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Why Japanese Entrepreneurs Don't Give Up Control to Venture Capitalists

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Abstract: The biggest difference in the incentive bargains between entrepreneurs and venture capitalists in the US and Japan is that American entrepreneurs abandon control while Japanese entrepreneurs do not. Years ago, Black & Gilson tried to explain the difference by the existence and non-existence of liquid IPO markets. Although now there are multiple liquid IPO markets in Japan, Japanese entrepreneurs are still reluctant to abandon control of their companies to venture capitalists. While there must be many complementary reasons, such as different market situations, different social norms, etc., for the difference, I will raise a hypothesis that it can be partly explained by the different legal systems.

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Appendix: Double Moral Hazard and Incentive Bargain

I. Introduction

The biggest difference in the incentive bargains between entrepreneurs and venture capitalists in the US and Japan is that American entrepreneurs abandon control while Japanese entrepreneurs do not. Years ago, Black & Gilson tried to explain the difference by the existence and non-existence of liquid IPO markets\(^1\). Although now there are multiple liquid IPO markets in Japan\(^2\), Japanese entrepreneurs are still reluctant to abandon control of their companies to venture capitalists. While there must be many complementary reasons, such as different market situations, different social norms, etc., for the difference, I will raise a hypothesis that it can be partly explained by the different legal systems.

We can observe a typical incentive bargain between human capital providers (entrepreneurs) and monetary capital providers (venture capitalists) in a venture company. If one party feels too much risk, she will hesitate to invest her capital. For maximizing each party's payoff, both parties need to bargain with each other to

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2 See infra notes 14-16 and accompanying text.
motivate each other to invest their respective monetary and human capital. It is a typical two-sided agency problem situation. The incentive bargain will be made on control sharing and value sharing.

In Silicon Valley, such a two-sided agency problem is resolved by making entrepreneurs abandon control to venture capitalists and complementarily giving entrepreneurs additional cash-flow right as “sweat equity.” In Japan, venture capitalists are constrained from gaining control and entrepreneurs are constrained from obtaining sweat equity. As a result, the two-sided agency problem is not yet solved.

Actually, changes in the Japanese venture capital industry over the last ten years have been impressive. Several IPO markets for emerging growth companies were created. Deregulation of corporate law was revolutionary. The legal infrastructure needed to facilitate incentive bargains between entrepreneurs and venture capitalists looks to be in place. Many non profit organizations (NPOs), among professionals, who are interested in helping entrepreneurs, were borne around 2000 and have been contributing to create venture communities in Japan. Infrastructure of the type found in Silicon Valley to promote venture capital investments is fast developing. Still, however, Japanese entrepreneurs do not abandon control to venture capitalists.

On the enigma of why Silicon Valley entrepreneurs abandon control to venture capitalists, Black & Gilson explains that entrepreneurs can, even once having abandoned control, regain control if they successfully go to IPO. Hellmann’s explanation is that it is economically beneficial for entrepreneurs to keep more equity stake by giving control to VCs. Now, another enigma is why their arguments cannot explain the Japanese current situation.

Silicon Valley venture capitalists usually obtain control by using the four different complementary ways: viz., obtaining stock majority; obtaining board majority; staged financing; and entering into agreements.

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3 See infra notes 45-46 and accompanying text.
4 See Appendix.
5 See infra notes 58-62 and accompanying text.
6 See Black & Gilson, supra note 1, at 243.
8 See Steven Kaplan & Per Stromberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, 70 REV. ECON. STUD. 281
Japanese entrepreneurs do not abandon stock majority for two reasons. First, they typically do not require the amount of capital that would require them to issue the amount of capital stock that would cause them to end up with a minority share. Second, the cost of losing stock majority is higher than in Silicon Valley, because (1) Japanese corporate law is based on the shareholder choice doctrine, (2) reputational markets are not mature enough for entrepreneurs to trust venture capitalists, and (3) entrepreneurs cannot get sweat equity as a complement to abandoning stock majority.9

On the other hand, Japanese venture capitalists are not as eager as their Silicon Valley counterparts to obtain board majority for two reasons. First, gaining board control has smaller benefit than in Silicon Valley because of the shareholder choice doctrine of Japanese corporate law. Second, the costs of sending directors are higher in Japan than in the United States because of the corporate law differences between the two countries, particularly, Japanese corporate law statute of directors’ liability to creditors.10

Japanese venture capitalists gain less informal control by staged financing than their counterparts in Silicon Valley because they do not always continue to invest over different rounds and because syndicate financing is not a standard. We can point out several corporate governance problems of Japanese venture capital funds as reasons for such practices.11

Finally, Japanese venture capitalists gain some informal control by entering into stock buy-back agreements with entrepreneurs, which is a copy of the practice engaged in by so-called “main banks” in their corporate lending practices. Such a unique contractual arrangement makes it difficult for venture capitalists and entrepreneurs to trust each other.12

Several of the institutional infrastructures, such as capital markets, reputational markets, and the legal system, complementarily affect the incentive bargain between entrepreneurs and venture capitalists. Those institutional

(2003).

9 See infra note 71 and accompanying text.
10 See infra notes 86-92 and accompanying text.
11 See infra notes 94-101 and accompanying text.
12 See infra notes 102-104 and accompanying text.
infrastructures in Japan look to have caught up to their American counterparts, but, as a whole, do not yet provide the conditions for entrepreneurs to abandon control to venture capitalists.

In Chapter II, I will discuss the rapid changes to the institutional infrastructures, including the legal system, for venture capital investments in Japan that have occurred over the last ten years. In Chapter III, I will point out that, even in Silicon Valley, abandoning control by entrepreneurs to venture capitalists is not a matter of course, and review the debate between Black & Gilson and Hellmann on the reasons for this. In Chapter IV, I will explain why control is so important from the point of the two-sided agency problem. In Chapter V, I will try to find out the reasons why Japanese venture capitalists cannot gain enough control to resolve the two-sided agency problem, by analyzing the four major ways of gaining control by venture capitalists. Chapter VI will be a conclusion.

