

## **EXIT STRATEGIES FOR VENTURE CAPITAL IN HUNGARY**

**– in Light of Experiences from the United States of America**

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## Abstract

The paper presents the most important exit strategies employed by the Venture Capital (hereinafter: VC) investment fund managers in Hungary and the United States of America (hereinafter: US). The key proposition the thesis aims to show is, first, that the presently prevailing sales-based exit strategies in Hungary will continue to produce only modest results and might have negative effects for the investee and the venture capitalist. Secondly, as the US experiences suggest, more efforts should be invested into the amelioration of the regulatory environment that would make IPO-s more trusted and favored to the VC community. The paper is based on legal literature as well as data provided by the relevant Venture Capital Associations, especially regarding significant IPO-s or sales of startups. The paper views the presented issues mainly from the point of view of the venture capitalist, but the perspective of the investee firm is also taken into consideration during the research.

The focus of the paper is on the Hungarian jurisdiction, which is contrasted to the approach to exits reflected in the US. In order to provide a beneficial recommendation for the Hungarian VC investment fund managers I will review the main characteristics of VC funds in Hungary. I will present the most frequently resorted to exit methods and the concomitant exit rights of the investee company's shareholders, the tag-along, drag-along and call or put provisions or clauses that can aid the VC manager in structuring the exit of the investment. The paper will tackle the practical advantageous results of the IPO and less advantageous outcomes of the sale, with a special focus on the sale to management. The IPO is a more rewarding avenue, while the sale provides a safer return on the investment of the investors but might lead to drawbacks for the investee and the

venture capital experts, too. I argue for a more favorable, active and trustful approach to IPO-s, against the excessive reliance on sales to management.

# Introduction

## 1) On the Importance of VC Firms

VC is a private equity investment where the venture capitalist plans the investment in an investee company with his interest focused on the moment and the way he will exit the investment. Startup companies often lack a viable credit history or assets that could be used as collateral, VC financing companies provide much needed sources for financing startups' growth in exchange for profit for the venture capitalist and the investors of the fund. Thanks to VC financing, startups can access finance for their business without the burdensome help of a bank and without taking out loans secured with assets. I chose to research the types of exits and the possible benefits of exit strategies in Hungary due to VC's significance for the startup market in Hungary and the possible benefits a paradigm shift in favor of IPO exits can provide, for establishing an even more flourishing VC and startup market.

What sets venture capital apart from other private equity investment types is that the investee companies are usually new startup enterprises, generally with a novel technological product that lack funding and business experience. The professional fund managers of the venture capital investment companies can provide both in exchange for equity, while setting their eyes already on the moment they will exit.<sup>1</sup> The VC investment relationship involves a deep trust between the investee and the venture capitalist, and the venture capitalist and the investors in the fund, since the investee companies are startups without experience who benefit from the investment but also the expertise offered by the venture capitalist. Trust is crucial during the cooperation between the parties and for structuring a proper exit.

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<sup>1</sup> Darek Klonowski, *The Venture Capital Investment Process, Principles and Practice*, Palgrave Macmillan 2013 2.

Venture capital is considered high risk investment (in some jurisdictions, for example Hungary, this fact is also reflected by venture capital being called – metaphrased – as “risk capital”) since the target companies are early stage businesses with minimal business experience and unproven potential. Where the risks and the potential gains start to become fruitful is the exit stage and therefore the question of exits is crucial to the business and the goal of the venture capitalist.<sup>2</sup> Venture capitalists provide considerable resources for startups (for example, in 2018 HUF 345.9 million into Hungarian companies)<sup>3</sup> and thus, for the Hungarian economy as a whole. This puts them in a powerful position to build a more trustworthy capital market for their own benefit and for the benefit of the investee and the Hungarian economy as well. I aim to show that it is in venture capitalists’ interest to structure more IPO-s to provide better investment for themselves and better financing opportunities for the investee.

## 2) On the Importance of Exit Strategies

Exiting the investment means that the venture capitalist will sell the shares he owns in the given company. The most generally used forms of exiting the investment are the IPO and the sale of the shares to another buyer. Due to the exit being usually strategically postponed until a future date when the investee becomes more valuable than in the moment of initial investment, the venture capitalist provides not only financial funding to the investee company during the contractual relationship but also business expertise and hands-on management. This way, the venture capitalist also makes sure that the investee company improves between the moment of investment and the exit. In the past few years, Hungarian venture capitalists have proved to prefer sales exits,

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<sup>2</sup> Ibid. 11.

<sup>3</sup> ‘Venture Capital and Private Equity Update Hungary - 2018’ (*Hungarian Venture Capital and Private Equity Association*) (HVCA) <[https://www.hvca.hu/documents/Investment\\_monitoring\\_report\\_2018\\_Final.pdf](https://www.hvca.hu/documents/Investment_monitoring_report_2018_Final.pdf)> accessed 5 April 2020.

especially sale to the management, and have not preferred going public – this choice and the possible consequences will be discussed in the paper.

While choosing an exit strategy is a decisive issue for the future of the investee and for the venture capitalist as well, their interests might not always align. Therefore, the parties to the shareholders' agreement or the term sheet need to agree on the terms of the exit from the early stages to be able to plan their co-operation accordingly. The term sheet is a non-binding agreement encompassing the basic terms and conditions for the VC investment into the investee company, which will usually be incorporated into the shareholders' agreement. The term sheet phase is followed by the due diligence into the investee company and, finally, the investment.<sup>4</sup> I will present what contractual clauses need to be observed by the venture capitalist during the structuring of the exit and which exit routes they are useful for.

### 3) The Jurisdictions Observed

Hungary has shown a relatively stable tendency of economic growth in the past few years. However, as it is common in the region, the economy is not so stable so as to weather any storm easily.<sup>5</sup> Hungarian VC activity has been growing noticeably in the past few years, and in the past few years the main preferred exit route was sale to management, and not so much the IPO.<sup>6</sup> Hungary is the main jurisdiction observed herein which will be contrasted to the United States of America.

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<sup>4</sup> Andrew Metrick, Ayako Yasuda, *Venture Capital and the Finance of Innovation*, (2nd Edition, Wiley 2011) 9.

<sup>5</sup> OECD, Economic Surveys – Hungary January 2019 Overview (*OECD*, 2019) <<https://www.oecd.org/economy/surveys/Hungary-2019-OECD-economic-survey-overview.pdf>> accessed 1 June 2020 12.

<sup>6</sup> 'Venture Capital and Private Equity Update Hungary - 2018' (*HVCA*) (n. 3).

The US is the country with the most venture capital investments according to the OECD for 2018.<sup>7</sup>

The US had a very favorable position on the VC market before the Credit Crunch; in 2003, for example, North America provided 64% of the overall venture capital investments of the world.<sup>8</sup>

The US has strong capital markets and the exit routes have varied through the years, but IPO-s are usually relied on steadily by venture capitalists; there was record IPO activity in 2019, for example.<sup>9</sup> The attitude of the US vis-à-vis venture capital and exit options is the obvious market to compare with the approach in Hungary.

#### 4) Methodology

I will present how Hungarian venture capitalists can provide for exits to maintain the parties' interests: I will take the US VC exit treatment and US examples to be the benchmark for the Hungarian treatment of VC exit routes employed by the venture capitalists, based on the collected data and practices. I will mainly use *literature* to present the relevant exit strategies for VC investment, with an important *methodology caveat*: this paper is heavily influenced by the practical nature of the Capstone Project itself. I have chosen to research a relatively new area of law that has not been vastly explored before and this impacts the somewhat unorthodox literature I use. I rely in some extent on collected data from the Hungarian Venture Capital Association (hereinafter: HVCA) and the US National Venture Capital Association (hereinafter: NVCA), and other sources, which are provided by the VC industry or capital markets analysts. The topic of exits is very practical, and the data is helpful in revealing the practices of venture capitalists and investee

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<sup>7</sup> OECD, Entrepreneurship at a Glance 2017 (OECD, 2017) <[https://www.oecd-ilibrary.org/employment/entrepreneurship-at-a-glance-2017\\_entrepreneur\\_aag-2017-en](https://www.oecd-ilibrary.org/employment/entrepreneurship-at-a-glance-2017_entrepreneur_aag-2017-en)> accessed 5 April 2020.

