Eötvös Loránd University Faculty of Law

Doctoral School of Law

VENTURE CAPITAL INVESTMENT CONTRACTS

A comparative legal study

via the analysis of the legal solutions applied by the United States of America, Germany, and Hungary

Synopsis of a PhD thesis

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1. Introduction

Venture capital investments constitute a type of company financing. Those (typically early-stage) businesses which do not own assets which would make it possible for them to be financed by banks but wish to develop rapidly may raise the funds necessary for their operation via the investment of capital.

Capital investment contracts are typically performed by newly established, innovative businesses which are capable of producing the significant – when compared with the interest rates of banks – return expected by the investor. These investments are extremely risky for the investors since, at the early stages of a companies, there is no prior data available based on which conclusions could be drawn with regard to the future development of the business and to its profitability. The risks faced by the investors include legal risks as well.

The investor becomes only a member in the company receiving the investment (hereinafter

referred to as the 'target company'), and therefore it may wish to protect its legal interests and the value of its investment via special rights in addition to the traditional solutions available under company law. Such protection may be achieved via a venture capital investment contract.

The venture capital investment contract is not a typical contract; it has no special rules prescribed by the Civil Code. The first venture capital investment contracts started to spread in Hungary only in the 1990s then, following the JEREMIE initiative, became more and more common in the 2000s[1] and, due to the activity of state-owned capital investment companies, became widespread from the 2010s.[2]

Notwithstanding the foregoing, the substantive elements of venture capital investment contracts have not been examined in the Hungarian

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[1] Judit Karsai: A kockázatitőke-finanszírozás nyílt és rejtett csatornái Magyarországon; Külgazdaság, 1995/10., p. 17.

[2] Pénzügyi eszközök értékelése 2007–2013, prepared by: Századvég Gazdaságkutató Zrt., 30 November 2016., pp. 41-72., URL: https://www.palyazat.gov.hu/download.php?objectId=71209 (1 July 2018).

professional literature. Venture capital investment contracts with regard to millions of dollars are concluded regularly, however, these contracts include English terms which are challenging to be translated into Hungarian and are often the literal translations of an American contract. These translations may not be a cause for concern solely due to their wording, but also due to the issue of the applicability of common law legal concepts and solutions in a continental (Romano-Germanic) legal system.

The present thesis aims at the detailed examination of venture capital investment contracts.

The thesis follows the typical structure found in the contracts examined. First, it examines who the parties to investment contracts are and what the subject matter of the transaction is. Then, it elaborates on the system by which companies are directed and controlled (corporate governance) subsequent to an investment. Finally, the thesis enumerates the special preferential rights to which

investors may be entitled and which may usually be found only in venture capital investment contracts.

However, it should be noted that the thesis does not examine the early stages of corporate investment, that is, angel investments or seed investments. In addition, the thesis does not examine either later-stage corporate investments, that is, the so-called private equity transactions, or contracts performed in the initial public offering (IPO) stage or in the stage subsequent to it.

2. The methods applied

The scientific approach of the thesis is empirical, focusing on the legal issues which have arisen in my daily practice, and the method of reasoning is inductive, since it attempts to understand the standard practice by drawing conclusions from the individual contracts examined. The final aim of the thesis is pragmatic: it wishes to provide the legal practice with in-depth scientific answers to the legal issues which have arisen. Considering its topic, the thesis is of a comparative nature, since it compares

the legal practice of Hungary, Germany, and the USA, and it also examines the legal solutions applied in the USA from the perspective of the Hungarian legal practice. The thesis is a comparative analysis at national level, since it focuses on the conclusions which may be drawn regarding the relevant Hungarian legislation by examining the legislation of other countries.[3] The indirect aim of the thesis is to attempt the collection of the known legal issues of the international movement of capital and, wherever possible, recommend solutions to such issues.

As a practicing attorney-at-law, my approach was to present the experience acquired from my practice and to give a comprehensive description of the new notions with regard to each new legal concept. In order to achieve this, I first examined which legal concepts were the most common in the capital investment contracts I had drafted and which were

[3] Konrad Zweigert, Hein Kötz: Introduction to Comparative Law, 3. ed., Oxford University Press, NY, 1998, p. 46.

those three Hungarian contracts in which these legal concepts were the most common. I applied the same method of research in the German and American law firms which were the sources of the contracts compared. During my months of research in the law firms LUTZ | ABEL Rechtsanwalts PartG mbB, München and Foley & Lardner LLP, Boston, I asked my German and American colleagues to provide me with and allow me to use in my research those venture capital investment contracts (three from each law firm) which they had drafted and which they considered to be the most typical. Webley calls the research method in which the researcher first asks other experts to recommend further material for research to them 'snowball sampling'.[4] Consequently, a total of nine contracts – collected from the Hungarian, the German, and the American practice – constituted the material for the research.

