounts of the participants cannot exceed the face value of the property share already amortized

(3) The property share becomes the property of the participants if the sum on the share account reaches the face value of the share, or, in the case of business quotas it complies with the provisions in Article 159, section (1) of Act VI of 1988 on economic associations relating to the measure of the primary stake falling on the business quota

(4) The acquisition of property on the basis of section (3) is free of stamp duty

(5) The statutes can also provide that the property shares acquired by the organization - with the exception of those purchased from own resources - remain for a definite period and measure in the property of the organization even after the termination of the amortization

(6) The organization shall transfer the property shares purchased by using

own financial resources immediately into the property of the participants in the proportion of the individual payments. If this provision cannot be met in its entirety, the countervalue of the property share remaining in the property of the organization shall be registered in the same proportion on the share account. If the own resources are not paid in by the participants, the delivery of the property shares purchased from own resources shall be governed by the statutes.

### Article 19

(1) The property shares transferred into the property of the organization in accordance with Article 18, section (3) cannot be alienated until the termination of the amortization of the loan debts still subsisting in relation to the property of the organization, the lending financial institution, and/or, in case of payment by instalments the state trustee organization is entitled to right of pledge thereon. These property shares continue to be administered by the organization, this, however, does not affect the shareholder's (member's) rights deriving from the legal relationship of company membership.

(2) The organization is entitled to the right of pre-emption for the property shares already transferred into the property of the participant in case of the retirement or death of the participant during the period of amortization. In other respects the prohibition of alienation and right of pledge described in section (1), as well as the right of administration of the organization cease to exist at the time of the retirement or death.

(3) In other cases of the termination of the participant's relationship during the period of amortization, the organization can repurchase the property shares transferred into the property of the participant within the period defined in the statutes, but at latest within 6 months. The right of repurchase shall be exercised by the organization at the value defined in the statutes, but this shall not be less than half of the market value. In case the employee terminates his employment illegally or if the employer terminates it by extraordinary notice, the organization can pay the purchase price within the maximum of five years, and in other cases, within two years in instalments, too. If the organization does not make use of its right of repurchase the provisions of section (1) shall apply until the termination of the amortization.

(4) Under the conditions defined in the statutes, the other employees of the company, the participants and the members of the company are entitled - in this order - to the right of pre-emption for the repurchased property shares.

(5) The provisions of this Article shall not apply to property shares purchased from own resources.

### Article 20

(1) If the organization does not comply with its obligations towards the financial institution or the state trustee organization at due date, the further procedure shall be governed by Decree 39/1984 (XI 5) MT on money circulation and bank loans.

(2) If the procedure of execution against the organization was unsuccessful, the financial institution or the state trustee organization shall inform the Court about this simultaneously attaching the documents, and the Court shall - informing at the same time the Attorney's Office - abolish the organization with immediate effect. An appeal can be lodged against this decision on abolition within 15 days.

#### **Article 21**

In case the property shares are not sold by the state trustee organization, the parties can deviate from the provisions of Article 14, sections (1) and (4) to (6).

#### **Article 22**

If pursuant to the provisions of another Act, a definite part of the revenues of the state trustee organization from privatization are due to another organization, for this part, the benefit of payment by instalments can be granted instead of the preferential loan construction regulated by this Act, under conditions identical therewith.

#### **Article 23**

If the state trustee organization sells property shares to the organization, Article 21, section (1) of Act XIII of 1989 on the transformation of business organizations and economic associations shall not apply.

### **The Cessation of the ESOP Organization**

#### **Article 24**

(1) Once the organization has transferred the property right of all the property shares, the executive body shall convene the general assembly within 30 days, which shall decide on the abolition of the organization and the distribution of its property.

(2) The provisions of section (1) shall apply also if the company is abolished without a legal successor.

(3) Apart from the cases described in sections (1) and (2) of this Article and in Article 20, the organization can only be abolished on the basis of the initiative of the majority of the participants, after an agreement concluded with the company, the lending financial institution or the seller providing the benefit of payment by instalments, and after the final settlement with the participants.

### **Concluding Provisions**

#### **Article 25**

This Act comes into force on the 15th day following its promulgation.

## Article 26

(1) Article 6, section (1) paragraph e) of Act XC of 1991 on the income tax of private persons shall be replaced by the following provision

[Note: unless provided otherwise by law]

"e) the pecuniary value obtained in the form of co-operative business share, co-operative property share, property bill or share granted without direct compensation (countervalue) with respect to his legal relationship to the member, ex-member of the co-operative, to the heir of the member, to the employee of the co-operative, in case of agricultural co-operatives to the helping member of family, furthermore, the property bill granted by the employer to the employee without direct compensation (countervalue), the sum of the face value of the employee's share reduced by the compensation of the share (business quota) acquired in the framework of the Employee Stock Ownership Plan (ESOP), the sum with which the individual share (business quota) account of the participant of ESOP has been credited above the own payment (hereinafter, all of them together gratis securities), until this has been alienated by the private person, and/or the other conditions enumerated in Article 33, sections (4) to (6) have not arisen "

(2) Article 35, section (1) of Act XC of 1991 on the income tax of private persons shall be complemented by the following

- " furthermore, the sum actually paid in by the participant in the year of reference in the framework of the Employee Stock Ownership Plan under the title of own payment from his after-tax income "

(3) The organization is not subject to corporation tax, as it does not engage in business activity

(4) Article 4, section (2) of Act LXXXVI of 1991 on corporation tax shall be complemented by the following paragraph k)

[At the calculation of the basis of tax assessment, the pre-tax profit shall be reduced by]

'k) the sum remitted by the subject of taxation to the Employee Stock Ownership Plan (hereinafter ESOP) organization in the framework of ESOP connected with the privatization of state-owned enterprises or companies owned in part or as a whole, by the State, as well as with the sale of the property shares owned by them, in the interest of the realisation of the basic objective of the ESOP organization, during the period of the organization's obligation of loan amortization, but not more than the sum defined in Article 5, section (7) In case of the joint alienation of state-owned and not state-owned property shares (in the framework of ESOP), the part of the sum remitted, proportional to the quota of the State property can be taken into account, which, however, shall not exceed the measure defined in Article 5, section (7) In case of the alienation of the property share in a company owned in part, or as a whole, by the State (in the framework of ESOP), the proportional part corresponding to the State's ownership quota in the company can be taken into account which, however shall not exceed the measure defined in Article 5, section (7) "

(5) Article 5 of Act LXXXVI of 1991 on corporation tax shall be complemented by the following section (7)

"(7) in the course of fixing the basis of tax assessment, not more than 20% of the pre-tax profit increased by the items defined in Article 4, section (3) and reduced by the sums defined in Article 4, section (2) paragraphs a) to j) from the sum transferred to the ESOP organization can be taken into account "

(6) Article 39, section (2) of Act LXIX of 1991 on financial institutions and the activities of financial institutions shall be substituted by the following provision

"(2) For the purpose of the purchase of securities embodying the membership rights of the financial institution, it shall not grant a loan exceeding 50% - in the case of sale by a state trustee organization, 85% - of the resale price, or, if this cannot be ascertained, of the purchasing price, of the securities wished to be purchased "2