March 12, 2011

Law and Venture Capital: The Case of Japanese Entrepreneurs

Zenichi Shishido, *Hitotsubashi University*

Law and Venture Capital:
The Case of Japanese Entrepreneurs

Zenichi Shishido[*]

Abstract: The biggest difference in the incentive bargains made in the venture capital industries in the US and Japan is that American entrepreneurs abandon control while Japanese entrepreneurs do not. Years ago, this difference was thought to be caused by a lack of liquid IPO markets by some experts in the field. However, there are currently multiple liquid IPO markets in Japan, yet Japanese entrepreneurs are still reluctant to abandon control of their companies to venture capitalists. While there are likely to be many complementary reasons for this difference, it can be partly explained by the different legal systems in the two countries.

Table of Contents:

---

[*] The author is a Professor of Law at Hitotsubashi University Graduate School of International Corporate Strategy and has taught as a Visiting Professor of Law at University of California Berkeley School of Law in 2010; Visiting Professor of Law at Columbia Law School from 1998-1999; and Visiting Professor of Law at Harvard Law School in 2005. This paper was originally prepared for the "Business Law and Innovation" conference at Columbia Law School taking place October 30 - November 1, 2008. The author wishes to acknowledge the helpful comments of Patrick Bolton, Richard Buxbaum, Merritt Fox, Jesse Fried, Mark Gergen, Ronald Gilson, Michael Klausner, Michael Korver, Joseph McCahery, Sadakazu Osaki, Mark Ramseyer, Roberta Romano, John Sasaki, Robert Scott, Hajime Tanahashi, Eric Vermulen, and David Weinstein. Benjamin Jones and Anthony Bertero provided skillful research assistance.

INTRODUCTION

Ten years ago, the author founded Venture Law Forum in Tokyo, Japan - a community for lawyers, venture capitalists, and other practitioners purposed to gather data and observe trends in Japan's emergent venture capital industry. Earlier in 2010, the forum's findings were released in a book titled *Law and Finance of Venture Companies in Japan*. Based on years of observation and analysis of the Japanese venture industry, the author is qualified to speak on the subject of why the venture capital industry in Japan has developed differently than its Silicon Valley counterpart.

The most pronounced difference between these two situations lies in the incentive bargains between entrepreneurs and venture capitalists. It has been conclusively shown that American entrepreneurs abandon control of their companies while Japanese entrepreneurs do not. Years ago, Bernard Black & Ronald Gilson tried to explain the difference by pointing to the lack of liquid IPO markets.[1] Even though there are now multiple liquid IPO markets in Japan,[2] Japanese entrepreneurs are still reluctant to abandon control of their companies to investing venture capitalists. While there must be many complementary reasons, such as different market situations, different social norms, etc., the difference can be partly explained by the different legal systems affecting the respective venture capital industries.[3]

A typical incentive bargain involves human capital providers (entrepreneurs) and monetary capital providers (venture capitalists, *hereinafter* VCs) that agree to invest in the creation of a venture company. If one party feels too much risk, she will hesitate to invest her capital. In order to maximize each party's respective payoff, both parties are compelled to bargain with each other in a fashion that motivates the other to invest her respective monetary or human capital. Without a bargain that acceptable to both sides, the venture is likely to fail. Moreover, when creating this bargain a typical two-sided agency problem must be overcome.[4] Control sharing and value sharing are at the middle of each incentive bargain; both parties vie for a bargain which allows for sufficient control sharing to lower potential risk, and value sharing sufficient to incentivize each to provide their capital. [5] These two aspects of the bargain are also complementary each other.

In Silicon Valley, this two-sided agency problem is resolved by having entrepreneurs abandon control to venture capitalists and complementarily giving entrepreneurs additional cash-flow rights through "sweat equity."[6] In Japan, venture capitalists are prevented from gaining control and entrepreneurs are not able to take advantage of sweat equity. Because of the two-sided agency problem both parties downsize new venture

---

[1] Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

[2] *See infra* notes 17-19 and accompanying text.