[4] Lisa Webley: Qualitative Approaches to Empirical Legal Research, in: Cane, Kritzer (eds.): Oxford Handbook of Empirical Legal Research, Oxford University Press, 2010., p. 7.

After listing the substantive legal elements derived from the contracts, I performed the comparative legal analysis of the legal concepts in question. In the course of this, I performed the traditional analysis of the professional literature and of the judicial practice, focusing on the most significant substantive elements in the relevant German and American professional literature and aiming at achieving completeness with regard to the Hungarian professional literature.

The conclusions of the thesis, the methodological approach of the researcher, and the methodology of the research are qualitative.[5] There are no binding statutory provisions for the structure of capital investment contracts; the contents of the contracts are especially heterogeneous and show great variety both with regard to the place of the origin of the contract and to the time in question. Due to this, if the research had been conducted from a different

[5] Corbin Juliet, Strauss Anselm: A kvalitatív kutatás alapjai, L'Harmattan, 2015., pp. 51-52.

sample or at a different time, the results of it would have probably been similar, but not identical, to the results of the present research. In the thesis, I constantly emphasize that I examine the nine contracts constituting the basis of the research and at no time do I claim that the contractual provisions examined have to comply with these rules in every case.

3. Synopsis

3.1. The structure of the thesis

No such work is known in the Hungarian professional literature which aims at the exhaustive analysis of venture capital investment contracts. In addition, I am not aware of any Hungarian paper which aims at achieving completeness in the enumeration of the substantive elements characteristic of or specific to venture capital investment contracts.

The thesis aims at addressing this academic deficiency. Based on the contracts examined, the thesis presents, in the broadest manner possible, the

structure of, the specific logic of, and the legal solutions applied in venture capital investment contracts.

3.2. Parties

The thesis categorizes the parties to venture capital investment contracts in a novel manner, according to which the parties may be categorized as follows based on the definitions below:

a) persons necessarily involved in investment contracts:

   i. The target company, which entity is a private business organization which has or is developing an innovative product or service, operates with the limited liability of its members, has been established by its founder(s) or by its founder(s) and other persons, and in which the investor acquires, as a member or as a shareholder, a business share or share(s), respectively, via an increase of the capital at least partly with the provision of a capital contribution in cash.

   ii. The founder, who is (are) the first member(s), shareholder(s) of the target company or is (are) a person (persons) who join(s) later and the contribution of whom is indispensable with regard to the operation of the target company, either due to certain pieces of intellectual property provided by the founder or due to their personal contribution to the activity of the target company.

   iii. The investor, who is a natural person or a legal entity and whose primary service is the provision of capital contribution in cash for the target company with the aim of achieving the highest possible return when selling their business share or share and thereby exiting the target company and who may also provide other services for the target company.

b) other persons possibly involved in investment contracts:

i. Owners, that is, those members or shareholders of the target company who are distinct from the founders with regard to their rights and/or obligations but are neither investors not persons entitled to ESOP.

ii. Persons entitled to ESOP, that is, those employees of the target company who have acquired a business share or a share in the target company in return for their work performed in the interests of the target company but are neither founders nor owners.

iii. Holders of convertible notes, that is, those creditors of the target company who are entitled, upon the occurrence of a certain condition, to convert their debt claims towards the target company into stock claims.

The thesis analyses in detail the legal characteristics of the specific parties based on the examined contracts.

It was concluded that the target companies operated as limited business organizations in each of the jurisdictions examined. This form of business organization was Inc. or LLC in the United States, was GmbH in every German case, and kft. in Hungary. In the thesis, I analyze in detail the national laws regulating the said forms of business organization. However, in order to avoid deviating from the subject of the thesis, I omit the detailed analysis of other forms of business organization in the other parts of the thesis.

The founders were natural persons in each of the contracts examined.

