

# LEGAL ASPECTS OF VENTURE CAPITAL FINANCING

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## Introduction

**What does venture capital mean?** As a result of the PhD-study, venture capital is fundraising in a great growing potential company that is not publicly founded, which goal is raising value in the company through the joint ownership and sell the property with high return. The phenomena, which is in the focus of even more scientific areas, has so little history in the law science both in Hungary and worldwide. On the other hand, more and more lawyers in practice are facing these contracts and facing the venture capital industry in some of its appearances, so researches in this field cannot be postponed at all. We should nevertheless take into consideration, that – basically in Hungary, and in Eastern-European area – the venture capital financing has only some decades' past, so the precise categorization both economically and legally are opens even more doors of questions. The primary goal of this PhD-study is to suggest new ways of researches in this field.

On the most active market of venture capital, in the **United States** there is no question on the side of political will that the venture capital industry is useful and worth-to-support transactions. According to the 2011 Yearbook<sup>1</sup> of the National Venture Capital Association, the 3295 completed transactions of venture capital investments subtotal of 22 billion dollars had been transmitted to innovative companies, which means the 0,2% of the country's GDP. As the data of the IHS Global Inside<sup>2</sup> research institute, in 2008 the companies supported by venture capital gave the tax-income of USA in 21%, employed 12 million people, 11% of the whole employees of the private working sector. Companies supported by venture capital reached bigger net incomes and applied more people than other companies, who did not got this financial support. These results are not unique, as Josh Lerner's study confirms that the (state governed) venture capital-backed companies are acting significantly better in employment and income-data than

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<sup>1</sup> NVCA Yearbook 2011, [www.nvca.org](http://www.nvca.org) (date of download: 1st October, 2012.)

<sup>2</sup>IHS Global Insight 2009. [http://www.altassets.net/pdfs/nvca\\_venture\\_impact\\_5thedition.pdf](http://www.altassets.net/pdfs/nvca_venture_impact_5thedition.pdf) (date of download: 10th June, 2011.)



the average companies<sup>3</sup>. From the 1970's, more than 27.000 companies got some kind of venture capital finance from the total amount of 456 billion dollars<sup>4</sup>.

The **European Union (EU)** gave attention only from the late 1990's to venture capital backed finances, and the effect on the impacts to the Common Market. According to the 2008 Yearbook of the European Venture Capital Association's (EVCA), the 5200 companies financed by venture capital or private equity reached 73,8 billion EURs. 85% of these companies were small- and medium sized companies (SMEs), whose employees number were under 500. Statistics of the EVCA shows, that between 2000 and 2004 the venture capital backed companies created 1 million new workplaces in the EU, which is an enlargement of 5,4% p.a., while during the same period the average of the EU25 was 0,7%. The companies in their phase of extension, financed by venture capital produced 2,4% of growth in employment between 1997 and 2004, and the SMEs in their start-up phase reached 30,5% of growth<sup>5</sup>.

As the target of venture capital is the innovative young companies with a great potential of growth, the EU treated the question of venture capital financing with the topic of state SME- supports, innovation-support and state aids. As a result, the venture capital industry is seen through a different glass in the EU, which glass is the ease of reachable financial instrument for SMEs. At the same time, the working documents of the European decision-makers does not miss to admire the achievements of the European venture capital industry. It is worth to mention, that the venture-backed innovative companies spend 45% of their incomes to R&D, which means an average of 3,4 million EURs per company. This is 6 times more of what the best 500 EU25 company spends on R&D<sup>6</sup>.

The venture capital industry has two decades of history in **Hungary**. Judit Karsai states, that until the age of 2000, the industry transmitting venture capital and private equity in Hungary – taking into consideration the actors, working mechanism, function and effectiveness – reached the form of European venture capital industry<sup>7</sup>. Between 2002 and 2009 the venture capital funds made 230 contracts with the total value of 2,2 billion EUR in Hungarian companies<sup>8</sup>. The JEREMIE program<sup>9</sup> created by the EU and the execution of it gives hope that both number and volume of the transactions will increase

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<sup>3</sup> LERNER, Josh: The government as venture capitalist. The long-run effects of the SBIR programme. In. *Journal of Business* 1999, 72.285.

<sup>4</sup> Data from MoneyTree, presented by PricewaterhouseCoopers and NVCA

<sup>5</sup> EVCA Yearbook 2008.

<sup>6</sup> Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: Removing obstacles to cross-border investments by venture capital funds COM (2007) 853. final.7.

<sup>7</sup> KARSAI, J. A magyarországi kockázati tőke-finanszírozás másfél évtizede. 1989-2004. In. MAKRA, Zs. (ed.), *A kockázati tőke világa*. Aula, 2006. 35.