[3] Curtis Milhaupt pointed out the existence of legal obstacles in Japan many years ago. Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 887 (1997).

[4] *See infra* notes 55-56 and accompanying text.

[5] *See* the Appendix for a more comprehensive description of the incentive bargain.

[6] *See infra* notes 69-74 and accompanying text.

financing and are satisfied with smaller success. In fact, Japanese VCs invest less than 100 million yen (around $1M USD) in a company on average or less than one-tenth of the American average.[7]

There have, however, been remarkable changes in the Japanese venture capital industry over the last ten years. Several IPO markets for emerging growth companies were created. Deregulation revolutionized the shape of corporate law. The legal infrastructure needed to facilitate incentive bargains common in the American landscape looks to be in place. Many non profit organizations (NPOs) interested in helping entrepreneurs were borne around 2000 and have been contributing to the creation of venture communities in Japan. An infrastructure similar to that of Silicon Valley is fast developing and working to promote venture capital investments. Yet, Japanese entrepreneurs still do not abandon control to venture capitalists.

Regarding the enigma of the Silicon Valley entrepreneurs unquestioned abandonment of control to venture capitalists, Black & Gilson explains that entrepreneurs who have abandoned control, may be able to regain control if they successfully reach an IPO.[8] Thomas Hellmann's explanation is that typically, it is economically beneficial for entrepreneurs to keep more equity stake by giving control to VCs.[9] Why these arguments do not explain the current Japanese situation, is still an enigma.

Silicon Valley VCs usually obtain control by using the four complementary methods: viz., obtaining stock majority; obtaining board majority; staged financing; and entering into agreements.[10]

Japanese entrepreneurs do not abandon stock majority for two reasons. First, they typically do not require or believe they do not require an amount of capital that would necessitate the issuance of an amount 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: Japanese corporate law is based on the shareholder choice doctrine; reputational markets are not mature enough for entrepreneurs to trust venture capitalists; and entrepreneurs cannot earn sweat equity in trade for abandoning stock majority.[11] There is a strong belief that there is little benefit to Japanese entrepreneurs that give up the right to control their companies to VCs.

On the other hand, there are two main reasons why Japanese VCs are not as eager as their Silicon Valley counterparts to obtain board majority within venture capital start-ups. First, gaining board control is much less beneficial to Japanese VCs than to Silicon Valley VCs because of legal impediments under Japanese corporate law. The "Shareholder Choice Doctrine" gives shareholders of Japanese corporations much more control, a role played by the board under US corporate law. Second, the costs of sending directors to a start-up

---

[7] *See infra* note 79.

[8] Black & Gilson, *supra* note 1, at 243.

[9] Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998).

[10] *See* Steven Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

[11] *See infra* note 87 and accompanying text.

are higher in Japan than in the US. This is due to the corporate law differences between the two countries; the Japanese corporate law statute dictating a high level of director liability to creditors makes it a much riskier prospect to be a board member in Japan.[12]

Japanese VCs gain less informal control through staged financing than their counterparts in Silicon Valley because they do not always plan to continue investing in the start-up over different rounds. This can also be explained by that fact that syndicate financing[13] is not a standard in the Japanese market. A general review of the situation brings to light several corporate governance problems for Japanese VC funds as the reasons for such practices.[14]

Although not much formal control is desired by Japanese VCs, some informal control is acquired by entering into stock buy-back agreements with the entrepreneurs. This mimics the corporate lending practices engaged in by the so-called "main banks" that dominate the Japanese market. Such a unique contractual arrangement makes it difficult for venture capitalists and entrepreneurs to trust each other.[15] Essentially giving entrepreneurs a reason to believe the VC is not fully invested in their company while simultaneously giving the VC little incentive to help manage the venture.

Several of Japan's institutional infrastructures, such as the capital markets, reputational markets, and the legal system, complementarily affect the incentive bargain between entrepreneurs and VCs. Those institutional infrastructures in Japan have, for the most part, now caught up with their American counterparts. Yet they fail to provide conditions sufficient to entice entrepreneurs to abandon control nor push VCs to desire control over the board. These key differences are why the venture capital start-up world is still very different in Japan.