<sup>8</sup> Bob Wooster, Beat A. Brechbül, *General Report in Global Venture Capital Transactions, a practical approach*, (AIJA Law Library, Kluwer Law International, 2004) 4.

<sup>9</sup> Venture-Backed Exit Activity Eclipsed Annual Record Surpassing \$200 Billion In Only Three Quarters (*National Venture Capital Association – NVCA*, October 9 2019) <<https://nvca.org/pressreleases/venture-backed-exit-activity-eclipsed-annual-record-surpassing-200-billion-in-only-three-quarters/>> accessed 18 May 2020.



companies when considering exit strategies. I am confident that without these sources the analysis would be only theoretical, and the predominantly practical purpose of this paper would suffer.

## 5) Roadmap

The first chapter will provide a brief overview of the VC exits in the US and in the Hungarian jurisdiction, providing a brief presentation of the jurisdictions, while the main differences regarding the exit types in the two jurisdictions will be developed in the latter chapters, to provide a more comparative glance. The second chapter tackles the exit rights of the investee's shareholders, such as the drag-along, tag-along clauses, call or put provisions. The third chapter will present the IPO as one of the first main exit forms and its benefits. The fourth chapter tackles the possibilities given by acquisitions: the trade sale and the subcategory of management buy-backs. Finally, I will present the main aspects to consider when choosing an IPO or an acquisition and the benefits of each. The paper will not discuss the liquidation of assets of the investee since it is not an exit route that the investors plan for.

# 1. Chapter 1 – Venture Capital Investment and Exits in the United States of America and Hungary – A Brief Overview of the Jurisdictions

## 1.1. The United States of America

US companies frequently rely on VC for their funding needs, making the US the global leader, the inevitable benchmark jurisdiction that no scholar interested in this field of law should bypass. In the US, VC funds have been exempted from the registration requirements of registered investment advisors that other private equity funds have to observe, and has allowed VC funds to register as exempted reporting advisors.<sup>10</sup> This exemption was granted by the Dodd-Frank Act<sup>11</sup> for VC funds with less than \$150 million under management and was implemented by the SEC's Rule 203(l)-1 of the Investment Advisers Act of 1940.<sup>12</sup> This exemption is an advantage that allows VC funds to escape from general registration requirements and subjects the VC funds to less administrative costs.

VC funds have a major impact on innovation in the US and have become by now an unprecedented force driving the economy.<sup>13</sup> Only in the year 2019 the 43% of all US IPO-s, representing 82

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<sup>10</sup> US Securities and Exchange Commission Division of Investment Management, 'IM Guidance Update December 2013 | No. 2013-13 Guidance on the exemption for advisers to venture capital funds' (*US Securities and Exchange Commission*) <<https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-13.pdf>> accessed 21 May 2020.

<sup>11</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, 111th Congress (21 July 2010) s 407 <<https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf>> accessed 1 June 2020.

<sup>12</sup> Securities and Exchange Commission, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, 17 CFR Part 275 Release No. IA-3222; File No. S7-37-10 RIN 3235-AK81.

<sup>13</sup> Ilya A. Strebulaev, Will Gornall, 'How Much Does Venture Capital Drive the U.S. Economy?' (*Stanford Graduate School of Business*, 21 October 2015) <<https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy>> accessed 20 April 2020.

companies, were backed by VC funding,<sup>14</sup> and the aggregate exit value of 2019 added up to \$199 billion.<sup>15</sup>

The numbers show how relevant the VC business has become for US startups and how influential venture capitalists are for the economy. The numbers show a minor decline in IPO exit count compared to 2018, but a major increase in size of those particular exits, compared to the preceding year.<sup>16</sup> 2019 was an exclusively successful year for VC financing according to the NVCA – especially from the point of view of exits 2019 was admittedly a record year.<sup>17</sup> The data shows that mergers and acquisitions decreased since 2018, but IPO-s were a success story.<sup>18</sup>

VC funds are generally structured as Limited liability partnerships, or LLP-s, where the investors are the Limited partners and the VC fund managers and the VC the General partners.<sup>19</sup> While the Limited partners, the investors, are at peril of losing only the invested amount or the owned investment amount in case of losses, the VC and the managers are absolutely liable for any losses and can be sued for their liability. The VC fund directors have fiduciary duties toward the fund, the limited partners, and toward the investee company.<sup>20</sup> This means that they have duties to observe the best interest of the limited partners, but also must observe the investee's interest too. Nevertheless, breach of fiduciary duty by the venture capitalist has been shown to be hard to prove, unless unjust enrichment is proven.<sup>21</sup>

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<sup>14</sup> 'NVCA Yearbook' (*National Venture Capital Association*) (NVCA) <<https://nvca.org/research/nvca-yearbook/>> accessed 19 April 2020.

<sup>15</sup> 'NVCA 2020 Yearbook' (*nvca.org*, *Pitchbook.com*) Washington, DC | San Francisco, CA | Palo Alto, CA), 202-864-5920 <<https://nvca.org/wp-content/uploads/2020/04/NVCA-2020-Yearbook.pdf>> accessed 19 April 2020 7.

<sup>16</sup> Ibid 34.

<sup>17</sup> Ibid. 7.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid 10.

<sup>20</sup> Steven E. Bochner & Amy L. Simmerman, 'The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats' (2016) *Delaware Journal of Corporate Law*, Vol. 41 Issue 1, 1-27 4.

<sup>21</sup> *InfoSAGE Inc v Mellon Ventures, LP*, 896 A 2d 616 (Pa.Super, 2006).

Choosing an exit strategy in the US is significantly affected by the amount of regulation and disclosure that each exit possibility entails. While the management buyout means that the investee company will buy its own shares back from the venture capitalist, the acquisition or an IPO can mean a more pronounced “opening up of the company” to the new buyer or to the public – this also includes disclosing relevant and material business activities. The US capital markets’ efficiency in raising capital make the IPO an attractive possibility for startups and venture capitalists, even if going public on the US capital markets entails subjecting the investee company’s activity to immense scrutiny and accountability.

Such demanding requirements were introduced by the Sarbanes-Oxley Act (hereinafter: SOX) in 2002.<sup>22</sup> SOX established requirements for a Public Company Accounting Oversight Board, whose mandate is to oversee the audit of public companies and to enforce compliance with regulations.<sup>23</sup> The SOX also imposes enhanced financial disclosures for public companies.<sup>24</sup> The SOX has relevance and is mandatory for all public companies on US stock exchanges, meaning that not only companies whose place of registration is in the United States have to comply with the regulation, but all companies whose securities are traded on US exchanges. Non-compliance for officers of a company can even mean criminal liability, for example in case of non-compliance with the Securities and Exchange Commission’s disclosure requirements.<sup>25</sup> Nevertheless, IPO-s are still an attractive exit route due to their comparatively more advantageous returns, as shown by the above mentioned data.

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<sup>22</sup> Sarbanes-Oxley Act, 107<sup>th</sup> Congress (30 July 2002) (SOX) <<https://www.congress.gov/bill/107th-congress/house-bill/3763>> accessed 26 April 2020.

<sup>23</sup> SOX Title I.

<sup>24</sup> SOX Title IV.

<sup>25</sup> SOX s 302.

## 1.2. VC in Hungary

Venture capital financing in Hungary is regulated by the regulation of capital markets<sup>26</sup>, amended in 2014,<sup>27</sup> and are categorized as a form of “alternative investment fund”.<sup>28</sup> VC funds are closed funds established by the circulation of investment tickets between the investors, who are exclusively professional investors.<sup>29</sup> The investment tickets are transferable securities (shares) issued in favor of the fund. The tickets are owned by the Limited Partners and represent their share in the investee company’s equity.<sup>30</sup> The new legislation has repealed the separate act that previously focused on VC,<sup>31</sup> to incorporate relevant provisions regarding VC into the 2001 Act. This suggests that the Hungarian legislation has shifted the paradigm to place the otherwise solitary VC unit into a more unitary system of investment types and considers the VC stage as a sub-unit of potential capital markets investments.