With regard to the investors, I concluded that their legal characteristics and the investments they effected changed depending on at which stage of the development of the business of the target company they had entered the target company. I applied the following categorization, which had not been presented in any other source of professional

literature earlier and which was based on the degree of regulation by law and its sector-specific nature:

a) Early-stage investors, with the category consisting of
   i. FFF
   ii. business incubations
   iii. crowdfunding
   iv. business angels
b) Non-institutional investors (business organizations)
   v. private limited companies (kft.)
   vi. private limited companies (zrt.) and public limited companies (nyrt.)
c) Institutional investors (forms of collective investment)
   vii. VC funds
   viii. PE funds

ad a) Early-stage investors

Early-stage investors are usually the first investors in the target company, they effect investments of small amounts, and they are subject to either a low level of or no special statutory regulation.

The acronym 'FFF' used in the professional terminology stands for 'Family, Friends, and Fools'. It is widely believed that in the earliest stages of an target company, it is supported only by its founders, 'family, friends, and fools'. This concept is not a legal category, it is hard to take a legal and scientific approach to it, and therefore I decided not to analyse it in detail.

Business incubations provide the target company only with small amounts of money or with no money at all; instead, they provide services which are especially difficult to be financed in the early stage of a business. Such services may include the provision of a registered office, public utility services, business and IT services (e.g. an accountant, internet and telephone access), assistance, etc.

Regarding crowdfunding, I analyse Regulation (EU) 2020/1503 of the European Parliament and of the Council on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937, applicable from 10 November 2021.

Concerning business angels, I accept the definition by Peter Cowley, who calls business angels 'invested investors'. In his book, he characterizes business angels in the following way: 'invested investors not only provide money, but also help entrepreneurs as they build their businesses. They have money that they're willing to risk losing, experience in the sector their entrepreneurs are targeting and contacts that can help the new business find customers, suppliers and management skills. They also recognize when to re-invest, when to look for investors with bigger pockets, and when to fold.'.[6] Subsequent to this, I analyze and criticize the

[6] Peter Cowley: The Invested Investor, published by: Invested Investor Limited, 2018, pp. 5.

practicability and the applicability of the provisions on business angels prescribed in Government Decree 331/2017 (XI. 9.) on the detailed rules of the registration procedure of early-stage businesses and of businesses supporting early-stage businesses.

ad b) Non-institutional investors

I defined the concept of 'non-institutional investors' as those investors which have to comply with certain provisions of company law, however, are not subject to special legal provisions regarding investments, organizational structure, capital, or investor protection. Non-institutional investors have to comply with, e.g., the provisions of company law, but are not subject to the provisions applicable to different funds. Examples of this concept may be those business organizations in Hungary which usually operate as 'investment and consultancy Ltd'-s and have no distinguishing characteristics either in their activities or in their capital structure.

In the thesis, the company law legislation applicable to the forms of investment featured in the contracts

examined is analyzed in detail, and it is concluded that no special provisions regulate the operation of these business organizations in addition to the said legislation.

ad c) Institutional investors

Institutional investors are distinguished from all other persons involved in investment contracts by having certain special legal provisions which are characteristic only to them and are applicable to them due to their investment activities.

All institutional investors are legal entities or pools of capital without a separate legal personality which raise capital from one or more investors in order to have it invested in target companies for the purposes of achieving the highest possible return and which are managed by – separate or not separate – professional asset management business organizations.[7] Investment funds are included in this

[7] Timothy Spangler: A Practitioner's Guide to Alternative Investment Funds, 3. Ed., Thomson Reuters, London, 2015., pp. 48-51.

category. Regarding the relevant legislation, I analyze

a) the relevant provisions of the Securities Act of 1933 of the United States, especially the most important legal basis of investment funds (VC), the so-called 'private placements' ('Regulation D')[8]

b) with regard to the relevant German regulation

   i. I analyze, in connection with the applicable EU legislation, Directive 2011/61/EU of the European Parliament and of the Council, of 8 June 2011, on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, which directive is the piece of legislation providing the basis for

[8] John Hempill, Michael Rennock, Bruce Johnson, Christopher Arana: Private Placements And Securities Law Issues, in: Dror Futter, Issac J. Vaughn: Venture Capital, 2004, Practising Law Institute, pp. 85-125.

alternative investment funds (hereinafter referred to as 'AIF') at EU level, and

ii. I analyze the German alternative investment funds based on the relevant EU legislation, the German Sondervermögen, that is, the (not special) investment fund, the Spezial-Sondervermögen, that is, the special investment fund, [9] and the German alternative investment fund managers, the Investment AG and the Investment KG.[10]

c) The bases of the Hungarian regulation of AIFs are Act XVI of 2014 on the forms of collective investment and their managers and on the amendment of certain acts on finance, and Government Decree 78/2014 (III. 14.) on the rules of the investments and of the borrowing of the forms of collective investment. I analyze the

[9] Wolfgang Weitnauer: Handbuch Venture Capital, München, C.H. Beck, 2019. 6. ed. (e-book), Rn. 1-11.