In Part I, the paper focuses on the last decade, during which rapid changes to the institutional infrastructures occurred that affect venture capital investments in Japan. Part II points out that even in Silicon Valley, entrepreneurs abandoning control to venture capitalists is not a matter of course, and further reviews the different explanations given by Black & Gilson and Hellmann. In Part III, the reason why control is so important from the point of the two-sided agency problem is expounded upon. Part IV reviews why Japanese VCs cannot gain enough control to resolve the two-sided agency problem, considering the four common methods used by VCs to gain control. Part V will conclude with a few words on the issues faced by those in the Japanese venture start-up community.

I. Changes in the Japanese Venture Capital Industry Over the Last Decade

---

[12] *See infra* notes 105-111 and accompanying text.

[13] In syndicate financing, a lead VC heads the group of VCs participating in the same round, under the same contract.

[14] *See infra* notes 118-122115 and accompanying text.

[15] *See infra* notes 123-125 and accompanying text.

Although there have been numerous, substantial changes in the Japanese venture capital industry over the last decade, the changes have not been able to mimic the environment found in Silicon Valley. The biggest difference that remains between the two countries is the adherence to a system where Japanese entrepreneurs' maintain control even after VCs have input their maximum capital investment.[16]

Focusing on the venture capital industry, there have been three major changes in Japan. First, multiple IPO markets for emerging growth companies were created; second, substantial amendments to the corporate law were made; and third, venture communities have been gradually developing.

A. IPO Markets

After the deregulation of the financial and capital markets in 1996 (the "Japanese Big Bang"), several IPO markets were launched.[17] The Tokyo Stock Exchange created the "MOTHERS" market in November 1999 and subsequently, the NASDAQ-Japan market opened its doors in May 2000. NASDAQ-Japan was then absorbed by the Osaka Stock Exchange and renamed "Hercules" in December 2002, after NASDAQ decided to leave the Japanese market. The former over-the-counter stock market was reorganized into the JASDAQ Securities Exchange in December 2004. Most recently, the JASDAQ market and Hercules market merged into a singular JASDAQ market in 2010. [18]

Now, there are several IPO markets for emerging growth companies in Japan which are competing against each other for new public listings. Unfortunately, several immature venture companies went public, tainting the reputation of Japan's fledgling IPO markets.[19] This may have also played a role in slowing the growth of the newly emerging venture capital industry.

B. Corporate Law Amendments

Japanese corporate law has been deregulated rapidly over the last ten years as well. Although these

---

[16] Actually, not only in the 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 Japanese corporate governance practices have changed significantly. This is also true when considering publicly held corporations; an important characteristic of Japanese corporate governance is management's adherence to control. For more on Japanese venture capital and corporate governance before 1997, *see* Milhaupt, *supra* note 3.

[17] *See* Sadakazu Osaki, *Innovation and the Regulation of the Capital Markets in Japan* (Working Paper for Business Law and Innovation Conference at Columbia Law School, Oct. 30 & Nov.1, 2008).

[18] Mothers -Tokyo Stock Exchange (http://www.tse.or.jp/listing/mothers/index.html); Centrex - Nagoya Stock Exchange (http://www.nse.or.jp); Ambitious - Sapporo Stock Exchange (http://www.sse.or.jo/pdf/about_amb.pdf); Q-Board - Fukuoka Stock Exchange (http://www.fse.or.jp/index.html); JASDAQ (http://www.ose.or.jp/jasdaq); Tokyo AIM Exchange (http://www.tokyo-aim.com).

[19] *See* Osaki, *supra* note 17, at 9; METI, Study Group for the Creation and Development of Start-ups Final Report 74 (2008).

corporate law reforms covered a very wide subject area,[20] the following four points are particularly significant for venture capital investments.

