

# Drag Along Right in Hungarian Venture Capital Contracts

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## Introduction

The topic of this paper is the drag along right in Hungarian venture capital contracts. In this paper, I aim to answer whether it is possible to apply valid drag along clauses with their original purpose in venture capital contracts under Hungarian law.

This study seems to be timely, since there are more and more venture capital deals under Hungarian law, and at same time, many new legal vehicles have come from the United States, which we are expected to use in domestic venture capital contracts, and it is not clear if they are able to produce the desired legal effect in Hungary. One of these new legal vehicles is the drag along right.

What is the drag along right; what is its definition, how does it work and, in particular, how can we use it in Hungarian contracts? There is no doubt that the drag along right works under the US or UK common law excellently, but it is not clear whether we can use it in Hungary in the same way. By the end of this study, I will give my answer to all these questions.

First of all, I examine the definition of the drag along right, using the United States, German and Hungarian venture capital institutes' statements regarding the term. It is necessary to study the regulation and daily practice of other legal systems' drag along right, as it is a quite new legal vehicle in the Hungarian contractual practice; there are no specific legal regulations and no court decision is known in connection with the drag along right.

Later, I introduce nine different contractual terms and conditions in connection with the drag along right. In each examined legal system, i.e. the legal system of the United States, Germany and Hungary, I studied three venture capital deals concluded in the last two years, so we can get a relatively complete picture of the terms and conditions applied in this context.

Finally, I analyse in detail how the drag along right can work under Hungarian law. I introduce the different approaches taken by different legal experts in the examined contracts or stated in the daily practice. I then reveal my own opinion of how we should explain the drag along right according to Hungarian law, but I also give room for the reader to choose from the possible legal solutions.

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## I Definition of the Drag Along Right

The drag along right serves the purpose in the venture capital transactions, the holder of the drag along right has the right to force all of the other investors and founders to do a sale of the company without the consent of the other shareholders of the company.<sup>1</sup> The drag along right secures that, in the event of a favourable bid for the shares of the company made by a third person but the minority of the shareholders being opposed to the bid and do not wishing to sell their shares, then the holder of the drag along right can force all other shareholders in the company to sell their shares to an (outside) buyer at the same price at which the right holder(s) sells their shares (a so-called hold-up problem).<sup>2</sup> As the buyer usually would like to buy the whole company, whereas the minority shareholders, who have shares in the company of only a couple of percent each, can prevent the transaction, the drag along right can ensure that the majority of the shareholders can sell their shares if the buyer would like to buy the whole company or more shares than the right-holder has. In reality, in venture capital deals, the drag along right belongs to the investor, and the investor usually has only a minority share in the company. As such, in venture capital deals, the drag along right transforms shareholders' majority rights into a minority right, in favour of the principle of venture capital deals, namely that the investor exits first from the company. From another aspect, the drag along right is an obligation for the founders and the other parties as shareholders, regarding venture capital transactions; if the investor gets a bid for the shares of the company that exceeds investor's shareholding in the company, the founders and other shareholders are obliged to sell their shares in it according to the terms and conditions stated by the investor.<sup>3</sup> To balance the rights and obligations of the parties, the drag along right always works *pari passu*, i.e. the investor cannot sell the shares of the obligors of the drag along right under worse conditions than those under which the investor will sell his own shares.

Although I examined the legal systems of the United States, Germany and Hungary, I have not found any *expressis verbis* law that defines the drag along right. Moreover, I also did not find any legal vehicle that properly describes the mechanism I characterised above. I therefore studied the standpoints of the most significant national venture capital institutes in the examined legal systems.

The drag along right has been defined in the term sheet template of the American National Venture Capital Association (NVCA) as follows.

Holders of Preferred Stock and the Founders [and all future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of

<sup>1</sup> Dick Costolo, Brad Feld, Jason Mendelson, *Venture Deals, Be Smarter Than Your Lawyer and Venture Capitalist* (2nd edn, John Wiley&Sons Inc. 2012, NY, USA) 68–69.

<sup>2</sup> Carsten Bienz, Uwe Walz, 'Venture Capital Exit Rights, 2008' CFS Working Paper No. 2009/05, 1–2.

<sup>3</sup> Robert B. Little & Joseph A. Orien, Gibson, Issues and Best Practices in Drafting Drag-Along Provisions, 2016. <<https://corpgov.law.harvard.edu/2016/12/14/issues-and-best-practices-in-drafting-drag-along-provisions/>> accessed 1 August 2019.

options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] [and the holders of \_\_\_\_% of the outstanding shares of Preferred Stock, on an as-converted basis (the “Electing Holders”)], so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder’s pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company’s stockholders in a liquidation under the Company’s then-current Certificate of Incorporation.<sup>4</sup>

On the website of the German Private Equity and Venture Capital Association (GVCA), I did not find a definition of the drag along right.<sup>5</sup> In the German legal literature, Ernst and Häcker analysed management rights and obligations in venture capital deals, and described the drag along right as the obligation of the management when the investor would like to sell the whole company:

In the event that the Investor intends to sell shares in the Company in an Exit Transaction (“Transaction”), the investor shall have the right to require the Manager to sell and transfer all Manager Shares or, at the Investor’s discretion, the Pro-Rata-Share Portion either to the purchaser in the Transaction (the “Purchaser”) or to the Investor or any other entity as determined by the Investor. (...) The sale of Manager Shares under the Drag-Along Right will be substantially under the same terms and conditions (in particular, but not limited to pro rata the purchase price, the representations and warranties, arrangements on payments and adjustments of the purchase price, payments into escrow) applicable to the sale of Investor Shares sold in the Transaction.<sup>6</sup>

According to Orrick’s Guide, in the German practice, we also can describe the drag along right as follows.