### 1.2.1 The VC Fund

Funds are generally structured as separate legal entities to provide limited liability to the investors with a determined duration.<sup>32</sup> The fund resembles the structure of a foundation (which is usually a non-profit entity managing patrimony for non-lucrative purposes), since the management company and the fund are separate legal entities, and the structure of *részvény-társaság* or RT, the Hungarian

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<sup>26</sup> ‘2001. Évi CXX. Törvény a Tőkepiacról’ s 3.

<sup>27</sup> ‘2014. Évi XVI. Törvény a Kollektív Befektetési Formákról És Kezelőikről, Valamint Egyes Pénzügyi Tárgyú Törvények Módosításáról’.

<sup>28</sup> Ibid. s 4(1) 59.

<sup>29</sup> Ibid. s 67(6).

<sup>30</sup> Judit Glavanits, ‘*A Kockázati Tőkebefektetések Egyes Jogi Kérdései*’ (Universitas-Győr Nonprofit Kft., 2015) 91.

<sup>31</sup> ‘1998. Évi XXXIV. Törvény a Kockázati Tőkebefektetésekről, a Kockázati Tőketársaságokról, Valamint a Kockázati Tőkealapokról’.

<sup>32</sup> ‘2014. Évi XVI. Törvény a Kollektív Befektetési Formákról És Kezelőikről, Valamint Egyes Pénzügyi Tárgyú Törvények Módosításáról’ s 59.

approximate equivalent of the US public corporation, even though, the two business forms do not match exactly.<sup>33</sup>

The funds themselves are required to have a definite duration of operation which cannot be less than 6 calendar years,<sup>34</sup> the fund manager, who is usually the VC company, can extend the term of operation of the fund with the same amount of time, if it was not forbidden by the fund management rules.<sup>35</sup> The limited duration is relevant to establish the moment of an exit: the investors and the venture capitalist establish a limited duration in which the venture capitalist has the duty to invest according to the investors' best interest and to exit the investment in the opportune moment.

Venture capitalists can have an active role in managing the investee. For example, in the Hungarian company Cryo, managed by Investeen, Investeen delegated the CEO and 3 of 5 of the top management – key positions in the investee company.<sup>36</sup> It is in the interest of the venture capitalist to get involved and to provide market experience and knowledge to the startups, and he can do this by taking part actively in the management.

It should be mentioned that Hungary being a member state of the European Union, Directive 61/2011/EU is applicable to the management of the relevant funds.<sup>37</sup> Accordingly, funds with values exceeding 500 million EUR come under the applicability of the directive and have special

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<sup>33</sup> Judit Glavanits, '*A Kockázati Tőkebefektetések Egyes Jogi Kérdései*' (Universitas-Győr Nonprofit Kft., 2015) 68.

<sup>34</sup> '2014. Évi XVI. Törvény a Kollektív Befektetési Formákról És Kezelőikről, Valamint Egyes Pénzügyi Tárgyú Törvények Módosításáról' s 67(8).

<sup>35</sup> Idem s 67(9).

<sup>36</sup> Péter Oszkó, 'Cryo case study: Story of the first successful exit. The role of Venture Capital in a Start-Up success' (HVCA) <[https://www.hvca.hu/wp-content/uploads/2013/06/4\\_Cryo\\_DrOszko.pdf](https://www.hvca.hu/wp-content/uploads/2013/06/4_Cryo_DrOszko.pdf)> accessed 5 April 2020.

<sup>37</sup> 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 [2011] OJ L 174 1.7., 1.

disclosure duties for the managers and the majority shareholders toward the regulatory authorities and the investors.<sup>38</sup>

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<sup>38</sup> ‘Alternatív Befektetési Alapkezelőkről Szóló Irányelv, ABAK - Szakkifejezések - HVCA - Magyar Kockázati- És Magántőke Egyesület’ (HVCA) <<https://www.hvca.hu/szakkifejezesek/alternativ-befektetesi-alapkezelkr-l-szolo-iranyelv-abak-aifmd/>> accessed 21 March 2020.

## Chapter 2 – Exit Rights – Drag-along, Tag-along, Call or Put

The venture capitalist, the investors and the investee company will usually be accorded a set of rights as a means of protection in the shareholders' agreement and the term sheet or even the articles of association. I will not discuss contractual clauses regarding the lockup period after an IPO when the shareholders are obliged not to sell their shares,<sup>39</sup> in order to maintain new investors' trust in the good governance and stability of the investee, since these provisions, albeit important, do not strictly concern the agreements regarding the exit possibilities of the shareholders.

The rights relevant for a VC exit are drag-along, tag-along, call or put options. These clauses' purpose is to provide answers for the problems due to the illiquidity of private companies and for the eventual exit. Start-ups funded by VC are privately held companies – their shares are not traded publicly unless the company opts for an IPO. Thus, shareholders do not have any easy opportunities to sell their shares, as it would be the case with companies listed on stock exchanges. Being trapped in such a situation can lead to tensions between shareholders and can represent a problem for the future of the company – and the venture capitalist, too. Therefore, exit rights included in shareholders' agreements or the articles of association are crucial for the exit and for the peaceful management of the investee company.

Another cause of illiquidity is exactly the absence of an open market on which the shares can be traded (unlike the market access an IPO would provide), and the lack of an objective valuation provided by the market to the shares of the company. In case of a sale of the investee company the separate valuation is crucial, for the protection of all parties – so that the venture capitalist does

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<sup>39</sup> Alon Brav, Paul A. Gompers, 'The Role of Lockups in Initial Public Offerings' (2003) 16 *The Review of Financial Studies* 19.



not receive too little in return for its investment and so that the buyer does not pay too much for the company.<sup>40</sup>

To exemplify the importance of exit rights, in the US case *Donahue v Rodd* it was held that the controlling majority shareholders were creating an exclusive market for their shares while excluding any opportunity of sale by the minority shareholder.<sup>41</sup> The entity was a closely held corporation where the majority sold his shares back to the company for a high price and distributed the rest of his assets to his children, also shareholders. The minority shareholder refused to ratify the sale and offered to sell her shares for the same price, but the company did not agree to purchase her shares for the same price. The court held that a fiduciary duty of the majority shareholder exists in partnerships or close corporations in favor of the minority shareholders and the majority was obligated to buy the shares at the same price. The situation is similar in most close corporations or privately held companies where venture capitalists are involved, since the lack of an openly available market holds all shareholders virtually captive in the contractual relationship.

Sale related exit rights are frequently used in Europe.<sup>42</sup> The drag-along, tag-along and the call or put options are explicitly mentioned in the template term sheet available on the HVCA website<sup>43</sup>

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<sup>40</sup> An open access working draft of the American Institute of Certified Public Accountants Accounting and Valuation Guide for portfolio companies can be consulted at <<https://www.duffandphelps.com/-/media/assets/pdfs/publications/alternative-asset-advisory/working-draft-pe-vc-guide-part-i-ch1-14.ashx?la=en&hash=B7A3872EAD0B3F0133DA80EC1CD7562DDF49587C>> accessed 22 March 2020.

<sup>41</sup> *Donahue v Rodd Electrotipe Co.*, 328 N.E.2d 505 (Mass. 1975).

<sup>42</sup> Bienz Carsten, Walz Uwe, 'Venture Capital Exit Rights' (2010) 19 Journal of Economics and Management Strategy 1079.

<sup>43</sup> Balassa Tamás, Budai Judit, Fabricius Ferke János, Réz Éva, Simon Barnabás, 'A Term Sheet és ami mögötte van' (HVCA, 2017 December) (Term sheet template) <[https://www.hvca.hu/documents/HVCA\\_\\_Term\\_Sheet\\_explained\\_HU\\_\\_2017\\_december\\_final\\_with\\_new\\_logo.pdf](https://www.hvca.hu/documents/HVCA__Term_Sheet_explained_HU__2017_december_final_with_new_logo.pdf)> accessed 2 June 2020.

and in the term sheet model provided by the NVCA.<sup>44</sup> The template is not intended to be used during contractual negotiations, according to the drafters of the template.<sup>45</sup>

## 2.1 Drag-along Clauses

Drag-along clauses offer protection for the majority shareholders in case of a sale of shares, where the clause enables the majority to enforce the clause and force the minority to sell her shares if the majority wants to sell.<sup>46</sup> The provision allows for a full sale of the investee company, allowing for protection of the new buyer and the minority shareholder as well, since they will not be forced to cooperate with each other in the future management of the company. The VC will usually own a minority stake in the investee; therefore, it should be cautious when drag-along clauses exist and should demand proper protection, especially regarding the price of the shares. Drag-along and Tag-along clauses can be important for the Hungarian jurisdiction, where the sale is the prevalent exit method currently (as it will be discussed more in depth in a separate chapter).