II. Changes in Japanese Venture Capital Industry Over the Last 10 Years

Although there have been many important changes in Japanese venture capital industry over the last ten years, there still remain big differences between Japan and the United States. The biggest and the most important one is entrepreneurs’ adherence to control.¹³

If we focus on the venture capital industry, we can observe the following three major changes in Japan. First, multiple IPO markets for emerging growth companies were created. Second, substantial corporate law amendments were made. And third, venture communities have been gradually developing.

A. IPO Markets

After the deregulation of financial and capital markets since 1996 (Japanese

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¹³ Actually, not only in venture capital industry but also in corporate governance of large publicly held corporations, 1997 was a turnaround year in Japan (See Zenichi Shishido, The Turnaround of 1997: Changes in Japanese Corporate Law and Governance, in CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY (Masahiko Aoki, et al. eds.)(1997)). Since then, the legal system and the practice of Japanese corporate governance have been changed a lot. However, also in publicly held corporations, an important characteristic of Japanese corporate governance is management’s adherence to control.
Big Bang), several IPO markets were launched. The Tokyo Stock Exchange “MOTHERS” market was opened in November 1999 and the NASDAQ-Japan market was opened in May 2000. The former over-the-counter stock market was reorganized into the JASDAQ Securities Exchange in December 2004.

Now, there are several IPO markets for emerging growth companies in Japan and they are competing against each other for new companies to be listed. As a bad aspect, however, several immature venture companies went public and tainted the reputation of Japan’s fledgling IPO markets.

B. Corporate Law Amendments

Japanese corporate law has been deregulated rapidly over the last ten years. Although those corporate law reforms cover very wide areas, we could pick up the following four points, which are particularly significant for venture capital investments.

1. Stock Options

In 1997, stock options were first introduced to Japan. Before this reformation, Japanese start-up companies were not able to use stock options as a scheme to give human capital providers equity incentives. A famous venture capitalist in Silicon Valley, who once had attempted to enter into Japanese market and abandoned after investigation of investment environment in Japan, pointed out deficiencies in corporate law, particularly the lack of stock options. Although stock options were

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15 Nasdaq-Japan was absorbed by the Osaka Stock Exchanged and renamed “Hercules” in December 2002, after NASDAQ left the Japanese market.
16 Mothers at Tokyo Stock Exchange (http://www.tse.or.jp/listing/mothers/index.html); Hercules at Osaka Stock Exchange (http://hercules.ose.or.jp); Centrex at Nagoya Stock Exchange (http://www.nse.or.jp); Ambitious at Sapporo Stock Exchange (http://www.sse.or.jp/pdf/about_amb.pdf); Q-Board at Fukuoka Stock Exchange (http://www.fse.or.jp/index.html); JASDAQ (http://www.jasdaq.co.jp); NEO at JASDAQ (http://www.jasdaq.co.jp/list/list_neo1.jsp); Tokyo AIM Exchange (http://www.tokyo-aim.com).
19 Interview with Steve Domenik, Partner, Sevin Rosen Funds, in Tokyo (Nov. 7, 2000).
originally restricted for limited use, they were totally deregulated in 2001.\textsuperscript{20} Now, stock options are widely used for many purposes, of course, including giving equity incentives to human capital providers of start-up companies.

2. Preferred Stock

Japanese corporate law had been quite loyal to the principle of one share-one vote and the equal treatment of shareholders. Consequently, issuing different types of stock other than common stock, particularly, no voting stock and multiple voting stock, had been strongly restricted.\textsuperscript{21}

Although such a legislative policy might be reasonable for keeping good corporate governance of publicly held corporations,\textsuperscript{22} it turned to be an obstacle to venture capital investments in Japan. In Silicon Valley, incentive bargains between entrepreneurs and VCs are made separately on sharing of cash-flow right and sharing of control, based on freedom of planning of almost any form of preferred stock.\textsuperscript{23}

In 2000 and 2001, Japanese corporate law deregulated the preferred stock system and now entrepreneurs and VCs can use almost the same type of convertible preferred stock as is used in Silicon Valley, including vetoes and class voting. However, such a convertible preferred stock has not yet been widely used in Japanese VC investments.\textsuperscript{24}

\textsuperscript{20} See Shishido, supra note 13, at 315.


\textsuperscript{23} See Kaplan & Stromberg, supra note 8, at 281.

\textsuperscript{24} See HIROKAZU HASEGAWA, BENCHA KYAPITARI SUTO NO JITSUMU [THE PRACTICE OF VENTURE CAPITALISTS] 64 (2007); Tatsuhiro Takahara, Torishimariyaku no Sennin-kengen no Bumpai to Torishimariyaku no Sekinin [Sharing Board Seats and Liability of Directors], in BENCHA KIGYO NO HOMU-ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN] (Zenichi Shishido, ed.) (forthcoming, 2009). It is also pointed out that the limited use of preferred stock is a reason for many living dead companies in Japan, because VCs have no liquidation preference and so no incentive to dissolve such companies. See Alen Miner & Kosuke Sato, Bencha Kigyo Ikusei no tameno Seitaikei [Venture Habitat], in BENCHA KIGYO NO HOMU-ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN] (Zenichi Shishido ed.) (forthcoming, 2009).
3. Limiting Directors’ Liability

The corporate law reform of 2001 allowed companies to put an upper limit on damages for negligence of their directors by amendment of their bylaws. There was a historical background of Japanese shareholder derivative actions for this amendment. Since the corporate law reform of 1993, which fixed the filing fee for shareholder derivative actions, the number of such lawsuits has increased a lot, and a couple of court decisions ordered directors to pay a huge amount of damages. The business sector seriously lobbied for some cap on the amount of damages.

The cap on the amount of damages is not allowed to be agreed ex ante for non-outside (executive) directors, but can be allowed ex post either by shareholder meeting or by board of directors. The important part of the amendment was the cap for outside directors. Outside directors can agree with the company, ex ante, on the cap of amount of damages up to their two years compensation from the company. It should have made venture capitalists easier to send directors to their portfolio companies. As I will discuss later, however, it is still not standard in Japan for VCs to send directors.