A drag-along (also called bring-along) is a contractual arrangement that gives one or more shareholders, who hold either alone or together a certain percentage of the entire share capital of the company (usually more than 50%) and who wish(es) to sell her (their) shares or a portion thereof to a third party, the right to request all other shareholders to sell a pro-rata portion of their shares to such third party. Sometimes, especially in early rounds, drag-along rights can only be enforced with the consent of an investor majority. The drag-along is appealing to acquirers as it allows a 100% exit, leaving behind no minority shareholders. Buyers will often want to acquire 100% in a company in order to gain more flexibility and freedom to run the company as they see fit without having to pay attention to minority shareholders with certain unalienable minority protection rights.<sup>7</sup>

<sup>4</sup> Model term sheet 14–15. NVCA, August 2019. <<https://nvca.org/resources/model-legal-documents/>> accessed 1 August 2019.

<sup>5</sup> See <<https://www.bvkap.de/>> accessed 1 August 2019.

<sup>6</sup> Dietmar Ernst, Joachim Häcker, *Applied International Corporate Finance* (2nd edn, Verlag Franz Vahlen 2011, München) 98.

<sup>7</sup> Orrick, Herrington & Sutcliffe LLP (Markus Piontek, Vanessa Sousa Höhl, Johannes Rüberg, John Harrison Barbara Hasse, Lars Wöhning, Justine Koston), *Orrick’s Guide to Venture Capital Deals in Germany* (Orrick, Herrington

Compared to the definitions above, the Hungarian Private Equity and Venture Capital Association (HVCA) uses a very simple definition:

If the venture capitalist sells his shareholding, he can require other shareholders to sell their shares to the same purchaser.<sup>8</sup>

As we see from the above-mentioned descriptions, drag along does not have a universal definition and almost every quotation emphasised different elements of the drag along right. At the same time, we can highlight some constant attributes of the drag along right's definition, as follows

- a) the drag along right is a right of the investors, and at the same time,
- b) the drag along right is an obligation on the founders and other shareholders,
- c) upon the drag along right, the dragging investor can force the dragged shareholders to sell that their shares in the company shall be sold to one or more third person(s) (buyer), because
- d) the buyer wants to buy more shares than the investor has, and
- e) the dragged shareholders' share shall be sold on the basis of *pari passu* and pro-rata compared to the investor's shares.

## II Contractual Practice

I examined three law firms' daily practice from the US, Germany and Hungary. During my research, I studied more than one hundred venture capital contracts, but finally, I chose nine contracts, three from each examined legal system, and analysed them in detail. I found that each examined venture capital contract has a drag along clause. Although the drag along clauses in the examined contracts were similar in their main points, there were however many important differences in the detailed rules. Therefore, in the following, I will present the main elements of the drag along right separately and highlight the different provisions of the contracts.

### 1 Main Elements in Each Examined Contract

In each examined contract, the main elements listed in the previous chapter were very similar. The definition I gave in the previous chapter therefore corresponds not only to the legal literature but to the daily practice, too. I posit that this definition can be acceptable as the general definition of the drag along right.

I must note that, in each examined Hungarian contract, the company in which the investor performed the investment, was established as a Hungarian limited liability company

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& Sutcliffe LLP 2018) 71. <<https://s3.amazonaws.com/cdn.orrick.com/files/Insights/Germany-VC-FINAL-web.pdf>> accessed 1 August 2019.

<sup>8</sup> See <<https://www.hvca.hu/EN/glossary/drag-along-rights/>> accessed 1 August 2019.

(*korlátolt felelősségű társaság*, hereinafter *Kft.*). For this reason, I will introduce only the law regarding Kfts and analyse the drag along right in the venture capital deals where the company is a Kft.

Now, let us see the different terms and conditions of the drag along right clauses.

## 2 Holders of the Drag Along Right

In the examined contracts, the parties of the contracts were the selling investors and the other shareholders. The selling investors had the drag along right ('dragging investors', or 'obligee of the drag along right') and the other shareholders were the obligors of the drag along right ('dragged shareholders' or 'obligor of the drag along right').

In each examined US contract, the investors had a significant majority in the company, so the drag along right was the right of the majority. In the German and Hungarian contracts, the dragging investors had only a minority share in the company, so the drag along right was the right of the minority.

## 3 Time Conditions

I did not find time conditions in the US contracts.

In the examined German contracts, the dragging investors could not use their drag along right within a certain period after the investment contract was signed. This period varied between 1 and 3 years.

Among the Hungarian contracts, I found only one contract in which the dragging investors could use their drag along right immediately after signing of the investment contract. In this contract, the investors' drag along right would be open if the purchase price in the bid was not less than a certain minimum price, which was defined in the investment contract, and it was also the investors' minimum expected return. The investors do not have a drag along right if the purchase price is less than the predetermined amount.

