

On the liability of venture capital fund managers

It has not yet arisen as a question until recently what liability the managers of venture capital funds have for the capital funds managed by them or even towards the investors of the funds. No practice has developed in respect of Act on Investment Trusts and their Managers entered into force in 2014 either but it seems that their liability may be still dubious on the basis of the recently published data. The expert of KRS Attorneys-at-Law, dr. Attila Pintér specialising in investments was questioned about the liability of venture capital fund managers.

According to the definition of the legislation, alternative investment funds– as venture capital funds – raise capital from their investors. Thus the resulting capital allocation is a separate legal entity, which, although, does not have an own management, is basically an amount of money, and nothing but a bank account. The investors receive security, investment unit as a compensation of their investments, as long as the fund managers exercise the right of disposition relating to the amount of money, namely its representation on behalf of the fund. The fund managers mainly operate in the form of a company limited by shares under the Hungarian legislation, under the general rules of the company law pertaining to them.

Finally, the executive officers of the fund managers make the ultimate decision on the money of the investors (so to say the relevant persons according to the European Union terminology). First of all, these persons belong to the management of the fund, so the chief executive officer, the members of the board of directors but persons liable for key decisions should also be included e.g. the head of investment management or the head of the portfolio management. These persons are usually employed by the fund manager, thus their liability is limited; in fact, they are liable for damages in a maximum amount of their twelve months' absentee pay for their worst decisions, which hardly consoles the investors in case of a loss of their investments of billion forints, which cannot be considered as irregular in the sector. It is true that the employer– except the extreme cases- is only liable vis-à-vis the employer, namely the fund manager. Thus, finally, the fund manager must pay damages caused by the management of the assets of the fund.

However, the Act does not say what liability relationship there is between the fund and the fund manager and what decisions the fund manager can be held liable for.



As regards the decisions, the Hungarian legislation broadly just refers to the European Union regulation and directive, which includes very short rules for risk arising from professional negligence of the fund managers. Such as loss of documents, misleading declarations, liabilities deriving from act of legislation or public authority etc. However, neither of the standards does clearly say but it can be assumed that the fund manager is liable for these cases. It is easy to see that the fund manager is liable for a number of decisions other than damages arising from professional negligence. Obviously, the criminal liability, (theft, fraud, embezzlement, etc.) considered as such or intentional injury, which is milder but goes beyond negligence. However, those business decisions cause the biggest debate, the risks of which cannot be predetermined. In case of venture capital investments, the majority of the decisions exceed the regular degree of business risk, thus it is hard to judge what constitutes as tolerable risk and which is the one which exceeds that.

From another approach, it can even be suggested that the fund and the fund manager will never enter into a fund management agreement (it would be curious if the fund manager would sign it in his own name on the left side, whereas he would sign it as the representative of the fund on the right side.) Therefore the fund may not enforce any claim against the fund manager referring to breach of contract or he may not take a legal proceeding due to damages resulting from a bad investment decision. This is so even if the fund manager must obviously be liable for breaking the rules of fund management policy.

It is not questionable since the parties failed to enter into a contract therefore the fund manager is liable under the non-contractual rules for damages, namely the total damage arising from a bad investment decision must be paid. He is exempted therefrom, if he proves that he did not foresee the damage and he should not have foreseen it. In case of venture capital investment, it is practically impossible to “predict” whether the investment will be unprofitable and how much it will damage the investors.

It is a sharper question how the fund will enforce its claim against the fund manager. It cannot fail to notice that the fund manager will represent the fund in enforcement of litigious claims, although it can hardly be imagined that the fund manager will take a legal proceedings against himself for the breach of representative rules. It is true even if the management of the fund will be changed since it cannot be emphasized enough that the management of the fund management is primarily liable for the profitable operation of the fund management and not for the fair management of the fund. There is hardly enough room for “taking legal proceedings against himself.” Of course this is not the case if a new fund manager will be appointed to manage the fund who forthwith will be entitled to take such legal



proceedings. If we leave this out of consideration, it is hard to give a realistic example when a fund sues its own fund manager.

Unfortunately, there is no statutory right granted to investors to start direct litigation, namely the claim of the investors is also linear and he may hold the fund manager liable through the fund. Comparing the operation of a regular limited liability company to the operation of a company limited by shares, which any member or shareholder may start proceedings against the decisions made by a body of the company; in case of venture capital investments, the rights of the investor are the rights mentioned in the investment unit, which rarely sets out the liability of the fund manager. Thus the risk of the investor is the risk of wild capitalism; a good fund manager may multiply its investment with good decisions whereas he may not hold the fund manager liable for the bad decisions, losing all his investments.

In conclusion, dr. Attila Pintér pointed out: assuming that the fund manager may be held liable for any liability pattern, which is currently difficult to predict and the question remained even unanswered who will take legal proceedings against him due to any of his investment decisions. It seems that the investor does not have such right and the capacity of the fund to bring proceedings can be excluded for practical reasons. We are eager to see how many investment units include authorisation for litigation against the fund manager because short-lived proceedings can be expected in the absence of these.