4. Freedom of Contract (Articles of Incorporation)

Besides each specific part of corporate law changes, which I have mentioned above, for last ten years, deregulation of corporate law as a whole is very significant for the practice of venture capital investments. Japanese corporate law used to be considered as mandatory law (over-riding contractual agreements in contravention of such law), even on corporate governance matters. For last ten years, area of freedom of contract, or free planning by articles of incorporation, has been expanded. In corporate law reformation of 2005, the principle of freedom of contract is established. Now, at least in closely held corporations, including start-up companies, Japanese shareholders

26 See e.g., In re Daiwa Bank, 1721 HANREI JIHO 3 (Osaka District Ct. Sep. 20, 1999).
27 See Shishido, supra note 13, at 319.
28 See Corporate Code Sec. 425, 426.
29 See Corporate Code Sec. 427.
30 See infra note 78 and accompanying text.
can plan their inter-relationship freely as their counterparts in the United States\textsuperscript{32}.

C. Venture Communities

A bilingual lawyer, who has been practicing both in Silicon Valley and in Tokyo for last ten years, observes: “In 1997, the venture community in Japan had not yet achieved any critical mass. There were a handful of entrepreneurs and start-up companies, and perhaps even fewer venture capitalists, but an infrastructure to assist these companies did not yet exist.\textsuperscript{33}” Venture communities have, however, been gradually developing for last ten years in Japan.\textsuperscript{34}

Several non-profit organizations have played an important role in organizing venture communities. In 2000, Nippon Angels Forum\textsuperscript{35} was organized. In 2001, Business Veterans Group\textsuperscript{36} and Venture Law Forum\textsuperscript{37} started. In 2002, Japan Venture Capital Association\textsuperscript{38} was launched. Those NPOs have provided entrepreneurs, venture capitalists, and other professionals with the opportunities for exchanging information and expanding human networks.

Professionals, such as venture capitalists, lawyers, and accountants, who are specialized for start-up companies, have been gradually increasing and provide an infrastructure to assist these companies.

There is no doubt that current situation of Japanese venture industry in 2008 is totally different from its situation in 1997. However, the development of a true venture community is still on its way and has not matured enough to provide good reputational market for decreasing risk of entrepreneurs and the risk of venture capital investment.

\textsuperscript{32} The symbolic thing of freedom of contract was introducing the limited liability company (LLC) in Japan in 2005. Japanese LLC is the organization with perfect freedom of contract. \textit{See id.}, at 23.
\textsuperscript{34} On the venture community in Silicon Valley, \textit{see Annaplex Saxenian, Regional Advantage: Culture and Competition in Silicon Valley and Route 128} (1994).
\textsuperscript{35} http://www.angels.ne.jp.
\textsuperscript{36} http://www.veteran.jp.
\textsuperscript{37} Venture Law Forum (VLF) is a non profit organization, which the author of this paper organizes with practicing lawyers, accountants, venture capitalists, capital markets specialists, journalists, and academics, mainly for gathering information on Japanese venture industry.
\textsuperscript{38} http://www.jvca.jp.
capitalists in Japan.39

III. Why Do Entrepreneurs Abandon Control to Venture Capitalists in Silicon Valley?

Even in the United States, abandoning control by entrepreneurs to venture capitalists is not a matter of course. Ten years ago, there were serious debates on why entrepreneurs abandon their control to venture capitalists in Silicon Valley.

In Silicon Valley, the venture capitalist usually obtains a control right, which is costly to the founder because the venture capitalist can fire the founder from the CEO position at any time.40 Why does the founder transfer the control right to the venture capitalist when it makes her so vulnerable? A number of possible explanations have surfaced.

A. Black & Gilson

Black & Gilson pointed out that the use of convertible preferred stock and the existence of liquid IPO markets creates the “call option of control” for entrepreneurs.

Their explanation is that an implicit component of a venture capital financing contract is an option on control given to the founder. This right to reacquire control is realized upon (i) a conversion of the venture capitalist’s preferred stock to common stock, which forces the venture capitalist to give up all contractual control rights, (ii) an exit by the venture capitalist through liquidating her stake in a public offering, or (iii) a dilution of the venture capitalist’s stake below a point where she exercises any meaningful control.41 Given that both parties share the common goal of a lucrative public offering, founders are typically given a powerful and heavily leveraged financial incentive to bring about this result. This incentive may be strong enough to outweigh the potential risk of losing the position at the helm of the venture company the CEO

39 See infra notes 94-104 and accompanying text.
40 The founder has the risk of his managerial quasi-rents being expropriated. See Erik Berglof, A Control Theory of Venture Capital Financing, 10 J. LAW, ECON., & ORG. 247, 248 (1994). See also Black & Gilson, supra note 1, at 258.
41 See Black & Gilson, supra note 1, at 260. As Black & Gilson explain, “the prospect of an IPO exit gives the entrepreneur something of a call option on control, contingent on the firm's success.” Id. at 261.
founded.

B. Hellmann

Hellmann simply explains that entrepreneurs abandon their control to VCs because entrepreneurs can keep more equity than otherwise.

His explanation is that the founder can retain significantly more equity when she gives up control. The venture capitalist permits the retention of a larger equity stake because it produces a two-fold incentive benefit. First, the venture capitalist thereby has an incentive to invest in finding superior management teams (to replace the founder). Second, providing founders with such a highly leveraged financial interest in the success of the venture company can create a sufficient financial incentive for founders to give up control even where they lose the private benefits associated with control.  

C. Why Not in Japan?

Both explanations by Black & Gilson, and by Hellmann, sound persuasive. Because of the above-described changes in Japanese corporate law and the maturing of the venture community, both explanations could also be true in Japan now, but the reality is that Japanese entrepreneurs still do not abandon control to venture capitalists.

Although there were no liquid IPO markets, and the Silicon Valley type convertible preferred stock was not available ten years ago, when Black & Gilson published their article, now, Japanese entrepreneurs and venture capitalists can enjoy several liquid IPO markets43 and freely planned convertible preferred stock.44 Black & Gilson’s argument are not sufficient to explain the current Japanese situation.