In other two Hungarian contracts, a three-stage timing system was established as follows:

- In the first period it was not allowed to exercise the drag along right. This period was 1 year in one contract and 2 years in the other contract.
- In the second period, the investors can exercise their drag along right, but they cannot sell the drag along obligors' business shares under a certain purchase price.
- In the last period, which started from the end of the 5<sup>th</sup> year after the signing of the investment contract, the investors can exercise their drag along right without any other restriction but with respect to *pari passu* and pro rata rules.

## 4 Trigger Events<sup>9</sup>

The events that trigger the investors' drag along right are called trigger events. It is a key question what conditions should be present to allow for the investors to have the right to exercise their drag along right. Drag along exists so that if an investor receives a bid for his or her shares then he or she will be able to sell them, even if he or she does not have enough shares to satisfy the bid. Usually, the buyer wants to buy the whole company (one hundred percent of the shares) or the majority of the shares (fifty percent of the shares and one more vote) and it is very rare that the investor has exactly enough shares to satisfy the bid, so in this case, the investor uses his drag along right and enforces that enough shares will be sold from the dragged shareholders' shares for the required transaction to take place. Moreover, there are other events that can trigger the drag along right not only the selling transactions. Moreover, the selling transactions can also be different. Trigger events were defined in different ways in the examined contracts. The different solutions of the contracts are presented as follows.

### I. Trigger events in the US contracts

- a transaction or series of related transactions in which a person, or a group of related persons, acquires from stockholders of the company shares representing more than fifty percent (50%) of the outstanding voting power of the company (a 'Stock Sale'); or

– a transaction that qualifies as a 'Deemed Liquidation Event'. In the contract, the Deemed Liquidation Event means the following:

- I) a merger or consolidation of the company or the subsidiary of the company, or
- II) the sale, lease, transfer, exclusive license or other disposition, in a single transaction or series of related transactions, by the company or any subsidiary of the company of all or substantially all the assets of the company and its subsidiaries taken as a whole, or (2) the sale or disposition (whether by merger, consolidation or otherwise, and whether in a single transaction or a series of related transactions) of one or more subsidiaries of the company if substantially all of the assets of the company and its subsidiaries taken as a whole are held by such subsidiary or subsidiaries, except where such sale, lease, transfer, exclusive license or other disposition is to a wholly owned subsidiary of the company.

### II. Trigger events in the German contracts

- any transaction in which any person or a group of persons acquires more than 50% of the outstanding shares of the company, or
- more than 50% of the moveable and immoveable property of the company is sold, regarding their real market value, and all and any transactions have to be counted together, regardless of whether the transaction is a stock, asset deal, merger or acquisition or it is fulfilled upon any other legal title.

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<sup>9</sup> In connection with the trigger events, see Lorenzo Sasso, *Capital Structure and Corporate Governance: The Role of Hybrid Financial Instruments*. A thesis submitted to the Department of Law of the London School of Economics and Political Science for the degree of Doctor of Philosophy (Harvard Law School Library print version 2012) 189–192.

### III. Trigger events in the Hungarian contracts

In two Hungarian contracts there was no special trigger event. As soon as the investor receives a bid that he cannot satisfy with his own business shares, he can force the other members of the company to sell, in whole or in part, their business shares.

In the third Hungarian contract

- a)* the drag along right was not exercised in the first 2 years after the investment,
- b)* between the end of the 2<sup>nd</sup> year after the investment and before the end of the 5<sup>th</sup> year after the investment, the investor could exercise its drag-along right if the company's net sales or EBITDA ('earnings before interest and taxes') for a given financial year are at least 50% below the net sales or EBITDA projected in the current or the subsequent year's business plan,
- c)* after the end of the 5<sup>th</sup> year after the investment, the investor could exercise his drag along right without any conditions.

The financial conditions in point *b)* are usually considered as bad news and we can conclude that, based on these financial data, the company is in a downside period. In these cases, it is unlikely that the investor will want to keep its shares since these companies usually do not provide a good return; moreover, it is more likely that it will end in a bankruptcy procedure. So, in these cases, the investor would prefer to get rid of the company at any price and not be involved in the forthcoming and very expensive liquidation process of the company. I assume that this drag along right term could be used as an escape opportunity for the investor in case of a financial difficulty of the company.

## 5 Minimum Purchase Price

I did not find a minimum purchase price either in the American or German contracts, however, in two of the Hungarian contracts there were purchase price conditions. In both contracts, the limitation only applied until the end of the first 5 years following the investment; thereafter the condition ceased, and the investor could exercise its drag-along right.

The minimum purchase price protects the founders against the investor's unrestricted drag-along right. Upon the terms and conditions of the minimum purchase price, the parties agree on a purchase price stated in the investment contract under which it is not possible to sell the company without the consent of each party. Since the drag along right is a selling transaction, the minimum purchase price must therefore be an objective obstacle to the exercise of the drag along right. I must note that, it is very difficult to find a correct future purchase price during the investment negotiation, because usually there is no reliable data regarding the future market value of the company and whilst the founders are interested in the highest purchase price possible, as the investor may not find a buyer at a higher purchase price, the investor is interested in the possibly lowest purchase price in order to exercise its drag along right as easily as it is possible.

## 6 Mandates, Power of Attorney

I have found explicit mandates and powers in each US contract and two Hungarian contracts.

