

focus on

Certain Characteristics of Private Equity and Venture Capital in the Republic of Hungary

September 2001

Tag-along and drag-along rights

What does a foreign private equity investor expect when entering the Hungarian market? Predictable profit, transparent legal system, investment friendly rules, secured investment techniques or all of the above? What difficulties might a foreign investor face? And lastly, what are the general features of private equity investments in Hungary?

This article focuses on some of the Hungarian investment characteristics by introducing the correlation between private equity and venture capital, and detailing the features of two commonly applied instruments, e.g., the tag-along and the drag-along rights.

Venture capital - how is this defined?

Venture capital is a form of private equity, in which private equity provides equity capital to companies not listed on the stock exchange.

How does Hungarian venture capital relate to the type of "venture capital" commonly used in international relations and transactions. Is there a commonly used and generally accepted form?

In Europe, private equity and venture capital are generally used as synonymous terms in which venture capital includes equity investment designated for the launch, early development or expansion of a business, including management buyouts (MBOs) and buyins (MBIs).¹

1. This is however, in contrast to the U.S., where MBO/MBIs are not classified as venture capital related transactions.

Act XXXIV of 1998 on Venture Capital Investments, Venture Capital Enterprises and Venture Capital Funds stipulates the various forms of venture capital investments; while Act CXLIV of 1997 on Business Associations provides for the establishment, operation and termination of the various corporate forms of companies.

This article defines venture capital in broad terms, referring to both indirect investments through venture capital enterprises or venture capital funds and direct investments like equity or interest participation in a given form of a company.

Why is the definition so broad?

The survey prepared by the Hungarian Venture Capital and Private Equity Association on the impact of venture capital investments on the Hungarian economy as of the fall of 2000 - where venture capital is used in its strict term, meaning investments through venture capital enterprises, funds or investment funds - reach instructive findings regarding the Hungarian venture capital market and developments over the last decade.²

The survey, among others, lists that, by the end of the 1990s, the venture capital sector in Hungary had risen to a standard which can be regarded as relatively developed by regional standards. By the end of 1998, venture capital investments, the overwhelming share of which had come from foreign sources, represented 6.5 percent of foreign direct capital investments. Their share within the total volume of the working capital inflow for 1998 amounted to more than 10 percent.

Under the findings, it is not the inadequate supply of venture capital that limits the growth in the number of venture capital investments in Hungary, but the inadequate number of profitable companies with high growth potential. The number of financing companies, which, among other activities, undertake venture capital projects is approximately 40. As a result of those investment activities, the total amount of venture capital invested in the financing of Hungarian companies by venture capital funds and companies exceeds HUF 1 billion.

Nevertheless, the number of ventures receiving venture capital financing in the Hungarian economy is still relatively small. The number of those companies (on a pro rata basis compared to the number of double book-keeping companies in the country) is 0.005 percent, however, they generally have a more significant role in employment (0.2 percent) and revenue (1.6 percent).

As the above listed numbers indicate, venture capitalists in Hungary were mainly interested in larger, well established companies. This is also supported by the fact that, while the average revenue of Hungarian companies with double-entry accounting in each of the years examined was below HUF 200 million, revenue of companies receiving venture capital financing was in the order of HUF 1 billion per year.

2. See <http://www2.hvca.hu/eng/docs/newsletter/2000winter/tanang.pdf> The survey was prepared upon the request of the Hungarian Venture Capital and Private Equity Association, by Judit Karsai, senior research associate of the Centre for Economic Research of the Hungarian Academy of Sciences and is based on data obtained from the members of the Association and data from news items published on them in financial press concentrating on data for years as of 1995 through 1998.

Nearly half of the companies financed by venture capitalists were less than 3 years old, in the legal sense, at the time of receiving the venture capital. This group of companies received 60 percent of the total amount of venture capital investments in Hungary.

In the past decade, venture capitalists invested primarily in 3 fields of the Hungarian economic sector: the food processing industry, the machine tools industry, and the area of IT and telecommunications.

A significant amount of foreign capital over the last decade resulted from the broader definition of venture capital. This foreign capital was invested directly in various forms of corporate entities.

The most commonly applied forms of both direct and indirect investments contribute to the equity in either a limited liability company ("korlátolt felelősségű társaság", "LLC") or a company limited by shares ("részvénytársaság", "RT").

Similarities

In both direct and indirect investments, the investors are primarily interested that their contributions - in addition to economic considerations - are handled in a secured way and that their equity investment, operation and a possible equity exit strategy serve their best interest.

The following section discusses the protection of majority and minority rights in cases of the exit of certain investment positions, "tag-along" and "drag-along" rights with call-, and put options.

Tag-along and drag-along rights

A tag-along right is commonly used as an instrument to protect minority shareholders' rights. Under the tag-along right, when the majority shareholder sells its shares or other equity interest the minority shareholder is entitled to tag along with the majority shareholder, and sell his equity contribution along with that of the majority shareholder. This is an optional right and does not impose an obligation on the minority shareholder to sell his interest.