[10] Dirk A. Zetzsche (ed.): The Alternative Investment Fund Managers Directive, Second Edition, Wolters Kluwer, Croydon, 2015. pp. 825-826.

relevant statutory definitions such as that of the venture capital fund (VC) and of the private equity fund (PE) and the fundamental provisions applicable to venture capital fund managers.[11]

At the end of the chapter on the analysis of the parties to venture capital investment contracts, I conclude the following:

a) I conclude that the target company operated under the general company law provisions in every contract examined (excluding the rules of corporate governance to be analyzed below), even if it was established for the business purpose of introducing a highly innovative technology to the market.

b) I also conclude that the regulation of AIFs is especially complicated and presumably imposes unnecessary administrative burdens on the investors. I make a recommendation that the

[11] Judit Glavanits: A kockázati tőkebefektetések egyes jogi kérdései, UNIVERSITAS–GYŐR Nonprofit Kft. Győr, 2015, and Judit Karsai: Válság után: változó állami szerep a kockázati-tőke ágazatban, in Külgazdaság, 2013/4-5., pp. 12-34.

regulation should be simplified similarly to the German and the American examples, which aim at having simpler rules apply to professional investors, who can and are willing to take the risk of investing in newly established businesses.

c) I also recommend urgent legislative amendments with regard to the current definition of AIF:

   i. Firstly, the definition of AIF includes that it raises capital from more than one investor, even though the Supervisory Authority regularly permits the establishment of AIFs operating with one investor. Amending the relevant legislation in order to be consistent with the practice of the Supervisory Authority would be opportune and necessary.

   ii. Secondly, an AIF may lend only if it is already a member or a shareholder of the target company. Even though this rule may be regarded as reasonable from an academic

perspective, considering the separation of loan and capital markets, it is actually obsolete from a commercial perspective and does not follow the international trends. It would be reasonable to permit loan placement prior to the investment as well (the so-called 'convertible loan transactions'). It would be a logical restriction of these transactions and may also serve as the feature distinguishing this from the special forms on loan markets if the AIF was allowed to use only a smaller part of its equity capital in loan transactions at a given time.

3.3. The subject matter of the contract

The subject matter of venture capital investment contracts is the investment of capital. From a legal perspective, the investment of capital is always performed via the increase of the share premium account of the target company. This is the so-called 'increase of capital at a premium'. In this regard, I

found no differences in the contracts examined. In the thesis, I analyze the legislation of all three countries applicable to the increase of capital, with special emphasis on the detailed analysis of the relevant provisions of the Hungarian Civil Code[12] and Accountancy Act[13].

I also analyze two issues of law which are especially important in practice, in the course of which analysis I demonstrate that it is possible to pass a resolution on the increase of capital at a premium in a contingent manner as well, and I also explain why that judicial decision[14] is incorrect according to which, in the case of an Ltd. (kft.), the rights of the members with regard to the increased authorized share capital may be exercised in the course of the increase of the capital only from the registration of the change.

[12] S. 3:198 of Act V of 2013 on the Civil Code (hereinafter referred to as the 'Civil Code').
[13] S. 36. ss. (1) para. b) of Act C of 2000 on accountancy (hereinafter referred to as the 'Accountancy Act').
[14] Decision nr. Gf.40199/2019/8. of the Regional Court of Appeal of Budapest.

3.4. **Corporate Governance** The main issue analyzed in this chapter is how the internal decision-making structure of the target company is organised, which bodies may pass resolutions on which issues. Ultimately, this chapter seeks to answer the question of who directs and controls the target company subsequent to the investment.

In the thesis, I analyze in detail the corporate governance solutions featured in the contracts examined, in the course of which I summarize the powers of the general meetings and the managements of the companies in each of the countries in question, and I also analyze the relevant legislation of these countries. I concluded that the contractual intentions of the parties were similar in each contract and the powers to pass the majority of the resolutions belonged to the management (except in the case of one of the Hungarian contracts).

The central issue in the chapter is the analysis of the theoretical models of the so-called one-tier and two-

tier corporate governance systems[15] with regard to venture capital investment contracts. As it is known, one-tier corporate governance systems are mainly characteristic of common law countries, while two-tier corporate governance systems are mainly characteristic of countries applying German legal solutions, such as Hungary.[16] As discussed earlier, the practice of venture capital investments follows the American legal solutions, and therefore the thesis analyses how the one-tier corporate governance system may be put into practice under German and Hungarian law. I concluded that the

[15] Carsten Gerner-Beuerle, Michael Schilling: Comparative Company Law, Oxford University Press, Oxford, 2019. pp. 284-291.