These mandates and powers are for the case where the dragged shareholders fail to fulfil their obligations related to the drag along right; then someone else can act for and on their behalf to perform their obligations under the investment contracts.

In the US contracts, the mandates and powers were established for the investors' attorneys, who could act on behalf of the dragging shareholders in the event of exercising the drag along right. In the Hungarian contracts, the mandates and powers were directly delegated to the investors, who could act upon the drag along terms and conditions of the investment agreements.

## 7 Other Rights, Obligations and Warranties

In the US contracts, not only the purchase offer had to be complete and eligible, but those entitled to do so had to vote to perform the transaction. On the one hand, this meant the company's board, on the other hand, this meant the company's general meeting. In the board; the investors' delegated member of the board had a veto right, upon which the investors' delegate could block the board members' decision to restrict the drag along transaction. In the general meeting, the investors had the necessary majority to vote through the drag along right, even if the other shareholders wanted to reject the transaction.

Each contract contained detailed procedural and implementing rules with special regard to making legal statements, carrying out the necessary voting and signing other documents (e.g. outstanding process of shares in US law or the company registration process in Hungarian law).

Finally, the US contracts contained a very detailed list of applicable warranties and statements, which was so that each shareholder was only required to take responsibility for his own shares; however, those shares had to be free and clear of all liens, claims and encumbrances and be capable of fulfilling the drag along obligations at the time of the transfer.

## III Drag Along Right under the Hungarian Law

In the chapters above, I have introduced the contractual practice and legal theory of the drag along right under the US, German and Hungarian law. No doubt, there are more and more venture capital contracts under the Hungarian law in which the parties agree on the drag along clause. In this chapter, I summarise the legal characteristics of the drag along right and analyse the different legal aspects of the examined legal vehicle. Throughout the analysis, I am looking for the answer to whether drag along right is a valid clause under the Hungarian law.

In my view, the drag along right is a legal vehicle for the protection of the investors, based on the contractual agreement of the parties, which restricts the property right and render it



possible to transfer the ownership. It is worth going through all the elements of this statement so that I can outline the legal problem.

The drag along right is a legal institution for the protection of the investors, since it protects the investor's interest in a way that if the investor would like to sell all the business shares in the company, it cannot be prevented or restricted by the other owners or founders. This is so, even if the investor does not want to sell all the business shares of the company, but wishes to transfer more than the amount of its own business shares (typically 50% + 1 vote) and also if the investor has a majority itself but the minority shareholders' business shares are forced to be transferred.

The drag along right is a contract-based legal institution, which is important from the aspect that it is not a corporate legal vehicle, so a 'cogens or dispositive' dispute cannot arise; the drag along clause is based on the contractual freedom of the parties. However, we cannot omit the consideration that the drag along right necessarily has consequences related to corporate law. It is beyond dispute that, in the event of exercising the drag along right, the contract has to allow for transferring the 'ownership'<sup>10</sup> of the business shares.

It is still debated whether drag along restricts ownership of the business shares. I have to make a very strong point in this question: is it better to restrict someone's ownership than to sell the thing at any time, regardless of the owner's contractual intention? This is such a limitation that there is no longer anything remaining to limit anymore.

It seems to be a similarly evident statement that drag along is a legal vehicle that makes the transfer the ownership. In terms of the economic substance of the transaction, we can hardly draw any other conclusion: the holder of the drag along right is entitled to sell the business shares of other members to a subsequent buyer. However, this statement cannot be easily overlooked in a legal study, so it is worth examining now from a legal point of view whether the drag along right can transfer the ownership of a business share, or the drag along right is able to trigger the legal effect, under which the shareholders will be obliged to sell their business shares to third persons.

The Hungarian law requires a valid legal title to transfer the ownership of any things, so if we stated that the drag along right can transfer the ownership at all, by itself, then we should find a valid legal title in the drag along contract.<sup>11</sup> The invalidity of the title excludes the transfer of ownership under the Hungarian law.<sup>12</sup>

Let us look at the possible legal titles of the Hungarian law that are capable of producing the economic effects we discussed in detail above.

<sup>10</sup> Let me overlook the question that is it even possible to have ownership of a share (*üzletrész*) of the Hungarian limited liability company.

<sup>11</sup> Kisfaludi András, 'Transfer of Property, Claims, Rights and Contracts in the New Hungarian Code Civil' (2014) (2) ELTE Law Journal 109–122, 111.

<sup>12</sup> Menyhárd Attila, 'A dologi jog szabályozásának sarokpontjai' in Vékás Lajos, Vörös Imre, *Tanulmányok az új Polgári Törvénykönyvhöz* (Complex 2014, Budapest 145–167) 161; and Vékás Lajos (ed), *Szakértői javaslat az új Polgári Törvénykönyv tervezetéhez* (Complex 2008, Budapest) 622–625.

## 1 Sale and Purchase Contract

The first and very logical answer, given by the members of the conservative drag along school, is the sale and purchase contract<sup>13</sup>, since the dragging investor would like to sell the shares of the other shareholders to a third person. This third person should be the purchaser; the dragged shareholders could be the seller party and the share could be the subject of the contract.

However, we have a significant legal problem because we do not know the purchaser party at the time of signing the drag along contract. The purchaser party will be known later when the dragging investor named it. So, we have to put the question: will it be a valid sale and purchase contract with the parties' agreement if the purchaser person is not known at the time of signing the sale and purchase contract?