<sup>8</sup> Hungarian Venture Capital Association (HVCA) Yearbook 2010. [www.hvca.hu](http://www.hvca.hu) (date of download 10<sup>th</sup>, June 2011)

<sup>9</sup> Joint European Resources on Micro to Medium Enterprises (JEREMIE)

significantly. The former data shows only the industry of formal venture capital, the companies founded for only this purpose of finance. But the business angels also play important part on the venture capital market, as they are the so-called informal investors, well-to-do individuals making also venture investments from their private asset. The Global Entrepreneurship Monitor (GEM) investigates the entrepreneurial activity and economic growth in its research program and among this the activity of informal investors in Hungary, and they figured out, that among the adult population 2,2%, about 144.000 individual made informal investment at the average amount of 1 million HUF<sup>10</sup>.

Judit Karsai divided the history of the Hungarian venture capital industry to four development stages, from which the last would start from 2001 to nowadays, as the stage of purifying and rationalizing<sup>11</sup>. The time passed since her study, and the financial-economic crises of 2008 indicates – to my opinion – to suggest a new stage in the industry not only in Hungary, but internationally, as this year meant worldwide a recoiling, and pushed the whole industry to focus on the latter stages of investments. But the data from the year 2010 and after shows the market's curiosity of the venture finance.

### Aims and goals

Working on the PhD-study the primary goal was the complete exploration of the national and international sources of the venture capital legal standards, and make a comparison of them. Elaborating the topic the historical descriptive method is dominant, while keeping the eye on the international best practices, which can be useful for the Hungarian or for the European practice as well. Working on the theses the lack of the Hungarian (legal) scientific literature was also an advantage and a disadvantage. This way we can look at the PhD-study as a completion of scientific achievements, but also a keynote document for the researches coming. The absence of national sources has the consequence of the need to elaborate the international literature as a whole thematically, practically mean sometimes the first Hungarian publication of foreign legal texts. The other main goal and aim of the PhD-study is to give a definition of venture capital that can be used both in the economic and legal scientific medium, define and systematize the related expressions, and modeling the investment process of venture capital financing from the sight of civil law. At the same time, an important aim is to put the created definition to the proof, and insert it to international medium<sup>12</sup>. Looking at the state's role in venture capital financing, the economic literature draws craggy line between direct and indirect

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<sup>10</sup> GEM Hungary. SZERB, L. (ed), Vállalkozásindítás, vállalkozói hajlandóság és a vállalkozási környezeti tényezők alakulása Magyarországon a 2000-es évek első felében. 2004.

<sup>11</sup> KARSAI, J. op. cit. 34-35.

<sup>12</sup> GLAVANITS, J: A kockázatitőkebefektetések jogi fogalmának meghatározása. In. *Jog-Állam-Politika* Vol.1 of 2012.

intervention tools<sup>13</sup>. To my opinion these governmental vehicles can only work properly by complementing each other, so much more as no country in the world has ever dared to apply the indirect tools alone.

The 6<sup>th</sup> figure of the PhD-study shows the direct and indirect tools elaborated by the former economic scientific literature, but the tax-advantages, which affect the central budget directly I rate among the direct supporting measures. Dealing with the questions regarding to public law the study is synthetizing and brand new at the same time, since nor the national nor the international science use this kind of approach. According to the subject of private law, the doctoral study is dominated by international comparison of laws. The chapter examines the content of deals related to venture capital, the structure and details of the contracts, and sets the legal documents into the timeline of the venture capital financing process. The method of the examination is the same as in the previous chapters: comparative presentation of Anglo-Saxon, EU and national practice of contracting.

The scientific literature and so the doctoral study deals with the following private law-questions of venture capital financing:

- a) informational asymmetry and agent-theory among the venture capital partners
- b) functioning and legal rules of formal venture capital (venture capital funds)
- c) protecting the business secrets, and confidentiality
- d) due diligence process
- e) secured transactions and covers in the contracts
- f) potential exit-strategies.

A main emphasis of the doctoral study is to present the venture capital policy of the European Union from the beginning up to the present days, and among this the international answers to the global financial crisis of 2008, for example the new legal framework for venture capital funds in the USA and Europe. This marks out the future way of the scientific studies according to the question of venture capital financing and venture capital markets, since during 2010-2011 brand new rules of financial acts came to effort across the whole world. Even Hungary will adopt these new rules in the following month or years.

### *Methodology*

I examined the relevant legal aspects and questions of venture capital financing among the following methodology.