Hellmann’s argument also should apply to Japan, now and even ten years ago. By gaining control, Japanese venture capitalists also could decrease their risk and could allow entrepreneurs to keep more equity than otherwise. It should be beneficial to

42 See Hellmann, supra note 7, at 57.
43 See supra notes 14-16 and accompanying text.
44 See supra note 24 and accompanying text.
entrepreneurs, too.

We need to find out the reasons why both arguments cannot explain the current Japanese situation.

IV. Why Is Control So Important?

Before discussing differences of Japanese venture capital investments from Silicon Valley practices, let me explain why control is so important in venture capital investments in any countries.

A. Two-sided Agency Problem and Control Sharing

Control is very important because of the existence of typical two-sided agency problem. If venture capitalists feel too much risk, they will hesitate to invest their monetary capital. On the other hand, if entrepreneurs feel too much risk, they will hesitate to invest their human capital. For maximizing their own payoff, both venture capitalists and entrepreneurs need to reduce not only their own risk, but also their counter part’s risk, by bargaining about sharing control.

What types of risk will venture capitalists feel?

First, entrepreneurs may lack management capability. Even though an entrepreneur is an excellent engineer, in most cases, he has little business experiences and could not manage the firm when it grows up above a certain size. In that case, venture capitalists would try to replace the founder CEO with a professional manager. If venture capitalists had no control and the entrepreneur stuck to CEO position, the entrepreneur could stay as CEO and the firm value would not increase, or even decrease.

Second, entrepreneurs may pursue their private benefits, such as a high salary

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46 See Appendix.
48 See Hellmann, supra note 7, at 57.
and perks. For example, if venture capitalists had no control they could not stop the entrepreneur from leasing a fancy new office or otherwise wasting money on obtaining the trappings of personal wealth and power.

Third, relating to the second point, entrepreneurs may prefer continuation even if the business ought to be shut down. The venture business may represent a “plaything” for some entrepreneurs. If venture capitalists had no control, they could not take away the “plaything”, which is now simply a source of unnecessary costs.

Fourth, entrepreneurs may exit at unfavorable timing for venture capitalists. For some start-up companies, their only valuable asset may be the talent of the entrepreneur and her management team. Without them, the firm is valueless. The entrepreneur may decide to leave the firm, after venture capitalists invested a lot of money but before the investments have produced any fruit. Actually, venture capitalists could not avoid such a risk by gaining control. They try to avoid this risk by contractual schemes, such as the requirement of vesting and “bring along” rights.

And fifth, entrepreneurs may reject IPO or M&A. It is understandable that entrepreneurs may be against the selling of their firms, even though M&A is an important way of exit for venture capitalists, because of either the entrepreneurs’ sentimental attachment to their firm, or of deemed liquidation clause unfavorable to entrepreneurs. It is also not surprising if entrepreneurs are against an IPO, which is supposed to be the common goal of entrepreneurs and venture capitalists, because entrepreneurs may dislike the cost of disclosure and the risk of hostile takeovers after the IPO.

Venture capitalists can reduce most of those risks, except the fourth one, if they gain control.

Then, what types of risk may entrepreneurs experience vis-à-vis venture

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49 See Fried & Ganor, supra note 47, at 989.
50 See id.
52 See id., at 6-18.
53 See Fried & Ganor, supra note 47, at 993.
54 As a recent phenomenon, disclosure regulations in the United States and Japan, so called, SOX and J-SOX, substantially increased the cost of IPO and being listed.
capitalists?

First, venture capitalists may behave opportunistically. For example, venture capitalists may squeeze out entrepreneurs or other existing shareholders; venture capitalists may value the company unfavorably for entrepreneurs or other existing shareholders when raising capital; or venture capitalists may benefit their class at the expense of shareholders as a group, if they own preferred stock.55

Second, venture capitalists may exit at unfavorable timing for entrepreneurs. Particularly, venture capitalists tend to choose immediate liquidity events.56

Entrepreneurs can reduce most of those risks if they keep control.

B. Sharing Cash-Flow Rights and Sweat Equity

Bargaining about sharing cash-flow rights can be complementary to sharing of control.57 Typical schemes in Silicon Valley are sweat equity.

Usually, the first transaction between the entrepreneur and the venture capitalist is a second stage financing. The first stage financing is typically a smaller infusion of seed capital, perhaps a “friends & family” round or an “angel” round. When the venture capitalist enters the scene, it invests in a company with some business history, and the company issues new stock to the venture capitalist—typically preferred stock that is convertible into common stock.58 The preferred stock is issued, for example, at a price of $2.00 per share to the venture capitalist, while the price of the common stock issued to the founder was $0.10 six months earlier.59 Suppose the preferred stock provides for (1) non-cumulative dividends, (2) a liquidation preference equal to the original issue price, (3) mandatory redemption, (4) voting rights equivalent to those of the common stock, (5) convertibility into one share of common stock, (6) anti-dilution protection, and (7) automatic conversion into common stock upon a public offering.60 These terms are fairly typical of a second-round investment. They also reflect

55 See Fried & Ganor, supra note 47, at 993.
56 See Fried & Ganor, supra note 47, at 994.
57 See Appendix.
58 HALLORAN, ET AL., supra note 51, at 6·11.
59 The example of pricing is taken from HALLORAN, ET AL., supra note 51, at 6·12.
60 Id., at 6·6, 6·11.
fascinating and complex incentives. To reiterate how useful it is to examine contractual organizations with respect to the contracting parties, these terms illustrate that the venture capitalist has chosen its remedy for bad outcomes (a liquidation preference) and its control and participation rights for good outcomes.

The feature that underlies the incentive conflict is that in allocating equity the parties exchange the financial capital contribution of the venture capitalist for the human-capital contributions of the founder. Because preferred stock is automatically converted into common stock upon a public offering—the common goal for both parties—the common stock and the preferred stock have comparable value if the venture is a success. Said differently, the preferred stock’s seniority disappears if the venture is successful, as measured by the ability to consummate a public offering.