In my view, we have to refer the *ingatlan-átruházási szerződés érvényességéről szóló XXV. számú Polgári Elvi Döntés* (Civil Principle Decision by the Supreme Court of Hungary, No. XXV., on the validity of the contract for the transfer of real estate, hereinafter referred to as PED). We are interested in point number I. of the PED, and its statement of reasons, as follows:

For the purposes of the existence of a valid real property sale and purchase agreement, it is necessary and sufficient that the deed, made from the contract of the intent of the parties, contains the parties' persons, their will to transfer the ownership of the real property, and also the deed has data about the real property and consideration, or if the transfer is free then it is stated from the content of the deed. (...)

It follows from these statutory provisions that it is essential for the validity of a sale and purchase contract for a real property that the written contract contains (a) the parties, (b) the subject matter of the purchase, (c) the purchase price, and (d) the statement that the contract is a sale and purchase contract.

Neither the law nor the implication thereof requires the contracting parties to be designated in the text of the contract. It is sufficient, therefore, that the identity of the contracting parties and the quality of their seller or purchaser (contractual status) can be clearly established from the signatures or other contents of the deed.

First of all, I have to explain why the analogy is not too remote, e.g. why I refer to PED in connection with the transfer of the real property, although a business share of a Kft is not a real property, but it is also not a thing, since it means the whole of rights and obligations arising in connection with the core deposit.<sup>14</sup>

First, it must be sufficient explanation as an *contrario* argument that it would be a very brave statement that the referred part of the PED is not valid in the case of sale and purchase contracts that have subjects other than real property. Perhaps we can accept, as a sort of axiom, that a sale and purchase contract is not validly able to be concluded for a movable thing unless it specifies the subject of the purchase, the person of the parties and the purchase price.

<sup>13</sup> In this study, it is not examined what the legally correct title is to transfer a Hungarian Kft's business share, although we note that it is allowed to transfer rights and obligations, such as a business share is, under Hungarian law.

<sup>14</sup> Ptk. 3:164. § (1).

The corporate aspects of our examination pose a more difficult question.

Nowadays, it is widely accepted that the business share of a Kft is not a thing; as a result, the rules regulating sale and purchase contracts do not apply to it.<sup>15</sup> If the business share is not a thing, then why would the referred PED be relevant in our case?

The Hungarian Code Civil (Ptk.) uses the expression ‘transfer of business share for consideration in money’ in two sections when providing for the transfer of business share for consideration.<sup>16</sup>

No more details of the regulation are revealed by the lawmaker about this legal instrument leaving hereby those applying the law alone and forcing them to draw conclusions.

The law provides assistance by associating the ‘transfer of business share for consideration in money’ with ‘acquisition of business share in priority’ to which *analogia legis* the underlying provisions of the pre-emption right shall be applied.<sup>17</sup>

As the pre-emption right is a legal instrument closely connected with sale and purchase contracts,<sup>18</sup> those applying the law may be right when they conclude that if the pre-emption right can govern the ‘acquisition of business share in priority’, the provisions on sale and purchase contracts can govern the ‘transfer of business share for consideration in money’, too. This view is supported by the Expert Proposal, which the lawmaker did not ascend to the level of statute.<sup>19</sup>

However, it must be noted that I am of the opinion that it would have been expressly written in the law if the lawmaker had wanted to apply the rules of the sale and purchase contract to the transfer of business shares in exchange for money. It did not happen; moreover, a new legal title was created and there is no cross-reference to the application of the rules governing sale and purchase contracts; hence I tend to share the opinion that the legal principles do not allow us to conclude that we have to apply the rules governing sale and purchase contracts for the transfer of business shares in exchange for money.

From a practical point of view, the previous statement appears to be nonsense. If it did operate like this, several legal affairs would be unmanageable, for example lien rights (a business share can hardly be defined as a thing, a right or a claim<sup>20</sup>), although company law does not exclude the possibility of registering a lien right,<sup>21</sup> and it would also be impossible to exercise call option, put option or repurchase rights regarding the business share if it is taken into consideration that, *per definitionem*, all of them are entitlements to things.<sup>22</sup>

<sup>15</sup> Pintér Attila, ‘Az üzletrész-átruházási szerződésről’ (2016) (5) *Gazdaság és Jog*.

<sup>16</sup> Ptk. 3:166. § (2) and 3:167. § (2).

<sup>17</sup> Sárközy Tamás, ‘A jogi személy II/Vl.’ in Sárközy Tamás, (főszerkesztő), *A Ptk. magyarázata* (HVG-ORAC 2018, Budapest) 226–227.

<sup>18</sup> Ptk., Chapter XXXIII. ‘az adásvétel különös nemei’, and Pk. 9. VII., és BH 1995.10.589., és BH 1995.12.666.

<sup>19</sup> Vékás (n 12) 290–291.

<sup>20</sup> According to the Section 8:1. § (1) point 1 of the Ptk., asset (*vagyontárgy*) means: thing, right and claim, whilst in Section 5:101. § (1) of the Ptk., the subject of a lien can be any asset.

<sup>21</sup> *2006. évi V. törvény a cégnyilvánosságról, a bírósági cégeljárásról és a végelszámolásról*, 27. § (3) c) pont.