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<sup>13</sup> eg. CUMMING, D. J.- JOHAN, S. A? Venture capital and private equity contracting. Elsevier Academic Press, 2009, KOVÁCS, B.: Innovation financing with venture capital- the role of state aid programs, Conference-proceeding, Právni Rozpravy 2011, KARSAL, *Helyettesítheti-e az állam a magántőke-befektetőket? Az állam szerepe a kockázati-tőke-piacon.* MTA Közgazdaságtudományi Kutatóközpont. Műhelytanulmány. Budapest. 2004.

### a) Normative method

The basis of the research was the legal rules applied in the previous quarter decade both national and international level, but primarily the principals of the USA and EU legislation, and their direct effect on market. I supplemented these results with the later Hungarian rules which are basically fitting to the international main stream. The Hungarian legislation has two periods: laws accepted before and after accessing to the European Union with grate effect on the content and efficiency of rules. Part of the economic literature states, that the efficiency of some countries venture capital activity can be drove back to the legal order of the state, and the timing of the intervention of the state to the venture capital market<sup>14</sup>. For the proving of this hypothesis we have to examine the differences of Anglo-Saxon and continental legal order, and the legal tools applied by the countries which may cause these great differences. The financial crisis started in 2008 resulted a legislation “dump” according to the financial markets, which affected the venture capital actors as well. During the last two years both in the USA, Asia and the EU adopted rules that will change the previous surrounding of venture capital industry. Examining these new frames are in focus of the doctoral study. Among these new rules studying the effect on the private contracts is also object of the study, primarily changes in the civil law and the company law. The international comparison of these changing rules is also we should not miss to get around.

### b) Functional method

Although the market of venture capital deals is an always changing world, the germane economic literature consistently reports on not eligible legal milieu. Both national and international surveys state, that the government dissatisfies to fulfill the requirements of the venture capital industry. The financial crisis has up-to-dated the question: on which level and how can the legislation help to support the venture capital industry?

The question is not new: practically since the venture capital financing itself exists, the role of the state is in the crossfire of scientific and practitioner experts. Several publications can be found on both sides, which state that the non-intervention of the state is desirable, or only the indirect measures are the keys for success, or even the active part of governmental institutions can be a solution for the financing problems for innovative small- and medium sized companies.

Dealing with this question, we have to look at the best-practices of certain successful countries, and examine the circumstances and the use legal vehicles to understand why some of them are more effective on supporting venture capital than the other. This means

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<sup>14</sup> eg. GILSON, Ronald J.: *Engineering a venture capital market: lessons from the American experience*. In: Stanford Law Review, 2003. 55(4). 1067-1103. AVNIMELECH, G-TEUBAL, M: *Targeting venture capital: lessons from Israel's Yozma programe*. In: SUNIL, M –. BARTZOKAS, A (eds): *Financial System, Corporate Investment in Innovation and Venture Capital*. Edward Elgar. 2004. 85-116. 2004, CUMMING and JOHAN: op.cit. 2009.

applying a bit more economic approach than legal, but at the end we can find a number of common distinctive features, which can be suggested to be the factors of success on this field.

### c) Historic approach

The scientific modeling of venture capital industry can be counted since the 1970's. This scientific field is this way quite new, no roots back to the ancient Greeks, and the published literature is primary economical. But we cannot set aside the relevant legal questions of the role of the state, and also the contractual practice configured by the actors of the industry.

According to Landström as to 1980 the venture capital's scientific literature simply not existed, and afterwards only the US scientific community showed activity on the subject<sup>15</sup>. The European Union gave attention only from 1998, so the doctoral study's goal is to collect the relevant publications of legal aspects of venture capital as a whole from the last three decades.

### d) Comparative method

In the globalized world of venture capital the areas of the world and countries alone can occur as a privileged region for venture capital industry, which has the consequence of economic advantages, and virtue of vantage in global competition. The EU has made it clear many times on different forums that the raising of competitiveness, employment and R&D expenditures are crucial, and the target of venture capital, the innovative small- and medium sized companies got to have adequate legal environment to attract the venture capital industry's money. This legal environment is studied by international organizations such as the OECD<sup>16</sup> and the EVCA<sup>17</sup>, and they are suggesting measures to governments. At the end it is still a fact that the conditions of the US market seems to be far the best place for the actors of venture capital.