[16] Bob Tricker: Corporate Governance, principles, polices and practices; Oxford University Press, Oxford, 2009., p. 64., and Jean J. du Plessis, Bernhard Großfeld, Claus Lutterman, Ingo Saenger, Otto Sandrock: An Overview of German Business or Enterprise Law and the One-Tier and Two-Tier Board Systems Contrasted, in.: Jean J. du Plessis, Bernhard Großfeld, Claus Lutterman, Ingo Saenger, Otto Sandrock, Matthias Casper: German Corporate Governance in International and European Context, Springer, Third Edition, 2017, pp. 8-13.; Mette Neville & Karsten Engsig Sorensen (eds.): Company Law and SMEs, Thomson Reuters, Kobenhavn, 2010, pp. 67-80.; Andreas M. Fleckner, Klaus J. Hopt (eds.): Comparative Corporate Governance, a Functional and International Analysis, Cambridge University Press, Cambridge, 2013. pp. 29-33.; and Carsten Gerner-Beuerle, Michael Schilling: Comparative Company Law, Oxford University Press, Oxford, 2019., pp. 303-307.

practice followed the American model (except in the case of one of the Hungarian contracts), that is, the parties had established a so-called 'other body' (as it is called in the Civil Code)[17] both in the German and in the Hungarian contracts, to which body different names had been given, but most often the 'board'.[18] The board is a body which has extensive powers provided for in the investment contract and in the memorandum of association and articles of association, and their resolutions passed under these powers bind the other bodies of the company. The members of the board are usually the representatives of the founders and of the investors, and, in some cases, external experts who are not necessarily members of the company. I also concluded that the officers (chief executive directors) of the target companies were always one of the founders in the contracts examined, while the representatives of the

[17] S. 3:132. of the Civil Code.

[18] Dornseifer Frank (ed.), Corporate Business Forms in Europe, Seiller. European Law Publisher GmbH, München, 2005. pp. 103-186 (Frank Dornseifer).

investors were officers not entitled to represent the company (non-executive directors).[19]

I also analyzed the decision-making mechanisms in the target companies, that is, those 'spheres of influence' which determine who actually directs and controls a target company. I discovered that the investors were always entitled to the right of veto. I called this right of theirs 'destructive veto'[20], since it did not entitle the investor to force the passing of certain resolutions on its own, but it did entitle them to prevent the passing of certain resolutions. Since the investor had always been entitled to a right of destructive veto – either in the general meeting or in the board – with regard to numerous key issues in the contracts examined, I concluded that even

[19] Jean Jacques du Plessis, Anil Hargovan, Jason Harris: Principles of Contemporary Corporate Governance, Cambridge University Press, IV. ed. Cambridge, 2018., p. 96.

[20] Sharifzadeh Azin, Venture Capital and Corporate Governance, Inaugural-Dissertation zur Erlangung des Doktorgrades des Fachbereichs Wirtschaftswissenschaften der Johann Wolfgang Goethe-Universität Frankfurt am Main, 2010., pp. 57-58., and compare: Neil J. Beaton: Valuing Early Stage and Venture-Backed Companies, John Wiley & Sons, Inc., 2010, New Jersey, p. 27.

though the founders were the primary officers of the company, and they managed the day-to-day affairs of the company, the investors were those who determined the strategies of the target companies. In the thesis, I analyze the so-called 'shadow director liability'[21] of the investors with regard to these decisions and conclude that even though there are certain statutory provisions in the Hungarian law with regard to this form of liability, and the issue itself is highly debated in the modern study of law, the exact rules are still missing. In my opinion, it is just a matter of – a very short – time for the legislature to decide on regulating shadow director liability in more detail.

3.5. The preferential rights of investors

[21] „A vezető tisztségviselők hitelezőkkel szembeni felelőssége" tárgykörben felállított joggyakorlatelemző csoport összefoglaló véleménye", a consolidated opinion approved on 12 January 2017 by the workgroup of the Supreme Court of Hungary for the analysis of the judicial practice and on 6 February 2017 by the Civil Law Department of the Supreme Court of Hungary p. 13. URL: https://kuria-birosag.hu/sites/default/files/joggyak/osszefoglalo_velemeny_6.pdf (6 July 2018).