<sup>22</sup> Ptk. 6:225. § (1) and (2).

This situation is not made easier even if we accept the view of the Commentary, according to which

the transfer of business share covers the transfer of all the membership, membership rights and membership obligations of a Kft; the legal title of that transfer is not to be regarded as a designated transfer of title ownership, as its statutory scope does not extend to business membership; rather, it is a contract for transfer of business share governed by a special company law regulation.<sup>23</sup>

All in all, I take the standpoint that the legal title of a transfer of business share poses a legal problem without a solution, the root of which is the dogmatic diffidence of legally determining a business share. In this sense, this legal instrument is not congruent with the basically well-structured and precisely established system of the Hungarian Civil Code. Depriving the business share of its in rem nature and separating its transfer in exchange for money from the traditional principles of the law of obligations have led to the emergence of an unmanageable legal problem, which can only be settled by using generous interpretation of the law.

I understand and accept the view that, based on the Hungarian legal history, we cannot regard a business share as a thing; however, our daily practice would be made significantly easier if the lawmaker considered the sale and purchase contract as an underlying regulation for the transfer of a business share in exchange for money, rather than forcing the use of the pre-emption right as a collateral means for the right of acquisition of a business share in priority. In this way, the right of acquisition of a business share in priority could become intrinsically manageable, too.

Let me set aside this problem and regard share as a thing to allow for the application of the general Hungarian Civil Code regulating sale and purchase contracts and options and turn our attention to the statements of the conservative drag along school.

After finding the answers to these questions, we can accept now that the above-cited PED regulations govern drag along law; that is, the buyer must be identified in drag along contracts.

However, the identification of the buyer is not possible at the time of signing the drag along contract. As a result, we seem to have ended up in a dead-end street and we cannot argue that the drag along is basically a sale and purchase contract capable of transferring the legal title of the business share per se.

I do not even accept the view that the obligee of a drag along right is a representative or an agent who enters into a contract in the name of the future buyer, as we do not know upon concluding the contract whose representative or agent this person is; as such, the identity of the buyer is not disclosed, resulting in the invalidity of the contract even if the buyer can be identified at the time of the hypothetical perfection of the legal relationship. In my view, the subjects of the legal relationship must be clearly identified at the time of entering into the contract, rather than at the time of performing it.<sup>24</sup>

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<sup>23</sup> Vékás Lajos, Gárdos Péter, *Kommentár a Polgári Törvénykönyvhöz*. I. kötet (Közigazgatási és Jogi Kiadványok, Wolters Kluwer 2018, Budapest) 405–406.

<sup>24</sup> See more: Kisfaludi András, *Az adásvételi szerződés* (KJK-KERSZÖV Jogi és Üzleti Kiadó Kft. 2003, Budapest) 63–64.

In my opinion, based on the above argument, the supporters of the conservative perception seem to be under a misapprehension and, under the Hungarian regulations relating to sale and purchase contracts, drag along cannot be regarded as a simple sale and purchase contract.

## 2 Call Option

In practice, several lawyers try to settle this problem by treating drag along as a call option, taking into consideration that it cannot be a sale and purchase agreement. They can also be grouped into two schools as follows

- i. some of them state that the obligee of the drag along right has the right to exercise a call option to acquire the business share that is encumbered with the drag along and he can acquire the obligor's business shares by his unilateral declaration in accordance with the other rules of the drag along,
- ii. the members of the radical call option school however think that the obligee of the drag along has a call option right, but he also has the right to transfer this call option right to a third person. Finally, the third person, using the call option right to the drag along obligor's business share, will be the owner of the business share.

As for the standpoint of the simple call option school's approach, it is necessary to note that it is another legal transaction; the obligee of the drag along right has no intention of acquiring the drag along obligor's business share: he would like to get rid of his own share instead.

It can be seen that the drag along right is far from being a linear series of transactions, by which the obligee of the drag along right first acquires the drag along obligor's business share and subsequently transfers it to the future buyer. It is important to note that such a transaction could not be disputed as two legal documents, that can legally be drafted perfectly, transfer the title of the ownership; however, the title is not the drag along. Furthermore, it is essential to pay attention to the fact that the obligee of the drag along does not aspire to exercise membership rights or fulfil obligations concerning newly-acquired business shares, and, in particular, the obligee does not wish to pay tax on acquiring or transferring a business share, etc.

The legal solution, when the drag along obligee shall be entitled to transfer his call option right to a third person, should be handled as a different legal question to a simple business share sale and purchase agreement. We will discuss this problem in the next chapter.

## 3 Drag Along Right as a Call Option Involving the Right to the Designation of a Buyer (*vevőkijelölés*)

In this view, the drag along right always involves a call option, upon which the obligee of the drag along right is able to acquire the business shares that are encumbered with the drag along right. The radical call option school goes further and states that this call option right is transferable, and the obligee of the drag along right has the right to transfer the call option

right to any third person that will be able to acquire the drag along obligor's business shares by his unilateral declaration based on his call option right. Hence, they state that, during the enforcement of the drag along right, the obligee of the drag along right transfers a call option to the buyer; the buyer purchases the drag along obligor's business shares and pays money to the obligor. The purchase price and other purchase conditions have been determined by the sales and purchase agreement's terms and conditions concluded to the drag along obligee's own business shares by and between the obligee of the drag along right and the buyer (*pari passu* and *pro rata*). The transfer of the call option between the drag along obligee and the buyer is free from any fee or charge.