## 2.2 Tag-along Clauses

Tag-along clauses represent an opposite possibility, of increased importance for the protection of the minority, such as the venture capitalist, who will generally be in this position. With the help of a tag-along clause the minority will have the chance to avoid being engaged with a new buyer, while the former majority shareholder leaves the investee.<sup>47</sup> The minority can, via the enforcement of a tag-along provision, force the majority to agree to a co-sale of her shares together with the minority's. The minority can thus join the sale or transaction and exit together with the majority,

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<sup>44</sup> NVCA Model term sheet 1, 'Model Legal Documents' (*National Venture Capital Association – NVCA*, last updated January 2019) (NVCA model) 14 <<https://nvca.org/model-legal-documents/>> accessed 2 June 2020.

<sup>45</sup> Ibid. 1.

<sup>46</sup> Evan Tarver, 'Drag-Along Rights' (*Investopedia*, updated 30 April 2019) <<https://www.investopedia.com/terms/d/dragalongrights.asp>> accessed 21 March 2020.

<sup>47</sup> James Chen, 'Tag-Along Rights Definition' (*Investopedia*, updated 21 March 2020) <<https://www.investopedia.com/terms/t/tagalongrights.asp>> accessed 21 March 2020.

making a possible profit on the sale. Without tag-along clauses the minority would be closed-in an illiquid investment during a merger or acquisition of the investee company. Tag-along rights are also mentioned in the HVCA template<sup>48</sup> but not in the US NVCA template.

## 2.3 Call or Put Options

The call or put options (i.e. redemption rights) allow shareholders to buy-back or sell back shares and exit from the investment by selling the shares to the other shareholder.<sup>49</sup> The terms of buybacks should be carefully drafted so that the VC and the investors who are planning to exit via the buyback do not receive less payment for their shares than they are worth – which is difficult to establish without an open market which could provide the value of the shares. For the investee company the call-rights allow to redeem the shares owned by the venture capitalist at the company's discretion.<sup>50</sup> The buy-back provisions can be used in the investee company buy-back or management sale, when the VC sells the shares owned by the fund to the management body or the company. Call or put options are listed by the HVCA term sheet template.<sup>51</sup>

## 2.4 Enforceability of Contractual Exit Rights

The listed clauses are usually part of the term sheet and will be incorporated into the shareholders' agreement as well, but it is advisable to include them into the articles of association too. It has been a topic for discussion whether shareholders' agreements are enforceable in the Hungarian legal system, since without enforcement, any clauses relating to exit rights would provide no

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<sup>48</sup> Term sheet template (n. 43) 17.

<sup>49</sup> Adam Hayes, 'Buybacks Explained' (*Investopedia*, updated 19 March 2020) <<https://www.investopedia.com/terms/b/buyback.asp>> accessed 22 March 2020.

<sup>50</sup> D. Gordon Smith, 'The Exit Structure of Venture Capital' (2005) 53 UCLA L Rev 315 <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=272231](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=272231)> accessed 26 May 2020.

<sup>51</sup> Term sheet template (n. 43) 18.

protection to any of the parties.<sup>52</sup> It has been considered that obligations included in Shareholders' Agreements according to Hungarian law are enforceable by the courts as a consequence of their contractual nature, according to the contractual civil law enforcement.<sup>53</sup> A breach of the shareholders' agreement amount to a contractual breach and can lead to judicial consequences, and the non-breaching party may request damages in addition to nullification, performance by the breaching party or non-performance of her own duties.<sup>54</sup> As a conclusion, the above mentioned rights have a relevant place in Hungarian shareholders' agreements and can provide protection in case of a breach of exit rights.

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<sup>52</sup> Menyhárd Attila, 'A szindikátusi szerződés kikényszeríthetősége', Acta Conventus de Iure Civili, Tomus X., Lectum Kiadó, Szeged, 2009.

<sup>53</sup> Ibid. 255.

<sup>54</sup> 'Új Ptk, 2013 V. törvény' V. Cím, A szerződés általános szabályai s 109(1) a)-d).

## Chapter 3 – The Initial Public Offering of the Investee Firm as an Obvious Exit Route?

### 3.1 The Concept and Benefits of the IPO

During IPO-s the investee's shares are offered for purchase on the primary market. The process is usually costly, since the implication of an underwriter is usually needed, and requires complete transparency: the company starts issuing securities on the relevant registered stock exchange to the public and will be able to increase its capital in a much easier way than before. When the investee company is still private and has a small number of shareholders, only its shareholders and the company's activity may be the sources to increase capital. After going public the pool of investors widens significantly and the securities can be traded (bought and sold) on the market. The shares issued by the investee company will be traded on exchanges where virtually anybody can buy securities and contribute to the capital of the investee.

“Going public” does not only refer to the fact that the shares of the investee company will be held by the public, thus, a large number of dispersed shareholders, but also to the fact that the general public, potential shareholders, have a right to know what they buy into, thus a general transparency and extensive disclosure is vital for the investee company to exit via an IPO.<sup>55</sup> Going public can entail a loss of control after the exit as well, since the market will be offering shares (float) of the company to the *public*. Disclosure and registration is advised when issuing securities to even a large private pool of potential investors, as it is demonstrated by the seminal *SEC v Ralston Purina*, where the test for registration and disclosure was imposed for the benefit of investors who were

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<sup>55</sup> Lerner Josh, ‘A Note on the Initial Public Offering Process’ Harvard Business School Background Note 200-018, October 1999. (Revised July 2007.) 7 3.

deemed not to be able to “fend for themselves” or to gain access to information without proper registration of the investee company.<sup>56</sup>

The capital markets are based on the core principle of trust: investors and issuers need to trust that the market will be able to provide advantageous solutions to the companies’ financial needs and proper investment avenues for the investors, and in case of any emerging problems the system will be able to protect the good faith actors. The investors have been shown not necessarily to trust the separate actors on the market, but the system itself and that it will prevail.<sup>57</sup> One of the ways to sustain trust is exactly through disclosure obligations and scrutiny on the market. Investors need to be aware of what happens on the market, to know that their trust is not being abused and that the market is trustworthy.<sup>58</sup> For this, the Hungarian legislator would have to step in and structure the capital markets in a way that favors investor protection and facilitates investor activity on the markets.

It has been observed that, historically, companies in the CEE region were especially against the public route and venture capitalists would much rather engage in a private sale or trade sale than an IPO, they would even consider not investing in a company if the shareholders’ agreement or other agreements included intentions of listing the company publicly.<sup>59</sup> The financial crisis of 2008 hit CEE hard, including the economy of Hungary – not just due to a big number of foreign currency-denominated debts that were assumed by individual Hungarian mortgagees but also due

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<sup>56</sup> *SEC v. Ralston Purina Co*, 346 U.S. 119 (1953).

<sup>57</sup> Lynn A. Stout, ‘Trust Behavior: The Essential Foundation of Securities Markets’ (Social Science Research Network 2009) SSRN Scholarly Paper ID 1442023 <<https://papers.ssrn.com/abstract=1442023>> accessed 18 May 2020.

<sup>58</sup> *Ibid.* 8.

<sup>59</sup> Görgényi Orsolya, ‘Hungary’ in Bob Wooder, Brechbül Beat A (eds), *Global Venture Capital Transactions, a practical approach*, (AIJA Law Library, Kluwer Law International, 2004) 237.

to the instability of the foreign markets.<sup>60</sup> Similarly unstable economies can suffer huge losses, such as is demonstrated by the Greek economy, which was almost decimated by the financial crisis.<sup>61</sup> The increased *mistrust* toward non-stable economy actors, such as the ones from CEE should not be disregarded as unimportant, and should be counteracted by attractive features of the investee company, the securities issued and by the venture capitalists work.