1. Stock Options

Stock options were first introduced to Japan in 1997. Before this introduction, Japanese start-up companies were not able to use stock options as a method for giving human capital providers equity incentives. A famous venture capitalist in Silicon Valley, who once had attempted to enter the Japanese market and eventually abandoned the idea after a thorough investigation of the investment environment in Japan pointed out deficiencies in the corporate law - particularly the lack of stock options.[21] Although stock options were originally restricted to very limited use, they were totally deregulated in 2001.[22] Now, stock options are widely used for many purposes, including a way to give equity incentives to human capital providers of start-up companies.

2. Preferred Stock

Japanese corporate law had been quite loyal to the one-share-one-vote rule and the equal treatment of all shareholders. Consequently, issuing different types of stock other than common stock, particularly, no voting stock and multiple voting stock, had been strongly restricted.[23]

Although such a legislative policy might be reasonable for keeping good corporate governance of publicly held corporations,[24] 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 the parties to agree to almost any form of preferred stock.[25]

In 2000 and 2001, Japanese corporate law was deregulated so that using preferred stock became more flexible, like American preferred stock. Now entrepreneurs and VCs can use nearly the same type of convertible preferred stock as is used in Silicon Valley, including veto rights and class voting. Although the number of cases involving venture financing through issuance of preferred stock has increased, particularly in cash-demanding industries such as telecommunication, biotechnology, and semiconducting, preferred stock has not yet been widely used within the Japanese VC investment world (see Table 1).[26]

---

[20] *See* Shishido, *supra* note 16, at 313.

[21] Interview with Steve Domenik (Partner at Sevin Rosen Funds in Tokyo) (Nov. 7, 2000).

[22] *See* Shishido, *supra* note 16, at 315.

[23] *See* Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189, 198 (2000).

[24] *See* Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[25] *See* Kaplan & Stromberg, *supra* note 10, at 281.

[26] *See* HIROKAZU HASEGAWA, BENCHA KYAPITARISUTO NO JITSUMU [THE PRACTICE OF VENTURE CAPITALISTS] 64 (2007); Tatsuhiro Takahara, *Torishimariyaku no Sennin-kengen no Bunpai 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] 414 (Zenichi Shishido & Venture Law Forum eds., 2010).

Table 1: VC's Use of Preferred and Common Stock

	2007/4 – 2008/3 (million dollars)	2008/4 – 2009/3 (million dollars)
Investment in Preferred Stock	17.862	12.705
Investment in Common Stock	125.279	92.141
All Investment	142.961	101.846

(Data from Hasegawa, *supra* note 25, at 81)

It should also be pointed out that the limited use of preferred stock may be the reason for many "living-dead companies" in Japan, which are not bankrupt but have no hope of reaching IPO. Usually, the VCs have no liquidation preference and thus no incentive to dissolve such companies, instead letting them stagnate.[27]

3. Limiting Director Liability

The 2001 corporate law reform allowed companies to put an upper limit on damages for negligent directors through clear amendment to company bylaws.[28] The amendment was a reaction to the prior reforms in the previous decade. The corporate law reform of 1993 had fixed the filing fee for shareholder derivative actions, resulting in an apparent increase in the number of such lawsuits.[29] Prior to the 2001 reform, some court decisions had ordered multiple, negligent company directors to pay extensive amounts in damages.[30] The business sector lobbied seriously for some cap on the amount of director liability for damages incurred by negligent conduct.[31]

The cap on damages can not be agreed to *ex ante* for non-outside (executive) directors, but can be

---

[27] *See* Allen Miner & Kosuke Sato, *Bencha Kigyo Ikusei no tame no Seitaikei* [*Venture Habitat*], in BENCHA KIGYO NO HOMU-ZAIMU SENRYAKU, *supra* note 26, at 130.

[28] Corporate Code of Japan (hereinafter, 'Corporate Code')§§ 425, 426, 427.

[29] *See* Zenichi Shishido, *Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective*, 49 AM. J. COMP. L. 653, 672 (2001). *See also* Mark West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351 (2001).