One of the reasons why venture capitalists invest in preferred stock in Silicon Valley is for tax reasons. They would argue that the common stock, which entrepreneurs acquired, and the preferred stock, which venture capitalists acquired, are different stock, so their price difference is reasonable.

As a result, entrepreneurs and managers of start-up companies can avoid current taxation and enjoy tax deferral and reduced tax rates as capital gain. It has been an established practice that the IRS will not challenge such a scheme of sweat equity, although the climate looks changing by IRS regulations under IRC Section 409A, which became effective as of January 1, 2009.

V. Ways of Gaining Control by Venture Capitalists

In Silicon Valley, the two sided agency problem has been solved by making

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62 Under the final regulations under IRC 409A, the standard for fair market value will be stricter, often requiring a third party valuation. However, many practitioners predict that the “10-to-1” rule might still effective for, at least, an early stage start-up company as long as the board determines “in good faith” that the preferred stock is worth 10 times the value of the common stock. See Zenichi Shishido, *Sweat Equity as a Gift* (Working Paper for Sho Sato Conference at UC Berkeley Law School, March 9-10, 2009).
entrepreneurs abandon control to venture capitalists.\textsuperscript{63}

Ways of gaining control by venture capitalists can be divided to formal ways of gaining control and indirect ways of gaining control. The formal ways are either by obtaining stock majority or by obtaining board majority. The indirect ways are either by staged financing or by agreements (monitoring contracts).\textsuperscript{64}

A. Control via Stock

First, venture capitalists can obtain control by gaining stock majority. It is, however, not the case in Japan. Japanese entrepreneurs keep stock majority even after IPO in most cases.

1. Reasons Entrepreneurs Are Able to Keep Stock Majority in Japan

In Silicon Valley, entrepreneurs are, in any event, forced to abandon control to venture capitalists if they need money. Japanese entrepreneurs can keep stock majority because they raise relatively small amount of money from VCs. Japanese VCs invest less than 100 million yen in a company on average, which is less than one-tenth of that in the United States.\textsuperscript{65}

Why do Japanese entrepreneurs raise small amounts of money from VCs? There are three hypotheses.

One hypothesis is that Japanese entrepreneurs do not need so much money. Most Japanese start-up companies are either in the software industry or in the service industry, which are not so cash demanding.\textsuperscript{66} Even Japanese entrepreneurs are forced to abandon control in the biotech industry, which requires huge amount of money.

Some venture capitalists point out that Japanese entrepreneurs generally have small dreams, compared with American counterparts. While American entrepreneurs try to dominate world markets as soon as possible, Japanese entrepreneurs only care for

\textsuperscript{63} In Silicon Valley, the reputational market plays an important role for filling gap of risk for entrepreneurs who abandon control to venture capitalists.
\textsuperscript{64} See Appendix.
\textsuperscript{65} See METI, \textit{supra} note 17, at 61.
\textsuperscript{66} See HASEGAWA, \textit{supra} note 24, at 60.
domestic markets.\textsuperscript{67}

The second hypothesis is that Japanese venture capitalists are risk averse. Most of them are “salary men” of banks, securities firms, insurance companies, and manufacturing companies. They have no equity incentive. It is economically reasonable for them not to put a large amount of money in a single company; rather, they prefer making portfolio investments.\textsuperscript{68}

And the third hypothesis is that debt finance can be complementary for Japanese start-up companies, including government loans. In Japanese capital market, debt finance has played major role and it had been true to venture financing in their early history.\textsuperscript{69} Still now the share of debt financing to start-up companies in Japan is much higher than in the United States.

2. Reasons for Entrepreneurs’ Adherence to Stock Majority

Why do Japanese entrepreneurs insist on retaining stock majority?

First, as a cultural explanation, Japanese entrepreneurs may not be genuinely equity oriented. Japanese entrepreneurs have special value, which is “more than money.” The most important thing for them is to keep control of the company they founded forever.\textsuperscript{70} Such a behavior very much looks like that of family company owners. A proposition of Hellmann’s logic is that venture capitalists and entrepreneurs share the same goal, that is maximizing their own IRR. Such a proposition looks, however, not to exist in Japan.

Second, there is another obstacle, which affects Hellmann’s logic. Another proposition of Hellmann’s logic is that entrepreneurs can retain more equity share as a complement of giving up control. Japanese tax law is unfriendly for using equity as an incentive. Particularly, the Japanese National Tax Agency would challenge the sweat

\textsuperscript{67} Presentation by Allen Miner (CEO, SunBridge) at Venture Law Forum (see supra note 36) (September 25, 2007).

\textsuperscript{68} See infra notes 98-101 and accompanying text.

\textsuperscript{69} See e.g., YUICHIRO ITAKURA, SHACHO SHIKKAKU [A Failed CEO] (1998).

\textsuperscript{70} It turns out that one reason Japanese entrepreneurs have historically resisted selling their companies is the unfavorable tax law treatment (vis-à-vis IPOs) and as a result there is only a limited M&A market in Japan. In other words, exits for venture capitalists are often limited to IPOs. See HASEGAWA, supra note 23, at 111.
equity practice as a gift and entrepreneurs would be required to pay gift tax. Therefore, sharing cash-flow rights cannot be complementary to sharing of control.

Third, bank-centered capital market influences still remain. It is a path-dependent factor. Venture capital industry cannot exist independently and is inevitably influenced by the capital market situation as a whole. In Japan, stock ownership of publicly held corporations has been stabilized by bank centered cross shareholding. Black & Gilson’s proposition is the existence of the Berle & Means world, where management keeps their control based on dispersed stock ownership, but that proposition is lacking in Japanese stock market after IPOs.

Fourth, the reputational market does not yet work well. Venture capitalists are not trusted by entrepreneurs. Although this point has been improved over the last ten years, venture communities are not yet matured enough to create good reputational mechanism in Japan for filling gaps of risk for entrepreneurs who abandon control to venture capitalists.