IPO-s have the advantage to provide for an exit to shareholders seeking an exit, while leaving the management of the investee unchanged. This advantage can be gained by the management buyback too, but without the possible disadvantages the latter involves. IPO-s and floats are generally structured so that the management stays on to conduct the business of the investee after the company is public.

IPO-s are costly, but provide the best return on investment for the VC funds in comparison to other methods of exit: according to one report 78% of total exit value of startups from the US in 2019 can be attributed to IPO-s.<sup>62</sup> The possible return following an IPO makes it a prime candidate for the preferred exit. Nevertheless, the timing of an IPO is crucial; whether the market is ready or whether the market is already saturated by other similar issuers is a key aspect to consider, as it is exemplified by Lyft and Uber below.

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<sup>60</sup> Magas István, 'Impacts of the Financial Crisis on a Small Open Economy: The Case of Hungary' *Dél–Kelet Európa – South-East Europe International Relations Quarterly* Vol. 1. No. 3 (Autumn 2010/3 Ősz). 10.

<sup>61</sup> Serdar Ozturk, Ali Sozdemir, 'Effects of Global Financial Crisis on Greece Economy' (*ResearchGate*) <[https://www.researchgate.net/publication/282555057\\_Effects\\_of\\_Global\\_Financial\\_Crisis\\_on\\_Greece\\_Economy](https://www.researchgate.net/publication/282555057_Effects_of_Global_Financial_Crisis_on_Greece_Economy)> accessed 19 March 2020.

<sup>62</sup> James Thorne 'Startups Smash Annual Record for VC-Backed Exit Value with 2019's IPO Onslaught' (*Pitchbook*, 13 January 2020) <<https://pitchbook.com/news/articles/startups-smash-annual-record-for-vc-backed-exit-value-with-2019s-ipo-onslaught>> accessed 15 March 2020.

### 3.2 US Examples

Many companies have taken advantage of the capital markets through an IPO. Lyft, the popular ride-sharing company with going public valuation of \$24 billion went public on NASDAQ at the beginning of April 2019 with its shares traded at \$72 each.<sup>63</sup> Beyond Meat Inc. the famous alternative non-meat based food producer company's share price almost tripled on the day of its going public – resulting in generous revenues for its shareholders.<sup>64</sup> On the other hand, Lyft's direct competitor Uber has also gone public in 2019, but since the exit was structured after Lyft had already had a very successful IPO, Uber was only able to trade at \$45 even if its pre-IPO valuation was \$82 million.<sup>65</sup> As this last example shows timing is a key factor when structuring an IPO.

An example of a company struggling to go public in the Covid-19 pandemic struck era is Airbnb. The one of the drivers of the sharing economy was meant to have a spectacular IPO in 2020, but the slowing economy and the implemented restrictions (such as lockdowns) that the Covid-19 pandemic imposed especially on travel have led to a steep decrease in Airbnb's activities and jeopardizes Airbnb's IPO prospects.<sup>66</sup> Airbnb is not alone; market volatility due to the current pandemic and crisis affects all companies on the verge of an IPO.<sup>67</sup> Timing is key for IPO-s, and

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<sup>63</sup> Business BC, 'Live Updates: Lyft IPO' (*CNN*, 1 April 2019) <<https://www.cnn.com/business/live-news/lyft-ipo-stock/index.html>> accessed 15 March 2020.

<sup>64</sup> Chris Davis, Dayana Yochim, '7 Upcoming IPOs to Watch in 2020' (*NerdWallet*, 17 June 2019) <<https://www.nerdwallet.com/blog/investing/upcoming-ipos-to-watch-in-2019/>> accessed 15 March 2020.

<sup>65</sup> Ibid.

<sup>66</sup> Jean Eaglesham, Maureen Farrell, Kirsten Grind, 'WSJ News Exclusive | Airbnb Swings to a Loss as Costs Climb Ahead of IPO' (*Wall Street Journal*, 11 February 2020) <<https://www.wsj.com/articles/airbnb-swings-to-a-loss-as-costs-climb-ahead-of-ipo-11581443123>> accessed 16 May 2020.

<sup>67</sup> 'Virus Triples the Pain for IPOs & At-Risk Options' (*Bloomberg Law*, 19 March 2020) <<https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-virus-triples-the-pain-for-ipos-at-risk-options>> accessed 16 May 2020.



the current market seems to be urging companies to wait. Nevertheless, in times of peace and without a crisis, IPO-s can be advantageous for the company and the venture capitalist.

### 3.3 Hungarian examples

The above examples were US companies who would generally go public on the New York Stock Exchange or NASDAQ, the latter being the so-called third market.<sup>68</sup> Hungarian companies might take this route as well. For example, Epam, the software development outsourcing company exited via IPO on the NYSE, according to Euroventures.<sup>69</sup> If Hungarian startups go public on US exchanges, they will be subject to such rigorous regulations as the SOX mentioned in a previous chapter. Companies can also go public in a domestic setting. For example, Waberer's, the freight company backed by the private equity firm Mid Europa, who decided to stay domestic and went public on the Budapest Stock Exchange (hereinafter: BSE) in 2017.<sup>70</sup>

During a crisis, most probably, due to the heightened risk aversion or lowered risk tolerance of the market actors, riskier activities, for example "concept IPOs", which require blind trust in the investee company, are most probably not advisable.<sup>71</sup> Protection for the venture capitalist in times of crisis can be a difficult problem: the market is not welcoming to most exiting companies in difficult times, so most probably an IPO would not be a preferred exit route. Some have shown that the economic environment produced by the 2008 Credit Crunch has led to the decrease of syndication, in other words less investors agreed to fund enterprises via VC.<sup>72</sup> In the CESEE

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<sup>68</sup> John C Coffee, Hillary A Sale, 'Securities Regulation – Cases and Materials' (Foundation Press, 2009) 594.

<sup>69</sup> 'Euroventures' <<http://www.euroventures.hu/en>> accessed 16 March 2020.

<sup>70</sup> 'Mid Europa - Mid Europa Lists Waberer's Through an Initial Public Offering on the Budapest Stock Exchange' (*MidEuropa*, 3 July 2017) <<https://www.mideuropa.com/media/news/2017/mid-europa-lists-waberer-s-through-an-initial-public-offering-on-the-budapest-stock-exchange/>> accessed 16 March 2020.

<sup>71</sup> Joseph W. Bartlett, 'Venture Capital – Law, Business, Strategies and Investment Planning' (John Wiley and Sons, New York 1988) 103.

<sup>72</sup> M.L.H. Breukers, 'Venture Capital and the Financial Crisis A Comparison of the Effects of the Financial Crisis on the Venture Capital Industry in the United States and Europe | Semantic Scholar'

countries, Hungary as well, EU support packages were needed to encourage private capital investments in the midst of the crisis.<sup>73</sup> Thin markets represent a more probable ground for manipulation, due to their infrequent trading and are, thus, less observed by analysts.<sup>74</sup> An unsuccessful IPO can have devastating effects not just due to loss of the possible liquidity but also due to possible reputation loss of the investee company, which can be seen as tainted in the future for future investors.<sup>75</sup>

A “*red herring*”, or a preliminary prospectus should be drafted for the benefit of the SEC and future investors for companies planning on going public in the US, and should be followed with the final prospectus.<sup>76</sup> The advantage of IPO-s is that they can be partial, where the float will only cover the disposal of some of the shares – this would allow the venture capitalist to continue take part as a shareholder in some parts and would allow the management to hold on to its shares while the venture capitalist exits. As the Hungarian Waberer’s and Graphisoft cases illustrate exemplarily, the Hungarian stock exchange does not need to be disregarded when choosing an exit route, since even the BSE can serve as a possible IPO for Hungarian companies.<sup>77</sup>

What is crucial from a legal point of view is to structure the shares offered during an IPO as attractively as possible, and this might not just mean to make the price of the shares low.

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<<https://www.semanticscholar.org/paper/Venture-capital-and-the-financial-crisis-A-of-the-Breukers/80de41aeeccfbadea22dbed1e2d941710e83717fb>> accessed 19 May 2020.