[30] *See e.g., In re* Daiwa Bank, Osaka Chihō Saibansho [Osaka Dist. Ct.], Sept. 20, 1999, 1721 HANREI JIHO 3; Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L.J. 11 (2003). Without finding any conflicts of interest, a large amount of damages were ordered to individual directors for their negligence in monitoring. This case shocked the business world, just as the Caremark case (*In re* Caremark International Inc., Derivative Litigation, 698 A. 2d 959 (De. Ch. 1996)) had in the U.S.

[31] *See* Shishido, *supra* note 16, at 319.

allowed *ex post* either by holding a shareholder meeting or by agreement of the board of directors.[32] A significant portion of the 2001 amendment was the new ability to cap potential liability for outside directors.[33] Outside directors can make an agreement with their company, *ex ante*, on the appropriate cap on the amount of damages, potentially up to two years of their compensation from the company.[34] This change should have made it less risky, and thus more likely for VCs to send board members to their portfolio companies. As discussed in more detail later, however, it is still not standard for Japanese VCs to send directors, instead choosing to send observers at most.[35]

4. Freedom of Contract (Articles of Incorporation)

Besides the specific parts of the corporate law changes mentioned above, deregulation of corporate law as a whole was and will continue to be very significant for the practice of venture capital investments. Japanese corporate law used to be considered mandatory law (over-riding contractual agreements in contravention of such law), even in regards to corporate governance matters. For last ten years, the ideology behind the term 'freedom of contract,' or the free planning of most governance issues through specification in the articles of incorporation, has gained considerable ground in legal basis. In the corporate law reformation of 2005, the principle of freedom of contract was formally acknowledged and established.[36] Now, at least in closely held corporations, which include start-up companies, Japanese shareholders can plan their inter-relationships as freely as their counterparts in the US.[37]

C. Venture Communities

A bilingual lawyer, with experience practicing both in Silicon Valley and in Tokyo, observes: "[I]n 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."[38] It does seem that venture communities have seen gradual development

32 *See* Corporate Code §§ 425, 426.

33 Japanese corporate law requires outside directors to have never been employees or executive directors of the company, but does not require other independency. Corporate Code § 2-15. Therefore, it should be noted that the meaning of 'outside director' is not the same as "independent director" in the U.S.

34 Corporate Code § 427.

35 *See infra* note 95 and accompanying text.

36 *See* Zenichi Shishido, *Teikan-Jichi no Hani no Kakudai to Meikakuka: Kabunushi no Sentaku* [*Expansion and Clarification of Area of Free Planning by Charters: Shareholders' Choice*], 1775 SHOJI HOMU [COMMERCIAL LAW REVIEW] 17 (2006). Kenjiro Egashira, chairman of the legislative commission (Hoseishingikai) at the time of the 2005 corporate law reformation, recalls that one of the major subjects of the reformation was to stimulate the venture industry. Kenjiro Egashira, *Kaisha-ho Seitei no Rinen to Kaishahosei Minaoshi no Yukue* (The Philosophy of Legislating the Corporation Act and the Direction of Ongoing Revision of Corporate Law) 1414 Jurist 95 (2011).

37 Introduction of the limited liability company (LLC) in Japan in 2005 represented the liberalization of the freedom to contract under the legal framework. The Japanese LLC allows for perfect freedom of contract. *Id.*, at 23.

38 John Sasaki, *The Silicon Valley Model: A Practitioner's Perspective* (Working Paper for Venture Law Forum, 2008).

over the last ten years in Japan.[39]

Several non-profit organizations have played an important role in organizing venture communities. In 2000, Nippon Angels Forum[40] was first organized. In 2001, Business Veterans Group[41] and Venture Law Forum[42] followed suit by starting their own venture partnerships. Then, in 2002, Japan Venture Capital Association[43] was launched. Those NPOs have set up an infrastructure to provide entrepreneurs, venture capitalists, and other professionals with opportunities to exchange information and expand their professional networks.