In this chapter, I analyze the special preferential rights characteristic of venture capital investment contracts, which rights usually protect the investor. This does not mean that these provisions may not appear in any other type of contract, however, I am of the opinion that these rules, in these forms, determine venture capital investment contracts by themselves. In the thesis, I continue to base my analysis on the examined practice of contracts in the United States, in Germany, and in Hungary, and I analyze the special rights found in these contracts from the perspective of the applicable national legislation and of the professional literature. Below, I present only the most important such rules from the thesis.

3.5.1. Right to information

I observed that there is a difference between the right to information granted by the relevant legislation[22]

[22] S. 220 of the DGCL., s. 51a. ss. (2) of the GmbH Act and s. 3:23. ss. (2) of the Civil Code.

and the obligation to provide the investor with the data they request. This latter concept entails a more extensive and more detailed preferential right to which only the investors are entitled in the contracts examined.[23]

3.5.2. Restriction of the transfer of the share in the company

a) General restrictions

In this category, I collected those restrictions which were included in the articles of association of the target companies without being individually named. Examples of these restrictions include that the founders were prohibited from selling their shares in the company to a competitor or that the transfer of

[23] Beat A. Brechbühl, Bob Wooder: Global Venture Capital Transactions, A Practical Approach (author of the chapter on Germany: Marco Goedsche), Kluwer Law & AIJA, The Hague, 2004, p. 164., and George, G. Triantis, Financial contract design in the world of venture capital, in The University of Chicago law review, 2001, pp. 305-316.; and Elizabeth Pollman: Startup Governance (2019), Faculty Scholarship at Penn Law. 2135., pp. 172-173., URL: https://scholarship.law.upenn.edu/faculty_scholarship/2135 (5 September 2020).

shares would be allowed only in a strictly limited group of persons for a certain period of time following the IPO[24]; the restriction regarding the transfer 'to a third party'[25] as prescribed in the Civil Code may also be included here.

b) Pre-emption right

A pre-emption right was stipulated in each of the contracts examined, however, it served different purposes in the different contracts. While it was rather an obligation of the founders towards the investors in the American[26] and in the German contracts, in one of the Hungarian contracts, the founders were the ones entitled to a pre-emption

[24] Susanne Espenlaub, Marc Goergen, Arif Khurshed: Governance implications of locked-in venture capitalists (VCs) and founder owners in newly floated UK companies, in.: Igor Filatotchev, Mike Wright: The Life Cycle of Corporate Governance, Edward Elgar Publishing, Inc., Northampton, MA, USA, 2005, pp. 99-122.

[25] S. 3:167. ss. (6) of the Civil Code.

[26] Jerry W. Markham, Thomas Lee Hazen: selected Materials and Statues on Corporate Finances, 2004 Edition, Thomson West, p. 170., and Mark T. Bettencourt, Mary Bevelock, Patrick Jhon Cammarata: Venture Capital and Private Equity Financing, MCLE, 2008, pp. 47-71.

right in case the investor wished to sell its business share.

c) Options

I found no examples of options in any of the American contracts examined (excluding the ESOP, to be discussed later). Both a purchase option and a sale option were stipulated in each German and Hungarian contract. Both types of options were used in the contracts but for completely different purposes. In each of the German contracts, the founders were entitled to a purchase option in order to be able to buy the investors out (including the return[27]).[28] In each of the Hungarian contracts, the purchase option was a collateral in case any member other than the investor breached the investment contract. In

[27] Brealey, Myers, Allen, Principles of corporate finance, 10. edition, McGraw-Hill/Irvin, New York, 2011. pp. 107-115., and Judit Karsai: A kapitalizmus új királyai, Budapest, 2012, pp. 34-48.

[28] The relevant professional literature corresponds to this: Christoph Winkler: Rechtsfragen der Venture Capital Finanzierung, Duncker & Humblot, Berlin, 2004. pp. 203-204.

this case, the investor was entitled to exercise its purchase option at a token purchase price (e.g. the nominal value or an amount of HUF 1.000,-).

I observed that in the German contracts, the sale option was used as a special warranty, security in case the founders failed to (fully) disclose a potential future risk in the course of the due diligence processes[29] preceding the investments. Similarly to the German contracts, the sale option was a security stipulated in the Hungarian contracts as well, however, in these contracts, it was the investor who was entitled to sell its business share to the founders if the founders committed a material breach of the contract, at a purchase price increased by the return.[30]

[29] Alan S. Gutterman: Technology-Driven Corporate Alliances, a Legal Guide for Executives, Quorum Books, London, 1994., pp. 61-85.