The scientific economic literature is divided in the question of the Anglo-Saxon legal order apparent benefit can be equilibrated by pure legal vehicles, so the advantages of vivid venture capital markets can be reproduced in other counties as well. The clear answer for this question is crucial for the legislative bodies of the European Union. It is clear since the 1990's, that the EU is searching for a model to follow from the Anglo-Saxon countries to approve the efficiency of its capital markets. Showing the legal rules from the last 20 years, and comparing them to the USA's legislative policy it is obvious for all, that the efforts stood on the ground of mere attitudes of mind instead of efficient

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<sup>15</sup> LANDSTRÖM, H.: Pioneers in venture capital research. In: LANDSTRÖM, H. (ed.): Handbook of research on venture capital. Edward Elgar. 2007.3-65.

<sup>16</sup> Organisation for Economic Co-operation and Development (OECD)

<sup>17</sup> European Venture Capital and Private Equity Organization (EVCA)

ruling. But the shock of financial crises can give a swing in this tendency, and can give an opportunity to re-define the attitudes. The doctoral study gives attention to the adopted and also the forthcoming rules of the USA and them EU, and among this the prepared document of European Venture Capital Fund, and also advises *de lege ferenda* legal possibilities.

#### e) Legal analysis of economy, as a method

Examining the venture capital financing from legal aspects arises the questions of law and economy, or the connection of economy and law, and the inspection of this relationship. Among the legal science an independent discipline is dealing with the aspects of “the economic analysis of law”, which has a great number of expert both in Hungary and abroad<sup>18</sup>. The Hungarian jurispudent Tamás Sárközy deals with the question of law and economy, and states, that the legal rules governing the economy creates new elements from the economic phenomenon, so the foregoing examination of legal vehicles is very important – for eg. the impact-analysis and cost-analysis of rules is crucial<sup>19</sup>.

Tibor Nochta and associates in their book presenting the legal framework of economic life state, that another perspective of the economic analysis of law can be to admit certain rules which legal dogmatic understanding and correct processing presuppose the cognition of economic information<sup>20</sup>. The logic of the doctoral study follows just the opposite of those upper perspectives: it tries to write down with legal vehicles the phenomenon experienced in the practice and examined by the economic literature, and it’s goal is to define and categorize. This way the doctoral study is more close to the method wrote by Galgano<sup>21</sup> named the “legal examination of economics”. Galgano’s work is translated to Hungarian by Peter Metzinger, who also uses this method for his doctoral study as well<sup>22</sup>.

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<sup>18</sup> POKOL, B: A jog gazdasági elemzése. In: *Jogbölcseleti vizsgálódások*, Nemzeti Tankönyvkiadó, Bp. 1984. 52-64.; CSERNE, P: Állam és gazdaság. Az állam gazdaságtudományi elemzése. In: *Államtan. Az állam általános elmélete* II. A modern állam sajátosságai és főbb formái. Állam és jog, TAKÁCS, P. (ed.), Bp. XVII.B; MENYHÁRD, A: Polgári jog és közgazdaságtan. In: STEIGER, J. (ed.) *Gazdaság és jog*, Bp. ELTE ÁJK, 2005. 87- 101.; WEBER, M. *Gazdaságtörténet. I-II.* Budapest, KJK., 1979; WEBER, M: *Gazdaság és társadalom I-II. A megértő szociológia alapvonalai.* Közgazdasági és Jogi Kiadó 1992.

<sup>19</sup> SÁRKÖZY, T: *Gazdasági státuszjog-Magyar gazdasági jog.* Egyetemi tankönyv. I. Aula, 2007. 23-24.

<sup>20</sup> NOCHTA T. – JUHÁSZ L. – SZÉCHÉNYI L.: *A gazdaság jogi szabályozása* Jogi szakvizsga segédkönyvek, Dialóg Campus, Budapest-Pécs, 2008, 21

<sup>21</sup> GALGANO, F: *Globalizáció a jog tükrében. A gazdasági jogi elemzése.* HVG-ORAC, 2006.

<sup>22</sup> METZINGER, P.: *A vállalat mint tartalom és a társaság mint forma a globalizált üzleti jogban.* Doktori értekezés. Budapest-Pécs. 2008.



## Introducing the scientific achievements

### Legal definition of venture capital

Since the current financial crisis caused a legislation “dump” in the world on the field of finance and financial markets, and according to the international statistics, the venture capital- type of financing is more and more widespread, the detailed study of the relevant legal issues cannot be delayed any longer for the legal science.