Besides those non-legal reasons, the deference of legal systems plays an important role for the different attitude of entrepreneurs to stock majority in both countries. Japanese corporate law is based on the shareholder choice doctrine, while American corporate law is based on the management choice doctrine. In Japan, if you keep stock majority, if the articles of incorporation says so, you can decide anything you want, whatever board of directors says. Therefore, stock majority is very important and Japanese entrepreneurs insist on maintaining stock majority.

71 On several possible reasons for such an unfriendly tax treatment of sweat equity by the Japanese tax agency, see Shishido, supra note 62; Zenichi Shishido, Zeisei ga Kigyo-Katsudo no Pureiya no Doukizuke ni Ataeru Eikyo [Influences of Tax on Incentives of Players in Firms], in KIGYO TOCHI NO TAYOKA TO TENBO [DIVERSIFICATION OF CORPORATE GOVERNANCE AND ITS FUTURE] 185, 189 (Hideki Kanda ed) (2007).
72 See Black & Gilson, supra note 1, at 243.
73 See id.
74 On significance of the reputational market, see Appendix.
75 See infra notes 82-84 and accompanying text.
B. Control via Board

Second, venture capitalists can obtain control by gaining board majority. It is, however, also not the case in Japan. Japanese venture capitalists almost never gain board control. They have no board seat at all in not small number of cases. Instead they send observers to the board.

Why do not Japanese venture capitalists control the board? It is because gaining board control in Japan makes smaller benefit and causes higher costs than in the United States.

1. Smaller Benefit

Board control is less important in Japan than in the United States. Shareholder meetings can decide everything in Japan, while, in the United States, board meetings are more influential. Additionally, in Japan, venture capitalists invest through preferred stock not in many cases. Accordingly, they are less worried by bad behavior of common shareholders because of fewer conflicts of interests.

Interestingly, on the role of the board, Japanese law is less regulatory than American law. In other words, Japanese law is based on the shareholder choice doctrine, whereas American law is based on the management choice doctrine.

In the US, several business decisions must be made by the board and even bylaws cannot let the shareholder meeting decide them. The board manages the business and affairs of the company and initiates fundamental transactions, such as mergers, IPOs, or liquidations. Shareholders, on the other hand, usually cannot initiate fundamental transactions even when their approval is required to effectuate the transaction. In Japan, the shareholder meeting can decide anything if the articles of

77 See Kaplan & Stromberg, supra note 8, at 290.
78 Presentation by Tatsuhiko Takahara (Partner, TMI Law Firm) at Venture Law Forum (see supra note 36) (April 7, 2008): Takahara, supra note 24.
79 See Fried & Ganor, supra note 47, at 976.
80 See Hasegawa, supra note 24, at 64.
81 See Fried & Ganor, supra note 47, at 977.
82 See MITSUHIRO FUKAO, FINANCIAL INTEGRATION, CORPORATE GOVERNANCE, AND THE PERFORMANCE OF MULTINATIONAL COMPANIES 4 (1995); Shishido, supra note 21 at 198.
83 DEL. CODE ANN. Tit. 8, Sec. 141(a) (2001); CAL. CORP. CODE Sec. 3000(a) (West 1990);
incorporation say so. Shareholders can even initiate fundamental transactions.\(^{84}\)

Therefore, the importance of the board control is different in the two countries.

2. Higher Costs

Not only gaining board control, but also just sending a board member, costs more in Japan than in the United States.

There is no big difference of director liability to the company in the two countries now. Companies can set a cap of liability of outside directors by articles of incorporation.\(^{85}\) D&O insurance will cover most liability unless there is gross negligence. Shareholder derivative action systems are not exactly the same but almost the same. There is, however, an important difference relating to venture capital directors.

The problem is, in venture capital backed firms, there are many conflicting interest situations among shareholders, i.e. entrepreneur v. venture capitalists, such as valuation of the company at the time of raising capital, decision to sell a business, liquidations, mergers, and so on. The question is whether venture capital directors can use their voice and cast their vote to the direction of venture capital interest without violating their fiduciary duties as the directors of their portfolio firm.

Japanese written law says directors have fiduciary duties to the company\(^ {86}\). Some Japanese lawyers may be concerned about the possible fiduciary duty violation by their venture capital clients and courts may recognize their gross negligence, although there has been no such case so far.\(^ {87}\)

On this problem, Delaware courts have adopted a “control-contingent” approach to fiduciary duties.\(^ {88}\) When venture capitalists, preferred shareholders,

\(^{84}\) Corporate Code Sec. 295.

\(^{85}\) See supra notes 28-29 and accompanying text.

\(^{86}\) Corporate Code Section 355.

\(^{87}\) See Takahara, supra note 24.

\(^{88}\) Fried & Ganor summarized the case law as the following. “A common-controlled board is free to serve the interests of common shareholders at the expense of the
control the board, they are not required to serve the interests of common shareholders, and may reduce the value of the common stock. This Delaware case law provides the parties with an additional economic incentive to give venture capitalists board control\textsuperscript{89}. Beside the tax reasons, by using preferred stock, venture capitalists, which invest in Delaware corporations, could mostly avoid fiduciary duty litigations even if venture capital directors pursue venture capital's interests.

Even bigger difference in the United States and Japan exists on the director liability to third parties, i.e. creditors, rather than on the director liability to the company.

Japanese written law says directors will be liable for damage to the third party, which is caused as a result of their gross negligence in the course of executing their duty to the company\textsuperscript{90}. Actually, there are many cases, in which directors are ordered to pay damage of creditors particularly in bankruptcy cases, including the reason of insufficient oversight.\textsuperscript{91} There is no such law in the US, and only in the case of direct fraud to creditors, the director may be personally liable\textsuperscript{92}. Because of this corporate law statute and its case law, it is risky to be a director of start-up companies, which generally have higher risk of bankruptcy.