[30] The American 'redemption right', a right for the exit of the investor, is substantially similar to this. Compare: Neil J. Beaton: Valuing Early

d) Drag-along right

None of the national legislations I examined included a comprehensive regulation of the drag-along right, however, all of the contracts included such a clause.

The drag-along right (a possible translation of it may be 'the right to force a sale') serves the purpose of allowing the majority shareholder or, in our case, the investor to sell the company in its entirety.[31] In other words, it serves the purpose of preventing such situations in which a favorable takeover bid is received, however, one of the minority shareholders or a group of such shareholders resists the bid and refuses to sell their share(s), resulting in the investor not being able to exit the target company (this is the so-

Stage and Venture-Backed Companies, John Wiley & Sons, Inc., 2010, New Jersey, pp. 23-24.

[31] Dick Costolo, Brad Feld, Jason Mendelson: Venture Deals, Be Smarter Than Your Lawyer and Venture Capitalist, 2nd Edition, John Wiley & Sons, 2012, pp. 68-69.

called 'hold-up problem').[32] In the thesis, I examine the necessary elements of the drag-along right, then I analyze each special provision. I wish not to enumerate the special provisions here, however, it is worth mentioning the necessary elements here as well. In each of the contracts, it was stipulated that in the event of the transfer of a business share, share of a certain value in the target company, certain members, shareholders, or a certain group of them was entitled to force the other members, shareholders of the target company to sell their business shares, shares with the same conditions under which the exiting member or shareholder had sold their business shares or shares, respectively.

e) Tag-along right

A tag-along right was stipulated in all of the contracts examined, however, none of the

[32] Carsten Bienz and Uwe Walz: Venture Capital Exit Rights, 2008, CFS Working Paper No. 2009/05.

national legislations in question regulated this right explicitly.

The tag-along right is usually described as the right which allows the person entitled to it to join a transaction for the transfer of a business share or a share with the same conditions as the seller and in a proportionate manner. In the event that the buyer no longer wishes to conclude the transaction under such conditions, then the sale and purchase transaction under the conditions of the original offer may not be concluded either. Due to this, the tag-along right is deemed to be suitable for shareholders wishing to maximize the value the company and to sell the target company to that buyer who offers the highest purchase price at any given time.[33]

[33] Compare: Simon Witney: The corporate governance of private equity-backed companies, a thesis submitted to the Department of Law of the London School of Economics for the degree of Doctor of Philosophy, London, April 2017, p. 85., and Beddow S., The Equity Deal, in C. HALE, Private Equity: a Transactional Analysis (Globe Business Publishing, 2007), p. 51., and Bartlett J.W., Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations, Aspen Publishers, p. 231., and Gilles Chemla, Michel A. Habib, Alexander

In the thesis, I examined the Hungarian civil law roots of the tag-along right in detail and demonstrated that the tag-along right may technically be described as a conditional restriction of the transfer of property.[34]

3.5.3. Dilution protection (anti-dilution clause)

Dilution protection serves the purpose of the redistribution ('pool') of the shares between an earlier and a later investor by applying a principle which is able to balance out or to reduce the difference between the two investments in the event that the later investor invests in the target company when the company value of the target company is lower than it was at the time of the investment of the

Ljungqvist: An Analysis of Shareholder Agreements, Journal of the European Economic Association, Volume 5, Issue 1, 1 March 2007., pp. 103-111., and Isabel Sáez Lacave and Nuria Bermejo Gutiérrez: Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses, in. European Business Organization Law Review, 2010, pp. 423-458, 430-433.

[34] S. 5:31. § of the Civil Code.

earlier investor (this is called 'downside' or 'downside protection').[35]

In the thesis, I analyze the formulas usually agreed on by the parties in earlier-stage investment contracts. These formulas may result in the decrease in the business shares or shares of the founders during later-stage investments, to the benefit of the earlier-stage investor.

3.5.4. ESOP

In the thesis, I examine the different ESOPs (Employee Stock Option Plans) in detail. I analyze two elements of ESOPs:

a) 'Vesting' is that part of an ESOP by which the employees (or the officers of the company) are incentivized to remain with the target company via granting them extra business shares or

[35] Dick Costolo, Brad Feld, Jason Mendelson: Venture Deals, Be Smarter Than Your Lawyer and Venture Capitalist, 2nd Edition, John Wiley & Sons, 2012, pp. 55-59.

shares based on the passage of time or on the fulfilment of certain conditions.[36]

b) In the case of 'reverse vesting', those shares in the company which were acquired by the employee earlier are gradually decreased or lost. The trigger event of the reverse vesting is when the employment relationship between the employee and the target company is terminated.