The venture capital deal seem to be unclarified phenomenon for both the economic and the legal sciences. As until recent days there were no punctual legal definition of venture capital actions, we can say there were no authentic interpretation of venture capital investment. The economic literature however created his own terminology, but it was all without any legal roots to refer. This terminology is based upon the Anglo-Saxon legal order, and used mainly in the United States, but the prompt circle of actors and actions were not a common knowledge. During the writing of the doctoral study two important legislation appeared, which contained definitions on venture capital, which shows the actuality of the questions proposed it the doctoral study. The definitions constituted by the author are influenced by these sources of laws, and reflects the expectation on internationalization of these definitions. At the same time we should not disregard that the new legislation is still a debtor with the prompt definitions of additional categories of venture capital investments, such as “early stage investment”, or “business angels”, this way the categorization and comparative examination of these phenomenon are the duty of the scientific literature, and at the end – duty of the parties who applies the law.

As a definition, we use the term ‘venture capital for agreements which aim is to acquire property in publicly not listed companies with great growing potential, and the goal is to raise value in the company by taking part in the decision-making, and as a result of the capital invested sell the acquired property with high profit rate. Venture capital as a *terminus technicus* became well-known after 2000, in Europe mostly after the European Commission and the European Investment Fund created the program of JEREMIE<sup>23</sup>. Though the legal definitions exist only for venture capital fund and venture capital companies, these seems to be stable enough not to change them any ways.

On the other hand, it is worth to think that while adopting the new rules of venture capital investments to Hungarian law, the hiatus of the definitions could be filled. For the method it is possible to use the terms of the EU legislation word-by-word, or to adopt a definition that is not opposite with the content and spirit of the EU texts, but which shows the specifications of the contracts, and refers the distinctive features which makes the venture capital contracts special from another investment action. According to the prepared text of the regulation of European venture capital fund, the venture capital investment (qualifying investment) means equity or quasi equity instruments that are

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<sup>23</sup> Joint European Resources for Micro to Medium Enterprises - JEREMIE



- issued by a qualifying portfolio undertaking and acquired directly by the qualifying venture capital fund from the qualifying portfolio undertaking, or
- issued by a qualifying portfolio undertaking in exchange for an equity security issued by the qualifying portfolio undertaking, or
- issued by an undertaking of which the qualifying portfolio undertaking is a majority owned subsidiary and which is acquired by the qualifying venture capital fund in exchange for an equity instrument issued by the qualifying portfolio undertaking<sup>24</sup>.

We can summarize the upper as *a transaction during which a venture capital fund as collective investment company acquires equity or quasi equity in a non-listed small or medium sized company*.

From the terms used by the European Union legislation it would be admirable to derecognize the term “risk capital”, as looking at the international terminology it is unique, and can cause confusions, and relativize both the term venture capital and both private equity while comparing the content of the terms used in different documents. The doctoral study analyses the changing and delusive terminology of the EU in Chapter II.

The recent crisis made the governments to set up the goal of regulating the monetary intermediary system as a whole, and among this, the venture capital actors’ activity as well. The doctoral study’s third and fourth chapter is trying to clear up the role of the state on the market of venture capital investments. The economic scientists’ opposite attitude on this question can already be seen in current Hungarian literature as well. While some authors state with statistical data that the motivation programs of the government can show significant success<sup>25</sup>, at the same time other authors state with other data respective that the state is crowding out venture capital and private equity partners from the market. As a summary of the different theories we can say that the crucial role of state’s direct efforts can be admitted when it only catalyzes the market actors, and is not taking their job away. Best practices can be seen in the United States<sup>26</sup>, Israel<sup>27</sup>, Finland<sup>28</sup>, significant success in Great Britain<sup>29</sup>, but the crowding-out mechanism is

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<sup>24</sup> COM(2011) 860 final, Article 3, c.

<sup>25</sup> Details in the doctoral study’s Chapter IV. 1

<sup>26</sup> see Lerner: op.cit. 1999

<sup>27</sup> see Avnimelech and Teubal: op.cit. 2004

<sup>28</sup> see MAULA ET AL, M.: *The prospect for success of early-stage venture capital in Finland*. Sitra report 70. Helsinki. 2006.

<sup>29</sup> see BÜRGELE, O. – FIER, A – LICHT, G. – MURRAY, G: *Internationalisation of High-Tech Start-Ups and Fast-Growth Evidence for UK and Germany*. Discussion Paper 00-35, Centre for European Economic Research (ZEW), Mannheim, 2000.; BVCA 2009: *Benchmarking UK venture capital to the US and Israel: What lessons can be learned?* BVCA, London. 2009.

documented in Canada<sup>30</sup> and partially in Hungary<sup>31</sup>. The European Union is dealing with the question of supporting venture capital activity through the glass of state subsidies, and the final question is if the support distorts the competition on the Common Market. In many documents the EU ascertained that the state's support is only acceptable in the companies seed and start-up phase<sup>32</sup>.