The drag-along right, however, protects the majority shareholders' rights. According to the agreement of the parties, if shareholders representing certain majority percentage of the capital (simple or higher majority), decide to sell their interest, the minority shareholders are obliged to drag along and sell their interest under the same conditions. For the most part, economic considerations influence the sale of the company's equity as a whole.

There has been increasing demand for those types of agreements - mainly in the form of shareholders' agreements - from foreign investors commonly applying those agreements in their home countries. The question arises, however, if and how could these rights fit in the basic principals of the regulations on the Hungarian company and civil laws. An additional issue is how foreign investors can secure their exit strategies from Hungarian investments. Are shareholders' agreements enforceable under Hungarian law before Hungarian courts?

Shareholders' agreements under various foreign jurisdictions - in addition to being enforceable along with the foundation documents of a company - serve the following solutions for tag-along and drag-along rights, challenging the Hungarian legal profession to constructively react to such demand:

Tag-along right

In case of a tag-along right, the minority shareholder offers a put option, upon which, due to the unilateral declaration of a party not being the minority shareholder, the sale is completed. The put-option type of solution has been gaining increasing popularity in the Hungarian practice, using put-option similarly to the provisions regarding the call option of Act IV of 1959 on the Civil Code of the Republic of Hungary ("Civil Code").³

The difficulty rests with the unavoidable rules of the Civil Code which state that a call option is valid and enforceable only upon a call, *i.e.*, when there is a purchase. It shall not be used, however, in the case of a sale. The result is that a contract applying the put option right for a sale shall be null and void under Hungarian law and consequently unenforceable in a legal procedure.

Preparation of a pre-agreement⁴ might serve as a solution in which the majority and minority shareholders agree in advance that they will conclude an agreement at a certain later date, which can be the date when they receive an offer from a third party. A pre-agreement must indicate the substantial elements of this later agreement, and may only include enforceable rights and obligations if those are imposed both on the majority and minority shareholders for the sale and purchase of the minority stake.

In addition to the pre-agreement form, the parties may agree to enter into a separate agreement and stipulate their respective obligations when an offer is presented by a third party. These obligations are mainly to establish certain procedural rules to follow for the negotiation of a sale.

Both the pre-agreement and the separate agreement forms are typically concluded in shareholders' agreements.

Please note that the enforceability of shareholders' agreements is inconsistent under Hungarian law. The enforceability of even those agreements, which are not contrary to Hungarian law, are ambiguous and there are only a few court rulings available to support consistency in the area of shareholders' rights. In this regard, the lack of established practice and consistent court rulings may be a deterrent to interested investors.

Drag-along right

In the case of a drag-along right, the minority shareholder shall grant either the majority shareholder or a third party appointed by the majority shareholder a call option. In this call option, the majority shareholder or the third party appointed by the majority shareholder may purchase the share or equity contribution by issuing a unilateral declaration.

The above described form may seem to be an attractive solution, however, when drafting the relevant agreement, we must carefully examine the mandatory provisions of the Civil Code.

If the call option is stipulated for a definite period of time, the period may be a maximum of five years. If it is for an unlimited period of time, it shall cease to exist after six months. This provision might be side-stepped by setting the date of effect of the call option as of the date of the meeting of a certain condition, *i.e.*, when the period open for the exercise of

3. Section 375 of the Civil Code.

4. Section 208 of the Civil Code

a call option is counted as of the date of the meeting of a condition, like the offer for purchase, submitted by a third party.

The above solution, however, still does not provide a bullet-proof solution for the issue of pricing. Pursuant to the provisions of the Hungarian Civil Code, the option price shall be set together with the agreement on the call option. To set a price valid for a longer period of time in a rapidly changing market is a difficult task. To solve this problem, the parties usually agree on a certain computation method instead of agreeing on a fixed price. If well defined, the formula for the definition of the purchase price at the date of the exercise of the call option might work best.

Conclusion

Following the political changes in Hungary starting in 1990, the economy defined by the state has been gradually succeeded by market economy features. The new laws created the possibilities for foreign capital to be invested and operate in the country. Private equity has been invested in the country both through direct and indirect investments. Between 1990 and 1995, we witnessed that investments were primarily directed toward already existing well-established businesses, while since 1995, investments in seed and start-up technology based companies have gained significance.

Hungary is still one of the best countries in the Central-Eastern European region for investment with excellent economic ratings and forecast. As is the case with any transition economy it is the duty of the investor to obtain all relevant investment related information, including updated legal information on the rules and regulations governing the many forms and methods of investment.

For more information, please contact the following Hogan & Hartson attorney:

Annamaria Ccenterics

+011-36-1-302-9050

email: acscenterics@hhlaw.com

Budapest, Hungary