I conclude that neither the Hungarian company law applicable to an Ltd. (kft.) nor the Hungarian employment law is prepared to handle vesting and reverse vesting clauses. The aim pursued by the parties may be achieved only via especially complicated contracts which are secured by purchase options, sale options, and repurchase options and which are difficult to put into practice. I also conclude that vesting and reverse vesting clauses may efficiently facilitate the dynamic growth of target companies and should be supported

[36] David R. Skeie: Vesting and Control in Venture Capital Contracts, FRB of New York Staff Report, No. 297., pp. 1-5.

by the legislature via the development of a suitable legal background.

3.5.5. Exit and liquidation preference

The exit is the most important event from the perspective of the investor. It is an economic principle of capital investment that the investor is the first to exit the target company, but it is also a principle that the investor is repaid first. [37] These principles serve as the basis of the concept of 'liquidation preference', that is, in what order the investor, the member or the shareholder, and the founder are repaid their investments in the case of a liquidation event and based on what principles the parties distribute the profit accrued in the course of the liquidation.

[37] Ellen B. Corenswet: Formation and Financing of Start-ups, in: Dror Futter, Issac J. Vaughn: Venture Capital, 2004, Practising Law Institute, pp. 664-665.

The different liquidation procedures are usually divided into three categories as follows:[38]

a) transactions for the transfer of business shares or shares, which transactions may be:
   - buyout by another financial investor (secondary buyout)
   - buyout by a professional investor
   - the target company purchasing its own business shares or its own shares
   - buyout by the founders and the members or the shareholders
   - leveraged recapitalization or leveraged buyout

[38] Judit Glavanits: A kockázati tőkebefektetések egyes jogi kérdései, Győr, 2015, pp. 138-147., and Judit Karsai: A kapitalizmus új királyai, Budapest, 2012, pp. 26-34., and Phillip D. Torrence, Richard A. Walawender: Legal Considerations in Exit Strategies: IPO vs. Sale, in.: Private Equity, History, Governance, and Operations, John Wiley & Sons, Inc., Hoboken, New Jersey, 2008. pp. 357-399., and Patrícia Becskyné Nagy, Sándor Biczók: A kockázatitőke-befektetésekből történő kiszállás útjai, in.: Zsolt Makra: A kockázati tőke világa, Aula, 2006, pp. 53-75.

   - management buyout or management buy-in[39]

b) the second category consists of liquidation events from a legal perspective (voluntary liquidation, involuntary liquidation)

c) the third category is the IPO, that is, the initial public offering.

In the thesis, I also analyze the techniques by which the contracting parties may divert the return which may be achieved in the course of the exit event:

a) distributing the return in a way which is more beneficial to the investor, that is, when the investor is repaid both the nominal amount of its investment and the expected return as well, or

b) distributing the return in a way which is more beneficial to the founders, that is, when the founders participate in a certain way in the

[39] According to a different categorisation, buyout may be included in the following categories: acquisition, debt financing, equity financing. In.: Jack S. Levin, Donald E. Rocap: Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, Wolters Kluwer, 2018., pp. 5-15 – 5-17.

distribution of the return prior to the repayment of the entire amount of the return of the investor (exit participation, catch-up).

4. **List of the other publications of the candidate published in the subject of the thesis**

a) A Ctv. nyilvántartási szabályainak és a Btk. gazdasági adatszolgáltatási kötelezettség elmulasztása tényállásának kollíziója (Céghírnök, 2014/6)

b) A tagsági jogviszony megszűnése a vagyoni hozzájárulás teljesítésének elmulasztása miatt (Gazdaság és Jog, 2015/4)

c) A tagsági és a részvényesi jogviszony keletkezéséről (Gazdaság és Jog, 2015/6)

d) Az üzletrész-átruházási szerződésről (Gazdaság és Jog, 2016/5)

e) Az üzletrészen alapított zálogjog, mint a kockázati-tőkebefektetések biztosítéka (Gazdaság és Jog, 2017/7-8)

f) Corporate governance in venture capital contracts, A German-Hungarian comparative law study (ELTE LAW JOURNAL 1/2019)

g) Drag Along Right in Hungarian Venture Capital Contracts (ELTE LAW JOURNAL 1/2020)