<sup>73</sup> Sándor Gardó, Martin Reiner, ‘The Impact of the Global Economic and Financial Crisis on Central, Eastern and South-Eastern Europe: A Stock-Taking Exercise’ <[http://ssrn.com/abstract\\_id=1626117](http://ssrn.com/abstract_id=1626117)> accessed 26 May 2020 67 39.

<sup>74</sup> William J. Carney, ‘*Corporate Finance: Principles and Practice*’, Foundation Press, New York, 2005 746.

<sup>75</sup> Josh Lerner, ‘A Note on the Initial Public Offering Process’ Harvard Business School Background Note 200-018, October 1999. (Revised July 2007) 3.

<sup>76</sup> For example something similar to the one accessible at the following link: ‘Final Prospectus’ <<https://www.sec.gov/Archives/edgar/data/1313275/000119312512066175/d200370d424b4.htm>> accessed 19 March 2020.

<sup>77</sup> ‘Waberer’s Launches IPO Today’ (*Budapest Business Journal*, 19 June 2017) <[https://bbj.hu/business/waberers-launches-ipo-today\\_134507](https://bbj.hu/business/waberers-launches-ipo-today_134507)> accessed 20 March 2020.

Convertible securities, such as bonds which yield a steady and secure income in the form of the principal and the interest, but can be converted to stocks with preferential treatment, could be enticing to the forward looking investors who currently need some steady revenue, such as the interest. This type of securities could have a reassuring effect even if investors in the CEE region (and, consequently, in Hungary) were generally not very trustful of capital markets. As a matter of fact, in the US, after the Credit Crunch, nearly 95% of VC investment were made with convertible preferred stock.<sup>78</sup> Convertible preferred stock will generally convert into common stock in case of a liquidity event, like an IPO.<sup>79</sup> An example of this could be the Hungarian success-story of Graphisoft, a Hungarian company with the form of association of a European Company Limited by Shares, who structured their shares so that owners of convertible bonds and owners of bonds with subscription rights will be able “to purchase shares equal to their pro rata interest in the share capital in case of a capital increase by cash contribution of the company” by, for example, a public offering.<sup>80</sup>

### 3.3.1 The Budapest Stock Exchange

The BSE has elaborated a 5-year strategy for SME-s by developing an SME market specifically for the needs of smaller issuers.<sup>81</sup> Another project of the BSE was to establish a fast track for medium size companies who want to gain finance from the BSE without necessarily going public, called the Xtend market.<sup>82</sup> This is basically a separate fund for Medium sized enterprises that

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<sup>78</sup> Theodore M. Hagelin, ‘*Technology Innovation Law And Practice – Cases and Materials*’ (Lexis-Nexis, 2011) 1260.

<sup>79</sup> Ibid.

<sup>80</sup> ‘Articles of Association, Graphisoft Park SE Real Estate Development, European Company Limited by Shares’ <[https://bet.hu/newkibdata/123437/23437\\_1\\_GSPARK\\_07122007Articles.pdf](https://bet.hu/newkibdata/123437/23437_1_GSPARK_07122007Articles.pdf)>accessed % April 2020, s 8.

<sup>81</sup> Márton Nagy, Richárd Végh, ‘SMEs at the Stock Exchange’ (*BET*) <<https://www.bse.hu/About-Us/Press-Room/Professional-Articles/SMEs-at-the-stock-exchange>> accessed 5 April 2020.

<sup>82</sup> ‘What Is BSE Xtend and What Benefits Does It Offer to Medium-Sized Companies?’ (*BET*) <<https://bse.hu/Issuers/services-for-medium-sized-companies/xtend/What-is-BSE-Xtend-and-what-benefits-does-it-offer-to-medium-sized-companies>> accessed 16 May 2020.

“provides capital to businesses that undertake being listed on the BSE Xtend market as well as preparing to issuing shares on the stock exchange. The typical investment size of the fund is HUF 1 billion, in exchange for a minority stake in the given company.”<sup>83</sup> It is a fund similarly conceived to a VC fund, but without the venture capitalist’s active involvement. It serves the medium sized enterprises that want an easy way to the market without a VC manager guiding them through the process. Nevertheless, this is not an avenue for most startups, and it is explicitly designed to not involve venture capitalists.

Another project of the BSE is the “Mentoring program” which is designed to provide, in this case small and medium size enterprises as well, but with focus on the medium enterprises, with a financing oriented training program that will aid the enterprises with the necessary knowledge they need to become a traded company.<sup>84</sup> The Mentoring program is meant to provide the other side of the VC activity, again with a focus on medium enterprises.

The two programs, together with the National Stock Exchange Development Fund<sup>85</sup> seek to revive the medium enterprises’ activity on the BSE. These are smart programs targeting medium enterprises that already have enough experience and business acumen to probably represent a steady investment for investors, but do not require the involvement of VC-s due exactly to their considerable experience on the field. Medium companies, according to the relevant legislation, are those which have less than 250 employees, up to 50 million Euro yearly net profits or up to 43 million Euro balance sheet total<sup>86</sup> (while the small enterprises have up to 50 employees and their

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<sup>83</sup> Ibid.

<sup>84</sup> ‘Mentoring Programme’ (*BET*) <<https://bse.hu/Issuers/services-for-medium-sized-companies/mentoring-programme>> accessed 16 May 2020.

<sup>85</sup> ‘National Stock Exchange Development Fund’ (*BET*, 2017 ) <<https://bse.hu/Issuers/services-for-medium-sized-companies/national-stock-exchange-development-fund>> accessed 3 June 2020.

<sup>86</sup> ‘2004. Évi XXXIV. Törvény a Kis- És Középvállalkozásokról, Fejlődésük Támogatásáról’ s 3(1).

net profits or balance sheet total is not more than 10 million Euros).<sup>87</sup> These enterprises have shown that they have some experience which makes them less likely to fail. While it is hopefully attainable that over time through the help of the venture capitalist the investee will develop into a medium company that can fulfill the requirements posed by the BSE's programs, it is clear that the BSE might provide preferences to medium companies directly, while smaller companies have to rely on other sources, for example venture capitalists. This is understandable from the point of view of the BSE who focuses on experienced and potentially successful future-public companies.

### 3.3.2 A lack of trust

As it was suggested above, in CEE there is a general lack of trust in the capital markets that affects Hungary, too. The main obstacles to the increased use of the capital markets by venture capitalists is not just represented necessarily by the difficulties private companies face due to red tape or administrative hassles when they plan to go public in CEE, but a lack of trust. CEE has been shown to have relatively thin and slow capital markets (even if admittedly the situation is better than the previous years) with investment professionals asking for a European common regulatory board to help development of the markets but also blaming the decline in investor trust in the local capital markets.<sup>88</sup> The majority of Hungarian investment professionals asked (76%) have explicitly picked "scarce supply of listed equity/debt securities" to be the obstacle the development of the capital markets face in their country.<sup>89</sup> This shows a deep lack of confidence in the capital markets among those who shape the capital markets, the investment professionals themselves.

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<sup>87</sup> Ibid. s 3(2).

<sup>88</sup> Roberto Silvestri, 'Unlocking the Potential of Capital Markets in Central and Eastern European Countries' (*CFA Institute Market Integrity Insights*, 29 January 2019) <<https://blogs.cfainstitute.org/marketintegrity/2019/01/29/unlocking-the-potential-of-capital-markets-in-central-and-eastern-european-countries/>> accessed 17 May 2020.

<sup>89</sup> Ibid.

In a way, the venture capitalist suffers due to the persistence of the thin capital markets. If the IPO is mainly just a theoretical exit route because most investees end up being sold for medium value or less than medium value, the capital markets will not be exploited. Having deep capital markets and active investor presence on the capital markets results in more advantageous financing opportunities for the investee companies, and higher possible profits for the venture capitalist.