As mentioned before, some authors see the roots of the different success of venture capital markets in the different kind of law regimes, like the Anglo-Saxon tradition fits more for this kind of transactions<sup>33</sup>. Examining the contractual design and practice, it can also be seen, that the quality of bank-connections is an important indicator for venture capital investments: significant connection is demonstrated in the international scientific literature between the bank-based countries relatively small venture capital market, and between the market-based counties relatively big venture capital market<sup>34</sup>. Pondering over the role of the state on venture capital financing the solution cannot be positive or negative solely, the only result is we can make some statements from the international empirical observations:

- those **state-supported programs** seems to be successful, which quit the market after fulfilling the catalyzing function, avoiding the risk of crowding out the venture capital actors from financing (eg. SBIR<sup>35</sup> and YOZMA<sup>36</sup>)
- **tax-incentives**, consequently mentioned in the doctoral study as direct support by the government mean obvious advantage in international competition for venture capital, so direct incentives for venture capital funds or for the target companies are helping to create and operate active venture capital market (eg. Australia, Great-Britain). In connection with this efforts, although Hungary is middle-ranked in the European field, there is still a lot of tools to apply for more targeted support for all the actors of venture capital transactions. Examining the international best practices in this subject, it seem obvious for Hungary that the former applied (1998) preferential tax-

<sup>30</sup> see CUMMING, D. J. – MACINTOSH, J.G: *Crowding out private equity: Canadian evidence*. Journal of Business Venturing, 21. 569-609. 2006.

<sup>31</sup> see KARSAI, J: *Helyettesítheti-e az állam a magántőke-befektetőket? Az állam szerepe a kockázati tőkepiacon*. MTA Közgazdaságtudományi Kutatóközpont. Műhelytanulmány. Budapest 2004; KOVÁCS, B.: *Állami kockázati tőke a kkv-finanszírozásban*. PhD értekezés, SZE RGDI. 2011.

<sup>32</sup> Details in the doctoral study's Chapter III.3.

<sup>33</sup> see eg. BASHA, A. – WALTZ, U.: *Convertible Securities and Optimal Exit Decisions in Venture Capital Finance*. Journal of Corporate Finance, 2011/ 7, 285-306.; GILSON, R. J: *Engineering a venture capital market: lessons from the American experience*. Stanford Law Review, 2003. 55(4). 1067-1103.; CUMMING, D. J. – SCHMIDT, D – WALTZ, U: *Legality and venture capital governance around the world*. Journal of Business Venturing. doi:10.1016/j.jbusvent.2008.07.001

<sup>34</sup> GILSON, R. J. – BLACK, B. S.: *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*. Journal of Financial Economics, 1999/ 47. 243-277.

<sup>35</sup> Small Business Innovation Research, USA

<sup>36</sup> world from the hebrew 'goal', Israel's program introducing venture capital in the country

rate can be introduced again. These losses for the central budget are not significant, but can be a gesture for the venture capital investors, and can almost immediately lower the shortage of resources for small- and medium sized companies.

- **entrepreneur-friendly administrative and law-environment** help the market-ready ideas to find capital and financing, which is not only good for venture capitalists but also increases the regions competitiveness. On this basis the EU support the state programs to ease the start to become and entrepreneur<sup>37</sup>. According to the international literature, introducing measures on this field may take more time, and/or rebuilding previous structures, so most of the countries choose the direct investment forms while they are easy and fast to set up, and can be better communicated as an immediate success of the recent government<sup>38</sup>.

Evaluating the legal documents created during the venture capital process we can see the lack national legal literature, primarily the Anglo-Saxon contractual design is known, and as a narrow view, the EVCA published some documents on the question but only for the proof of economic hypothesis. But we cannot forget, that the venture capital investing process produces many kind of legally relevant documents governing the rights and obligations of the parties, even in those cases which not ends with investment agreement.

The first question to answer is the prompt definition of the parties. Both in national and international legislation we can observe that the legislation searches the perfect fields for the actors of venture capital investment, either the place of the transaction itself in the legal order. The role of venture capital funds as formal venture capital investors is changing dramatically in the year 2011 according to the changes in regulation of alternative venture capital funds and fund-managers in the EU, and according to the new rules of investment advising in the USA. The mentioned regions both agree on the venture capital funds as small parts of the monetary intermediation play negligible part on the current financial crisis, though a “reloaded” regulation on these actors cannot be avoided. But due to their slight effort on capital markets the new and very strict regulation of investment funds and investment advisors cannot take effect these funds and fund managers – with the same content. In the United States easier rules should be applied for venture capital funds and investment advisers who are dealing only with this kind of financing<sup>39</sup>, while in the EU’s directive on alternative investment fund managers the venture capital fund managers will be out of the scope because of the minimum capital-level of applicability. The prepared document of the European Venture Capital Fund<sup>40</sup>

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<sup>37</sup> eg. COM (2011) 669 final. Communication from the Commission: A roadmap to stability and growth.