It looks like the real contractual intention of the parties, but we have to examine whether the legal framework is given by the mandatory law.

On the first hand, according to the Hungarian Civil Code, the sale and purchase contracts are defined as follows:

Sales contract means any contract under which the seller undertakes to transfer the ownership of a thing to the buyer, and the buyer undertakes to pay the price thereof, and to take possession of the thing.<sup>25</sup>

Although we cannot handle the call option right as a thing, since ownership is possible only on tangible things,<sup>26</sup> so that a right is not transferable via a sale or purchase contract, but we can use the rules of the sale and purchase contract to the transfer of the rights, based on the subsidiary rule of the sale and purchase contract.<sup>27</sup>

On the other hand, the Hungarian Civil Code expressly allows the transfer of the rights:

The entitled person may transfer his right to another person, provided that the right is declared non-transferable by law, or unless non-transferability follows unambiguously from the nature of the right.<sup>28</sup>

Analysing the text of the law, we must state the follows:

i. First of all, the law allows generally the transferability of rights. It comes from the general rule of the Hungarian Code Civil:<sup>29</sup>

This Act governs the property and personal relations of persons under the principle of interdependence and the principle of equality.<sup>30</sup>

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<sup>25</sup> Ptk. 6:215. § (1).

<sup>26</sup> Ptk. 5:14. § (1).

<sup>27</sup> Ptk. 6:215. § (3).

<sup>28</sup> Ptk. 6:202. § (1).

<sup>29</sup> Osztovits András (ed), *A Polgári Törvénykönyvről szóló 2013. évi V. Törvény és a Kapcsolódó Jogszabályok Nagykomentárja*. Book no. III., (Opten Kft. 2014, Budapest) 482.

<sup>30</sup> Ptk. 1:1. §.

The law does not make a difference between subjective rights such as pre-emption right, call and put options) or the rights with an absolute structure.<sup>31</sup> Rights with an absolute structure are transferable by the mandatory law, like the IP rights based on the Hungarian IP Law,<sup>32</sup> or the call option right on the capital market, based on the Hungarian Capital Market Law.<sup>33</sup>

ii. The rights are also transferable if

- the right based on the contract is transferable by law, or
- the transferability of the right based on the contract comes unambiguously from the nature of the right.

A right is transferable unless the transferability is forbidden by law. Generally, the transferability of the call option right is not forbidden by the Hungarian Civil Code; moreover, the transferability of the call option right on the capital markets has us conclude that the 'general' call option right should also be transferable.

We also have to review the transferability of a call option on a business share, as the nature (or real content) of the right. No doubt, the business share is transferable, since it is declared by the law; even so, the members of the company, the company and the person designated by the company have a pre-emption right in cases of the transfer of a business share to the 'outsider person'.<sup>34</sup>

Summarising the above analysis, we have to conclude that the transfer of a call option right on a business share is legally possible under Hungarian law. Factually, the contractual intention of the parties, based on the terms and conditions of the drag along agreement, is that the obligee of the drag along right should have the right to transfer his call option right on the obligor's business shares, which is part of the drag along agreement. Hence, we have finally found that the radical call option school's solution can be one of the legitimate interpretations of drag along right transactions.

#### 4 Drag Along Right as a Transfer of Contract (*szerződésátruházás*)

Supporters of the neoliberal wing of the radical perception intend to solve this problem by referring to the legal instrument of transfer of contract<sup>35</sup> in the Hungarian Civil Code and regard drag along as something incorporating the call option of the drag along obligee to acquire the business share of the drag along obligor who, upon entering into the contract<sup>36</sup>

<sup>31</sup> Petrik Ferenc (ed), *Polgári Jog I–IV. – Új Ptk. – Kommentár a Gyakorlat Számára*. Commentary for the Ptk. 6:215. §, online version, 2020.

<sup>32</sup> Act No. LXXXVI of 1999 on Copyright, 42. §.

<sup>33</sup> Act No. CXX of 2001 on the Capital Market, 323. §.

<sup>34</sup> Ptk. 3:166. § (1) and 3:167. § (1)–(2).

<sup>35</sup> Ptk. 6:208. § – 6:211. §.

<sup>36</sup> In my view, there is no legal basis for the remaining party to the contract (in this case the drag along obligor) to give its prior consent to the assignment only if the person entering the contract is already known at the time of the conclusion of the contract. Thus, in my opinion, the drag along obligor is validly making a contractual statement in which the drag along rightholder is entitled to transfer his contractual position to an unknown buyer at the time of the conclusion of the contract. Cf. Fazekas Judit, Menyhárt Ádám, Kóhidi Ákos, *Kötelmi Jog*,

consents to altering the person of the drag along obligee (meaning every right and obligation)<sup>37</sup> upon the unilateral statement of the drag along obligee. The new position will be taken over by the future buyer, who can buy the business share of the obligor of the drag along by exercising his or her newly acquired call option.