## Chapter 4 – Sales and Acquisitions of the Investee Company

### 4.1 The Concept of Selling

Selling the shares of the company after the relevant time scheduled for an exit is also an option. In Europe it is often held to be the most utilized exit route,<sup>90</sup> and in Hungary it seems to be the one most taken advantage of.<sup>91</sup> As a comparison with another European country, in the UK the IPO has been shown to be most utilized by venture capitalists and not the sales route.<sup>92</sup>

According to the HVCA's report for the complete financial year of 2018 (the most current overall report for one complete financial year available) the most common form of divestment or exit was *management sale* followed by *trade sale*.<sup>93</sup> In quarter 2<sup>94</sup> and quarter 3<sup>95</sup> of 2019 the most popular exit strategy was also the redemption or *sale to management*. The exit routes do differ from year to year, in 2017 for example the sale to *another private equity firm* or sale to *trade buyers* was the favored exit route,<sup>96</sup> while in 2016 it was again the *trade sale*.<sup>97</sup> The following sections will explain what the trade sale and the management buy-back are.

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<sup>90</sup> Elisabete Gomes Santana Félix, Cesaltina Pacheco Pires, Mohamed Azzim Gulamhussen, 'The Exit Decision in the European Venture Capital Market' (CEFAGE-UE Working Paper 2008/01), <<https://core.ac.uk/download/pdf/7094641.pdf>> accessed 23 March 2020.

<sup>91</sup> 'Venture Capital and Private Equity Update Hungary - 2018' (HVCA) (n. 3).

<sup>92</sup> Susanne Espenlaub, Arif Khurshed, Abdulkadir Mohamed, 'The Exit Behavior of Venture Capital Firms' (*ResearchGate*) <[https://www.researchgate.net/publication/228435765\\_The\\_Exit\\_behavior\\_of\\_Venture\\_Capital\\_firms](https://www.researchgate.net/publication/228435765_The_Exit_behavior_of_Venture_Capital_firms)> accessed 20 March 2020.

<sup>93</sup> 'Venture Capital and Private Equity Update Hungary - 2018' (HVCA) (n. 3) 4.

<sup>94</sup> 'Venture Capital and Private Equity Update Hungary - Q2 2019' (HVCA) <[https://www.hvca.hu/documents/Investment\\_monitoring\\_report\\_Q2\\_2019\\_final.pdf](https://www.hvca.hu/documents/Investment_monitoring_report_Q2_2019_final.pdf)> accessed 5 April 2020.

<sup>95</sup> 'Venture Capital and Private Equity Update Hungary - Q3 2019' (HVCA) <[https://www.hvca.hu/documents/Investment\\_monitoring\\_report\\_Q3\\_2019\\_final\\_v2.pdf](https://www.hvca.hu/documents/Investment_monitoring_report_Q3_2019_final_v2.pdf)> accessed 5 April 2020.

<sup>96</sup> 'Venture Capital and Private Equity Overview Hungary - 2017' (HVCA) <[https://www.hvca.hu/documents/Investment-monitoring-report\\_2017\\_v7-1.pdf](https://www.hvca.hu/documents/Investment-monitoring-report_2017_v7-1.pdf)> accessed 5 April 2020.

<sup>97</sup> 'Venture Capital and Private Equity Overview Hungary - 2016' (HVCA) <[https://www.hvca.hu/documents/Investment-monitoring-report-FY16\\_0314.pdf](https://www.hvca.hu/documents/Investment-monitoring-report-FY16_0314.pdf)> accessed 5 April 2020.

The sale should be negotiated with caution. In Delaware, it has been established that the trade sale (explained below) of a VC backed company, can be considered fair even if the common stockholders do not receive anything for their stocks during the sale – in *In Re Trados* the common stock had no value before the sale, thus the stockholder could not argue that the sale should have realized earnings for the common stockholders.<sup>98</sup> If the *entire fairness principle* is satisfied (regarding the procedures taken and the price of the sale), the directors have not breached their duty of loyalty. Similar unfavorable situations can be avoided by shareholders if drag-along provisions are included in the contracts.<sup>99</sup>

## 4.2 The Trade Sale

The trade sale involves the sale of the investee company to another company, or a business-to-business sale, where, most likely, the management of the company will also be required to get rid of their shares and their control in the investee company. It should be mentioned though that the “acqui-hire” route exists, especially for IT/tech companies, when a company buys another, usually a tech startup, but keeps the staff for their expertise.<sup>100</sup> While it is possible to focus on the sale of an insolvent business, I will not discuss this in detail since the aim of the investee company and the venture capitalist is usually not to get to the point of insolvency but to make the most of the

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<sup>98</sup> *In re Trados Incorporated Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013).

<sup>99</sup> ‘In Re Trados: Delaware Court of Chancery Reviews Venture Capital Exit Under Entire Fairness, Faults Board on Process | Practical Law’ (Westlaw, 22 August 2013) <[https://www.westlaw.com/2-538-8085?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=cblt1.0](https://www.westlaw.com/2-538-8085?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0)> accessed 31 May 2020.

<sup>100</sup> ‘What Is a Trade Sale? Trade Sale Definition’ (*SyndicateRoom*) <<https://www.syndicatoroom.com/learn/glossary/trade-sale>> accessed 20 March 2020.



company and then sell it as a going concern – instead of liquidation or sale in insolvency, where the value of the company is much lower than optimal.<sup>101</sup>

It has been shown that the most generally used acquisition structure for private equity-backed startups in Hungary is the acquisition of all (100% of the company) or the majority of shares of the investee company.<sup>102</sup> Since the acquirer is oftentimes an already successful and established company, competition and merger compliance needs to be taken into account when structuring an acquisition of a start-up. The relevant Hungarian statute regarding acquisitions and overall transformation of companies<sup>103</sup> should be observed in addition to the provisions of the Hungarian Civil Code,<sup>104</sup> and the competition act.<sup>105</sup> The latter statute imposes the obligation for the merging companies to inform the Competition Authority about the merger if one of the companies' net revenues exceed 15 billion HUF, and the relevant companies include at least two companies whose net revenues for the preceding year exceeded at least 1 billion HUF.<sup>106</sup>

During the structuring of the shareholders' agreement with the trade sale as an exit route in mind the tag-along or drag-along exit rights relevant for the VC agreement should be observed and included. Venture capitalists will usually be minority shareholders (since they do not want to have

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<sup>101</sup> Julia Palmer, 'What Is a Trade Sale of a Business?' (*Real Business Rescue*, updated 24 January 2020) <<https://www.realbusinessrescue.co.uk/articles/directors-advice/what-is-a-trade-sale-of-a-business>> accessed 20 March 2020.

<sup>102</sup> Márton Kovács, Gábor Puskás 'Hungary: Private Equity 2019' (*ICGL.com*) <<https://icgl.com/practice-areas/private-equity-laws-and-regulations/hungary>> accessed April 5 2020 s 2.1.

<sup>103</sup> '2013. Évi CLXXVI. Törvény Egyes Jogi Személyek Átalakulásáról, Egyesüléséről, Szétválásáról - Hatályos Jogszabályok Gyűjteménye' <<https://net.jogtar.hu/jogszabaly?docid=a1300176.tv>> accessed 21 March 2020.

<sup>104</sup> 'Ptk. (Új) - 2013. Évi V. Törvény a Polgári Törvénykönyvről - Hatályos Jogszabályok Gyűjteménye' <<https://net.jogtar.hu/jogszabaly?docid=a1300005.tv>> accessed 22 March 2020.

<sup>105</sup> '1996. Évi LVII. Törvény a Tisztességtelen Piaci Magatartás És a Versenykorlátozás Tilalmáról - Hatályos Jogszabályok Gyűjteménye' <<https://net.jogtar.hu/jogszabaly?docid=99600057.tv>> accessed 22 March 2020.

<sup>106</sup> *Ibid.* 4(1).

control in the investee), so with the given position in mind, drag-along and tag-along clauses should be agreed upon to protect the VC fund from possible friction with other shareholders.

### 4.3 The Management Buy-back

In recent years Hungarian VC-backed investments in investee companies have exited mainly via management buy-back or redemption by the management.<sup>107</sup> This option was first introduced to the Hungarian legal system in 2004 by the Amendment of the Companies Act and can be exercised via a unilateral declaration by the party whose option is provided for in the agreement.<sup>108</sup> In this scenario the call or put provision included in the term sheet is especially important since it provides opportunity for the venture capitalist to sell its stock back to the company, representing the easiest way for redemption. Without provisions allowing an easy buy-back the venture capitalist and the management have to agree on the terms of the buy-back at the moment the issue arises, meaning that the power dynamic and control will be heavily affected by the given actual performance of the company – leading to possibly lengthy and conflict ridden negotiations about the terms of the buyback. This can be avoided if the buy-back provision is added from the beginning to the contract.