<sup>38</sup> Harrison, R. T. – Mason, C. M. (ed.): *The role of public sector in the developement of a regional venture capital industry*. Venture Capital, 2000/4. 246.

<sup>39</sup> see the III.4.2. part of the doctoral study for the details. This part refers to the Dodd-Frank Act and it’s implementation rules by the Securities and Exchange Commission.

<sup>40</sup> COM (2011) 860 final

and its special regulation shows the way the European Commission is try to solve the problem of legislation of venture capital funds, which is observed in details in part III.4.5. in the doctoral study.

Among the parties of the venture capital contract there is the target-company to which the capital is transferred. As a legal form for this company it is possible to occur as a pre-company or even as a public limited company (not listed on stock exchange) depending on what kind of investment is under construction in a venture capital agreement. In the current European legislation the only barrier for the target-company is that it should be a small- or medium sized company, but the current legislation in the US does not contain restrictions on the size of the company. This target-company as the receiver of capital goes under serious changes in the phase of investment both in connection with property, governance and company law. After detecting the actors of venture capital can we go towards the field of examination the venture capital contract, as legal transaction.

Efficiently defending the business secrets can be a crucial question even during the start-phase of venture capital negotiations, as the business plan required by the investor can even contain significant information that is to keep in secret. In the life of early stage companies, these secrets can mean life or death, and as basically innovative companies the protection of intellectual property can occur in the early phase of venture capital investing. Taking into consideration that many of the venture capital investors work internationally, the worldwide protection of trade secrets, inventions and any kind of intellectual property is a basic question of the investment process.

As the Hungarian law does not know a separate type of contract that is called “venture capital contract” it is obvious that for examination of the legal practice we have to “borrow” the rules of different contractual types, such as the investment agreement. As the scientific description of the investment agreement is also under process nowadays, first, we have to look at the Anglo-Saxon literature and practice, where even model documents are available<sup>41</sup>. As these documents and the connected economic and legal scientific literature is based on a different legal order, they cannot applied to Hungarian or even European legal conditions without significant modifications. The main reason for this is in the difference of company formations, detailed in the doctoral study’s part V.3.

### Evaluation of the hypothesis

Connected to the aims and scopes of the doctoral subject, we set up the following hypothesizes for the examination of the legal aspects of venture capital investments.

ad (1) The venture capital fund and the venture capital fund manager are separate and specific actors of the monetary intermediation system, which needs to be dealt and regulated independently. According to the fact that in the United States the literature of

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<sup>41</sup> See the documents of BVCA or NVCA prepared directly for the practitioners of venture capital investors and target-companies.

venture capital investments is counted since the 1970's, and that the EU reacted to the expectations of the market only from 1998, and also that in Hungary the first regulation of venture capital activity appeared in 1998, we can state that the governments and regulators kept away from the venture capital investments for a long time. Even for long since then the role of the state was only to govern the basics of formal venture capital investors, i.e. the venture capital funds, and the regulation only covered the administrative and taxation minimums of these companies.

The other appearance of the state was to present itself as a sole actor on the venture capital market by managing state-affiliated venture capital funds, which brought up questions on competition law regulated primarily by the EU sources. Though the international scientific literature is divided in the question of the suitable role of the state on the venture capital market, the authors unity that the most important task for the governments is to create venture capital-friendly market conditions, such as legal and administrative rules, investor's security rights, and most of all, international harmonization of laws. A sufficient step in this way is the preparation of European Venture Capital Fund as mentioned above. Also an important fact is that the accepted rules as answers for the current financial crises are showing approximation of laws in connection with the USA and the EU in terminology, but it is also fact, that both regions guarantees privileges for the resident actors. The current legislation and regulations of the venture capital activity shows the urgent and up-to-date demand for adequate rules of venture capital investments. The accepted regulations also shows that the venture capital contract are separate phenomena of the investment activities, and needs to be handled with different legal instruments, than other alternative investment actors.

ad (2) On the globalizing financial regulation system placing the venture capital investments in harmonized legal frames gives significant competition-advantage for the economic actors. A great part of venture capital transactions are realized on international field, except of those supported by national government to increase the available amount of capital for national small- and medium sized companies. These state-backed funds has both territorial and target-company restrictions.