C. Control via Staged Financing

Many commentators pointed out that the most significant scheme by venture capitalists to gain substantial control in Silicon Valley is the staged financing.\textsuperscript{93} Japanese venture capitalists gain, however, less control by staged financing than their American counterpart. We can find two characteristics of Japanese venture capital preferred shareholders and aggregate shareholder value. In contrast, a preferred-controlled board can make business decisions that serve the preferred at the expense of common, as long as those decisions can be defended as in the best interests of the corporation.” Fried & Ganor, supra note 47, at 993. See Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997); Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48 (Apr. 1, 1997).

\textsuperscript{89} Fried & Ganor, supra note 47, at 993.
\textsuperscript{90} Corporate Code Sec. 429.
\textsuperscript{91} See EGASHIRA supra note 76, at 458.
\textsuperscript{93} See PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 139 (1999).
investments.

1. Reasons for Less Control by Staged Financing in Japan

First, the rate of continuous investments over different rounds by a same venture capitalist is much lower in Japan than in the United States. Bank affiliated venture capitalists and securities firm affiliated venture capitalists make one-shot portfolio investments in most cases, although a small numbers of independent venture capitalists try to make staged financing as a part of their hands-on investments. Such a practice gives entrepreneurs no incentive to follow venture capitalists’ directions.

Second, syndicate financing organized by a lead investor is not a standard, instead, simply multiple venture capitalists make portfolio investments at the same round. Each venture capitalist makes different investment contract with a start-up company. Such a practice gives entrepreneurs bargaining power because they can make venture capitalists compete against each other. A statistic shows that more venture capitalists in the same round lead to lower IRR in Japan, which is opposite in the United States.

2. Corporate Governance Problems of Venture Capital Funds

Why is such a practice continuing in Japan? It is mainly because of corporate governance problems of venture capital funds. First, most venture capitalists have no equity incentive. Many of them are “salary-men,” such as bank employees. Second, most investors of venture capital funds are not genuinely equity oriented. They are either banks or cross-shareholding business firms, which do not care about the financial return of funds so much. Pension funds’ share is still negligible. As a result, low

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94 See HASEGAWA, supra note 24, at 129.
95 Japanese venture capitalists are generally categorized into five groups depending on their parent companies. Bank / insurance company backed venture capitalists, securities firm backed venture capitalists, business company backed venture capitalists, government backed venture capitalists, and independent venture capitalists. See id., at 51.
96 See id., at 65, 105, 132.
97 See id., at 92.
98 See id., at 65.
99 See id., at 75.
100 See id., at 57; METI, supra note 17, at 65.
IRR funds can survive.\textsuperscript{101} Third, such salary-man type venture capitalists have no incentive to follow up a specific start-up company and organize a syndicate with other venture capitalists. It is safer for them to make many portfolio investments to minimize risk.

D. Control via Agreement

Even Japanese venture capitalists cannot invest money in start-up companies without gaining some kind of control. They gain some informal control by entering into shareholder agreements peculiar to Japan.

The shareholder agreements consist of two parts. First part is preliminary consultation agreement, in which entrepreneurs agree to consult with venture capitalists before the board decides certain subjects, including business judgment matters in many cases.\textsuperscript{102} Second part is stock buy-back agreement, in which entrepreneurs promise to buy back venture capitals’ stock at cost personally in case of breach of the shareholder agreements, and, in some cases, in case of no IPO within certain years.\textsuperscript{103} Venture capitalists do not necessarily intend to monitor entrepreneurs, but intend to avoid downside risk, like banks.\textsuperscript{104} Such a contractual practice is one of the reasons why Japanese venture capitalists are not trusted by entrepreneurs.

VI. Conclusion

We observed a vicious cycle in Japanese venture capital investments. Although venture capitalists gain some informal control by shareholder agreements, they cannot gain enough control to reduce risk of venture investments. Therefore, venture capitalists in Japan have lower IRR compared to their American and European counterparts. See METI, \textit{supra} note 17, at 63.

\textsuperscript{103} Among the subjects of preliminary consultation, there are not only shareholders meeting matters and board meeting matters, but also often including annual business plan and the annual budget plan. See Takahara, \textit{supra} note 24.

\textsuperscript{104} According to the questioner research by METI, 70\% investment contracts include such a stock buy-back agreement, and 7\% of them were actually executed. See METI, \textit{supra} note 17, at 93, 95.

\textsuperscript{104} Such a practice is one of the examples of the bank-centered capital market influence. Japanese venture capitalists trace to the practice of “main banks”. Another possible reason of the practice is different tax treatment of the “living dead.” While, in the United States, investors can deduct their investment as cost if the portfolio company is doubtful as a going concern, investors have to actually sell the stock for deduction in Japan. See Miner & Sato, \textit{supra} note 24; METI, \textit{supra} note 17, at 57.
capitalists cannot invest a lot of money in a single start-up. They are forced to spread their risks by investing small amounts in many companies and behave like banks. Entrepreneurs are not willing to forego formal control because they cannot trust venture capitalists. Also they do not have enough cash-flow incentive to abandon control, partly because the tax law is restrictive about the use of sweat equity.

In Silicon Valley, the two-sided agency problem has been solved by making entrepreneurs cede control to venture capitalists. Why is such a resolution not available in Japan? The reasons why Japanese entrepreneurs do not cede control to venture capitalists are complementary to one another.

Black & Gilson’s logic cannot explain Japanese situation because their proposition of the existence of the Berle & Means world is lacking in the Japanese stock market. In Japan, stock ownership of publicly held corporations has been stabilized by bank centered cross shareholding.

Hellmann’s logic cannot explain the Japanese situation because his propositions of economically reasonable entrepreneurs and the availability of sweat equity as a complement of abandoning control do not exist in Japan.

Venture community in Japan is not yet matured enough to organize the Silicon Valley type reputational market, which fills the gap of risk for entrepreneurs.