This, as it was observed, also represents a partial exit, since not all shares are sold in the same transaction but only the ones held by the venture capitalist.<sup>109</sup> In addition to providing an easy possibility for the venture capitalist to divest, the management can also benefit due to the exit of the venture capitalist from the control of the investee company, but still maintaining the initial

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<sup>107</sup> ‘Venture Capital and Private Equity Update Hungary – Q3 2019’ (HVCA) [https://www.hvca.hu/documents/Investment\\_monitoring\\_report\\_Q3\\_2019\\_final\\_v2.pdf](https://www.hvca.hu/documents/Investment_monitoring_report_Q3_2019_final_v2.pdf) accessed 5 April 2020.

<sup>108</sup> Görgényi Orsolya, ‘Hungary’ in Bob Woode, Brechbül Beat A (eds), *Global Venture Capital Transactions, a practical approach*, (AIJA Law Library, Kluwer Law International, 2004) 235.

<sup>109</sup> Armin Schwienbacher, ‘Venture Capital Exits’ in Douglas J Cumming, *Venture Capital: Investment, Strategies, Structures, and Policies* (John Wiley & Sons, Inc 2012) <<http://doi.wiley.com/10.1002/9781118266908.ch18>> accessed 22 March 2020 10.

management know-how the venture capitalist provided for the investee company during the investment.

This represents a share repurchase, in other words a form of distribution of the companies' earnings or values generated during a given period. The buyback is an equivalent distribution as dividends, the main difference regarding the two forms of distribution being that dividends will usually be distributed pro rata, in accordance with the number of shares owned by the shareholder, while a buyback, or repurchase does not have to observe such restrictions.<sup>110</sup> With this method the investee company, the management, buys the shares of the venture capitalist, which have ideally and according to the venture capitalist's plans increased during the investment period. The shares of the venture capitalist will generally be cancelled and the value of the shares of the remaining shareholders will increase, leaving the investee company in the control of the remaining shareholders, in case of a management buyback.

#### 4.3.1 Drawbacks

Buy-backs are an easy way for the venture capitalist to make sure that the shares it owns are sold – albeit, the sale takes place to the company in which he invested. This also suggests a lack of confidence in alternative methods of exit, for example an IPO, and a preference for a surely structured insurance sale to the company.

The possible problems regarding a company buyback primarily affect the investee company, and the venture capitalists only in a secondary way. It might be that during the years of cooperation between the venture capitalist and the investee company the investee company's management or shareholders other than the venture capitalist do manage to become successful and to cumulate

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<sup>110</sup> William J. Carney, '*Corporate Finance: Principles and Practice*', Foundation Press, New York, 2005 742.

enough money to buy back the shares from the venture capitalist, but if this is not the case, the investee might have to resort to borrowing from a bank by leveraging the company's own assets, or by inviting the cooperation of another venture capitalist to take the place of the initial VC fund. And if the Shareholders' Agreement is structured for a management buyback, the company might have a contractual obligation to pay the venture capitalist, regardless if the company was successful or not (depending on the terms of the agreements). The company would have to exchange its own assets for the shares which would not represent actual financing value or economic advantage for the company, but could affect the company's any kind of possible market presence and lead to speculative valuation of the securities of the company.<sup>111</sup> While the "insured" venture capitalist in haste manages to recover some of its investment, the company will often be put in a difficult position. This step endangers the interests of the Limited Partners, and maybe even the investee, since an IPO, generally, has the potential to lead to a higher share-price than the buyback and does not require additional burdens from the investee.

Buy-back provisions should be conditioned upon other types of exit methods being unsuccessful by some point after the investment has been made. For example, if after 6 years (the minimum duration of the VC fund) the investee company does not have an IPO or a trade sale, the buy-back provision will be triggered and will give the venture capitalist a clean exit. The provision should also contain provisions regarding the calculation of the price of the buy-back and provisions for possible interest on the price.

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<sup>111</sup> Fuglinszky Ádám, 'A saját részvények megszerzésének szabályozása a tőkevédelmi irányelvben és a német jogban (PJK, 2002/2., 30-35. o.)' (*Új Ptk. – az új Polgári Törvénykönyv és Kommentár*, 11 November 2012) <<https://ptk2013.hu/polgari-jogi-kodifikacio/fuglinszky-adam-a-sajat-reszvenyek-megszerzesenek-szabalyozasa-a-tokevedelmi-iranyelvben-es-a-nemet-jogban-pjk-20022-30-35-o/576>> accessed 16 May 2020.

## **Recommendations, Conclusions and a Few Words about Trust**

The paper showed that the Hungarian VC preference for sales, exemplified by past practices is less advantageous than IPO exits. I also argued, that considering these findings, venture capitalists should structure more IPO exits and should put more efforts into the implementation of changes in the capital markets regulation that would support an increased number of IPO exits and less sales. I have demonstrated that IPO-s have the advantage of keeping management structures and control intact. IPO-s allow for the venture capitalist to leave all voting power to the management while exiting the investment. IPO-s have the benefit of allowing investors to enjoy the company's progress in the company and to aid in the economic progress of the country. Capital markets activity and going public can provide investment opportunities not just for the venture capitalist and the investee company but also for the investors.

The issue of exits boils down to trust from all participants on the market, starting with venture capitalists. An (understandable) lack of trust is exhibited by the BSE when providing special programs for medium enterprises but not for small companies. This is reasonable, since smaller companies are riskier due to their lack of experience. Nevertheless, some targeted programs could allow for a better "education" of these smaller companies.

A lack of trust is exhibited by the investment professionals, for example the venture capitalists, who have expressed a need for a common European regulatory framework to protect the market actors and are untrusting of the capital markets in lack of the European structure. The lack of trust in the market and the possibilities it can provide explains how and why venture capitalists agree on management buybacks in advance, instead of proposing a possibly more rewarding issuing route on the capital markets. Nevertheless, it should be emphasized, that it appears to be in their best interest to have vivid market activity by structuring more IPO exits.

And it is a lack of trust in the company and the capital markets which might drive the venture capitalists to predominantly structure the exits to prefer the management buyback against going public. This places the responsibility on the shoulders of the company and shows a low level of trust from the venture capitalist in the investee and its financing prospects. It is in the best interest of the investors, and the venture capitalists, to gain as much on the exit as possible and IPO-s could provide a more profitable avenue.

This lack of trust is not present in the US, where the capital markets have been supported by the legislation and, especially, the Securities and Exchange Commission to build a steady confidence. The trust in the US capital markets is generally strong, but it can be deconstructed by abuses or errors (such as the 2008 Credit Crunch or the 1930's Great Depression), while in Hungary the trust seems to be generally weak – regardless of prominent abuses or errors.

My *recommendation* would be to learn from the US primarily to build a trustworthy capital market, where companies can achieve financing, and this task mainly falls on the governmental authorities' shoulders but should be demanded by the VC community. If "scarce supply of listed equity/debt securities"<sup>112</sup> is one of the issues, a deep market will be hard to build without the implication of the market actors themselves, who will have to increasingly make use of the capital markets. Hungarian venture capitalists should follow the US example and try to structure more IPO exits to increase revenue and to activate the markets, and use the management buy-backs only as an alternative to fall back on, if the IPO and, secondly, the trade sale do not occur within due time.

It would be beneficial for the venture capitalist, the investee and the Hungarian economy if the VC investment stage would not just be a nominal part of the capital markets legislation but would

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<sup>112</sup> Roberto Silvestri, 'Unlocking the Potential of Capital Markets in Central and Eastern European Countries' (n. 88).

increasingly lead to the activation of the capital markets. Venture capitalists are in a specifically advantageous position to demand the structuring of a more trustworthy market: VC investments are proven to be beneficial for startups and the economy in general; venture capitalists should take advantage of their central position for economic growth in the society to help build a more trustworthy market, which can be exploited in the future. However, the current time might not be ideal. The economic uncertainty generated by the pandemic might be the suitable time for campaigning for a regulatory change and a mentality shift by cooperation between the members of the VC community.

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