But for the – basically European – market actors we can set out that most of them make investments across the borders, and among them the “regional funds” play important role. As for the target companies it can be an important factor to start negotiations with more than one venture investor to boost the negotiation position, and to lower the risks arising from informational asymmetry. The specialized or market segmented venture capital investors also benefits from international appearance, for example on a small market like the Hungarian a biotechnology-based venture capital investor could not exploit its potential.

Operating in international level also has several risks, among them increased administrative and financial liabilities. The international organizations as the EVCA or OECD stated that the harmonized legal rules are the most important task for national governments to increase venture capital investments. The desirable regulation's base should be that the investment funds or investment companies may channel their capital

free across borders, and this way seek for the best investment alternatives. Transparent tax system is essential for investors, and there is also a need for the termination of rules hampering the money and capital transfers. A basic need is to admit the foreign-established venture capital investment bodies, and to avoid double taxation. Among the question of intellectual property the international protection of these rights is a *sine qua non* of venture-backed companies. Every bilateral or multilateral agreement or contractual system is to be supported that facilitates to have the protection acquired in another country.

In the mirror of the uppers we can state that both the Dodd-Frank Act, both the regulation on alternative investment fund managers (AIMF)<sup>42</sup> in the EU, and also the prepared regulation on the European Venture Capital Fund is a milestone in the international legislation of venture capital investments. All three rules contains significant advantages and also much stricter rules than before. The Dodd-Frank Act introduces extra administrative duties and activity restrictions for foreign established companies, and the AIMF-directive lets the foreign investors to operate in the territory of the EU only by a passport-system in case they fulfill the strict criteria. In this field the further communication of the two parties cannot be sidestepped, as the interest-groups on both sides has already communicated their displeasure on discrimination of foreign market actors in the current regulations.

ad (3) Venture capital investment contracts represent a sole, unique type of private law contract with identifiable legal distinctiveness. The Anglo-Saxon legal practice writes down the venture capital investment contracts as a serial of legally relevant documents. As the agreements on terms born in different stages of investment, and sometimes the caching of capital in a firm is also made step-by-step, in almost all the cases the contractual relation of the parties lay down in more than one basic document. An exception can be the government-supported venture capital fund's investment agreement, which can occur in only one document according to the empirical study of Hungarian and European contractual practice, but we have to settle down, that these state-backed companies apply different terms and conditions than the market actors do<sup>43</sup>.

Dogmatically the question is if the agreements or contract made by a venture capital investor and the target-company can be identified as a separate kind of contract in the private law, or is a mixed type with the features of other specified contractual types. In consideration of the content of the agreement is determined by a lot of factors like the age of the target-company, the number and relation of the investors, the transformation of the company caused by the investment, the author of the doctoral study states that the venture capital investment contract cannot form an independent kind of contract. In the

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<sup>42</sup> 2011/61/EU Directive on alternative investment fund managers

<sup>43</sup> see eg. HIRSCH, J.: *Why do contracts differ between VC types? Market segmentation versus corporate governance varieties*. CFS Working Paper No. 2006/12; BAUER, E. – BURGHOF, H-P 2004: *The economics of state subsidies in early stage venture capital investments*. University of Hohenheim, Working Paper, 2004; KOVÁCS, B *Állami kockázati tőke a kkv-finanszírozásban*. PhD értekezés, SZE RGDI.

Hungarian legal practice studying the terms and substance of different contractual forms, the venture capital investments' contractual conditions are closest to the syndication contract, but we have to set down, that this contractual type is very different from the Anglo-Saxon type of syndication. The latter is used when there are more than one party on the subject side of investors, and they raise capital in the company in regard to the others, and often a bank is involved in the investment.

The venture capital contract as an atypical mixed contract contains duties both on diligence and on result, as in the contract the investor takes responsibility to raise capital in the company under certain conditions (duty on result) in exchange for realizing a certain financial or business development that have to be achieved by the company's leaders by presenting the due foresight (duty on diligence). According to these, in the venture capital investment documentation we found the specifics of sale and purchase contract, the mandatory agreement, venture agreement, and the obligatory rules of company law also appear in the relation of the parties. It should be mentioned here that the agreement of the investor and the company cannot be opposite with the articles of association of the company.

According to the upper we can state that the content and conditions of venture capital investment contracts differ so much that the independent regulation of this kind of contract seems unsubstantiated. Although, the common contractual conditions give basis for the further examination of the agreements. For the upcoming research of venture capital investments it is obvious that the European Venture Capital Fund and its functioning is one important way to follow. The development of the industry and the increasing number of venture capital contacts shows the other important subject of further researches.