Besides, the different culture, capital market, and reputational market, the different legal systems play an important role. Japanese corporate law is based on the shareholder choice doctrine and stock majority is more important than in the United States. It is a reason why Japanese entrepreneurs are so insistent about maintaining stock majority. Board majority is less important in Japan and venture capital directors will owe more risk of liability. Therefore, Japanese venture capitalists do not have strong incentive to gain board control. Japanese tax law is unfriendly to use incentive of equity. Sharing cash-flow rights cannot be complementary to sharing control because of possible gift tax on sweat equity. Therefore, Japanese entrepreneurs have less incentive to abandon control to venture capitalists.

Appendix:
Double Moral Hazard and Incentive Bargain

The incentives at play in the venture company contexts are ripe for game theoretic analysis. The objective for the parties in venture capital investments is to try to maximize their long-term benefits in the face of two types of risk. One type of risk concerns being excluded from management and profit, or what I call the “risk of squeeze-out.” The other type of risk concerns the reliability of promises to cooperate by their partner, hereinafter the “risk of uncooperative behavior.” In the venture company, the joint profit of the entrepreneur and the venture capitalist is maximized when both parties cooperate, yet these two types of risk distort the incentive of each party to cooperate. This sets the stage upon which the game will be played out: to maximize her own interest, a party must not only reduce the risk she faces, but also reduce the risk the other party faces in order to induce cooperative behavior.

Figure 1, below, maps out these incentive effects. For discussion purposes, imagine a venture company, in which \( A \) (venture capitalist) and \( B \) (entrepreneur) are the parties. It begins with the mechanisms that can be used to increase \( A \)'s incentive to behave cooperatively. The two primary tools are value sharing and control sharing. Value sharing involves granting \( A \) an equity stake in the venture. The more equity \( A \) has, the more likely \( A \) is to invest optimally in the joint enterprise. (Notice that only at 100% ownership is \( A \)'s incentive perfectly optimal.) Control sharing involves giving \( A \) rights within the organization that can be used to limit \( B \)'s actions. One notable example is defensive monitoring contracts.\(^{105}\) These can be structured so that \( A \) will have information rights that help \( A \) make sure \( B \) is not extracting value from the joint project improperly. Similarly, obtaining board representation or veto rights over certain decisions will give \( A \) valuable rights that help \( A \) make sure it shares at parity with \( B \) in the profits of the venture.

These rights can also be thought of by looking to the risks they mirror. The risk of squeeze-out distorts the incentive to cooperate because a party is not incentivized to

\[^{105}\] These contracts are defensive in that they are protective of \( A \). That is to say, they grant \( A \) certain negative rights that help \( A \) prevent harm to herself. In contrast, an offensive monitoring contract would be an affirmative right granted to \( A \), permitting \( A \) to force to \( B \) to undertake some action. A paradigmatic example would be granting \( A \) the right to purchase a majority stock position or buyout \( B \).
invest optimally when the other party can expropriate the fruits of that investment. At the same time, the risk of squeeze-out by one party helps monitor the other party’s incentive to cooperate through a threat of exclusion (illustrated by the arrow from left to right at the center of Figure 1). This is so because the other party faces the risk that if it does not behave cooperatively, then later it will be squeezed out of the joint project. In this way, the risk of squeeze-out monitors the promise to cooperate.

A minority shareholding party faces this risk of squeeze-out by the controller. A minority shareholding party also faces the risk of uncooperative behavior by the controller. These effects lead to underinvestment by minority parties.

The majority party who faces no risk of squeeze-out can decrease his risk of being the victim of uncooperative behavior by using the threat of exclusion as a penalty, but he cannot entirely eliminate the risk of uncooperative behavior. As the controller’s threat of squeezing out an uncooperative minority becomes more credible, the minority party’s incentive to behave uncooperatively shrinks. But because the minority party knows that it may invest in the venture only to be squeezed out later, the minority party can be expected to under-invest in the venture. Because the controller’s position is always protected, however, the controller will have optimal ex ante investment incentives. Thus, the asymmetric equilibrium is that when the majority party has an absolute right to squeeze out the minority, the majority party will have optimal investment incentives but the minority party will under-invest.

Methods to decrease these risks are limited: equity sharing, board sharing, monitoring contracts, reputation, bargaining power, and contingent contracts.¹⁰⁶ The interplay of these devices and the parties’ ability to use them to combat various risks are responsive to the type of risk involved, as illustrated in Figure 1.

Both reputation and bargaining power can work to decrease the both the risk of squeeze-out and the risk of uncooperative behavior.

¹⁰⁶ Contingent contracts, accompanied by the legal enforcement, can decrease the risk of uncooperative behavior. The comprehensiveness of contingent contracts depends on the nature of the transaction. For those conflicts that are predictable, contingent contracts are an effective solution. However, assuming that the contracts will be incomplete in some material respect, that element is by definition not solved by a contingent contract.
If neither party enjoys a sterling reputation or operates in an industry where reputation is particularly important, then neither party can be expected to make significant investments based upon reliance on the other party's willingness to invest to protect its reputation. It depends, however, on the reputational market how effectively reputational mechanism works. Reputational market is an infrastructure of incentive bargain, and we can take it as given.

The relative bargaining power of the parties is likely established by the relative value of the capital they contribute to the joint project. A party contributing only financial capital will be forced to rely essentially only on bargained-for contractual rights and votes attached to equity investments. That is the reason why venture capitalists invest as staged financing. If venture capitalists made their investment all in once, they would lose their bargaining power against entrepreneurs. Although in most cases the relative bargaining power of the parties is given, at least in venture capital investments, venture capitalists can gain additional bargaining power by staged financing arrangement, even if it is not a legal contract.

Therefore, the alternatives that the parties can negotiate ex ante are equity sharing, board sharing, staged financing, and monitoring contracts.

Figure 1 maps out these relationships.

Figure 1
Factors increasing a party’s incentive to cooperate

Factors decreasing a party’s incentive to cooperate

Factors mitigating these incentive distortions

Value sharing
(granting an equity stake)

Control sharing
(granting defensive monitoring contracts)

Risk of squeeze out
(at other party > 50%)

Risk of uncooperative behavior by other party

But increases risk for other party

Relative bargaining power; offensive monitoring contracts; reputation; appraisal rights

State contingent contracts

Threat of exclusion

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