Well, it cannot be disputed that the future buyer has no intention of acquiring a contractual position in any drag along contract, taking into consideration that his or her single wish is to acquire the business share of the drag along obligor. At the same time, we have to accept that the transfer of contract can be a perfect theoretical legal option to model the legal content of the transaction, but I suppose this is not a position that is really wanted by the buyer. In the drag along contract, there are many obligations that are not based on the parties' (the later buyer and the obligor of the drag along) contractual will. I refer here only to the conditions, how it is possible to sell the drag along obligor's business share, although it would just be acquired by the buyer. The buyer's only will be to acquire the ownership of the business shares. He does not want to keep in the original position of the drag along obligee; he would like to be a simple owner of the business shares.

With that, I think the transfer of contract as the description of the legal content of the drag along right is just a theoretical and legally perfect solution but it is not able to present the real economic content of the parties.

## 5 Considering Drag Along as an Agency Contract Service

We also have to mention the approach of the ultra-liberal school. They argue that drag along should not be overthought and it is needless to crack drag along 'nuts' with sales contracts, or call option right 'sledgehammers', as drag along is not more than a simple transaction in which the obligor of the drag along mandates the obligee of the drag along to enter into a contract with the buyer for transferring business shares in his place and in his name. Moreover, it is supported with a power of attorney meeting the mandatory formal requirements; as a result, the obligor of the drag along does not have to take any action when the buyer emerges and the contract must be concluded.

However, there are two problems with this seemingly perfect solution.

If we regard the drag along as an agency contract, it is beyond any dispute that the obligor of the drag along is the principal. As such, the principal has the right to instruct, which makes it uncertain to whom and under what circumstances the obligee of the drag along (who is the obligor of the agency contract at the same time) is able to transfer the business share. The answer of the ultra-liberal school to this question is that there are no impediments to setting forth in the agency contract (which is also a drag along contract in this case) what kind of instructions

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*Általános rész* (2. átdolgozott kiadás, Gondolat Kiadó 2018) 228; Benke József, Nochta Tibor, *Magyar Polgári Jog, Kötelemi Jog I.*, (Dialog Campus Kiadó 2017, Budapest–Pécs) 261.

<sup>37</sup> Wellman György (ed), *Polgári Jog, Első és Második Rész* (3. átdolgozott, bővített kiadás, Az új Ptk. magyarázata V/VI., (HVG-ORAC 2018, Budapest) 510.



the principal can give to the agent, and it is also possible to exclude some instructions concerning the subject, the merit and the purpose of the contract (i.e. transfer of business share).

On the other hand, the restriction or exclusion of the right to terminate with regard to contracts for services is rendered null and void.<sup>38</sup> However, the obligee of the drag along could hardly sleep well if he or she tried to sell the business share of the obligor of the drag along without the consent of this person, based on a contract which can be terminated at any time. Here comes the argument of the supporters of the ultra-liberal school; that the lawmakers give us assistance in this matter as, in the case of a long-term agency contract, the parties may agree on the restriction of the right to terminate; furthermore, they can also preclude the exercise of the right to terminate within a prescribed term.<sup>39</sup> Thus, we have nothing else to do but to exclude the right to terminate for the obligor of the drag along, or make it fall on the closest day, which will obviously be the day succeeding the day on which the obligee of the drag along acting in place and in the name of the obligor of the drag along transferred the business share of the obligor of the drag along to the buyer.

Naturally, this argument also has some weaknesses. On the one hand, the contracts can be terminated, not to mention whether the termination was lawful or not. Hence, upon delivery of the termination notice, the legal effects of the termination are produced, making it impossible for the obligee of the drag along to transfer the business shares. Of course, later there could be a suit for unlawful termination and a judgment could restore the effect of the agency contract, after which the obligee of the drag-along right can legally sell the business shares, but factually, the buyers usually do not want to wait for the end of legal proceedings that could last for years, and they withdraw their offer. On the other hand, an agency contract is a complex set of obligations and so it can easily happen that a contractual breach is committed, and although it does not affect the main contractual obligation it can give the legal basis for the termination of the contract.

Taking every factor into consideration, the solution provided by the ultra-liberal perception cannot be regarded as a bad one. Although the principal-agent perception is definitely far away from the drag along approach and is not capable of handling the issue perfectly, it does offer a way that is operable even under Hungarian law.

## Summary

In this study I summarized my experience with US, German and Hungarian contractual practices related to the drag along provision of venture capital transactions. I have presented some of the relevant legal literature of the examined legal systems. After outlining the practical and theoretical background, I tried to give a general definition of drag along.

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<sup>38</sup> Ptk. 6:278. § (4).

<sup>39</sup> Ptk. 6:278. § (4).

I did all this work to address whether drag along clauses are valid under Hungarian law. The first related hypothesis was the conservative perception that drag along is a simple sale and purchase contract. I demonstrated that drag along cannot be considered as a simple sale and purchase contract or a special type of sale and purchase contract.

I found that, one of the special types of call options or an unusual perception of an agency contract can be the legal solution to the required legal content of the drag along right.

Drag along is one of the American legal instruments that, under Hungarian law entails potential violations; it leaves several contractual gaps in the agreements of the parties and violate the contractual intention of the parties. However, I do not think that an urgent law-making procedure is needed, as the drag along rules may have not reached their final form; we cannot anticipate their future changes and it is also possible that the whole legal instrument *ab ovo* will cease to exist in order to provide room for more innovative, creative and contractually well-founded solutions.