Professionals, such as venture capitalists, lawyers, and accountants that are specialized for start-up companies, have been gradually increasing and provide an infrastructure to assist these companies. There has also been growth in expatriate entrepreneurship with VC funding in Japan.[44]

In addition to venture capital firms, there is growing participation in early-stage investments by angel investors - wealthy individuals who provide seed capital to new ventures. In his 1997 article, Professor Milhaupt pointed out that there were no angel investors in Japan.[45] By 2008 however, there were more than ten angel networks in Japan,[46] comprised of roughly 360 investors.[47] It is likely that the number has continued to increase over the last three years. While the angel community remains comparatively small, with investment amounts that are far lower than those invested in the US, it has been it has been vital to the financing of certain biotechnology start-up companies.[48]

There is no doubt that the current situation Japan's venture industry in 2011 is totally different from the situation in 1997. Yet, the development of a true venture community is still distant and the industry has not matured enough to provide a good reputational market to help decrease the risk to entrepreneurs and improve the role of the VCs in Japan.[49]

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

---

39 For more on the venture community in Silicon Valley, *see* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994).

40 Nippon Angels Forum, *available at* http://www.angels.ne.jp.

41 Business Veterans Group, *available at* http://www.veteran.jp.

42 Venture Law Forum (VLF) is a non-profit organization, which the author has organized with practicing lawyers, accountants, venture capitalists, capital markets specialists, journalists, and academics. The main purpose of the forum is to gather information on Japan's venture industry.

43 Japan Venture Capital Association, *available at* http://www.jvca.jp.

44 *See*, *e.g.*, J-Seed Ventures Inc., a small venture-themed company in Tokyo that supports both Japanese and non-Japanese entrepreneurs in establishing start-up companies with venture capital derived from both domestic and international sources. For more information on the type of start-up companies in this sub-community of the Japanese venture capital industry visit www.j-seed.com.

45 *See* Milhaupt, *supra* note 3, at 877.

46 *See* METI, *supra* note 19, at 53.

47 *See* ROBERT KNELLER, BRIDGING ISLANDS 169, 183 (2009).

48 *See id.*, at 169, 182.

49 *See infra* notes 115-125 and accompanying text.

Even in the US, entrepreneurs occasionally attempt to keep control from falling into participating VCs' hands. Ten years ago, there were serious debates on why entrepreneurs often abandoned their control, particularly in the Silicon Valley model. It is clear that American VCs usually obtain some rights of control. This is costly to the founder/entrepreneur because the VC may have the legal authority to displace the founder from the CEO position at any time.[50] Why does the founder transfer control rights to VCs 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 create 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.[51] Given that both parties usually share the common goal of participating in 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 entrepreneur/CEO founded.

B. Hellmann

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

This explanation presumes that the founder can retain a significantly larger portion of equity when the choice to give up control is made. The venture capitalist permits the retention of a larger equity stake because it produces a two-fold benefit. First, the venture capitalist has an incentive to invest in finding superior management teams (to replace the founder if needed). Second, founders with a highly leveraged financial interest in the success of the venture company have sufficient financial incentive to give up control, even where

[50] 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.

[51] *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.

they lose the private benefits associated with control.[52]

C. Why Not in Japan?

Both the explanation given by Black & Gilson and that of Hellmann, sound persuasive. Because of the above-described changes to 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 choose not abandon control to VCs.

When Black & Gilson published their article ten years ago, there were no liquid IPO markets and the Silicon Valley type of convertible preferred stock was not yet available. Now, Japanese entrepreneurs and VCs are able to take advantage of several liquid IPO markets[53] and engage in freely-planned convertible preferred stock agreements.[54] Thus, Black & Gilson's argument is not sufficient to explain the current Japanese situation.

Hellmann's explanation should also apply to Japan under the current legal system, and even as it existed ten years ago. By gaining control, Japanese VCs could also decrease their risk and thus allow entrepreneurs to keep more equity than would be the case otherwise. Accordingly, it should be beneficial to entrepreneurs as well.

It is clear that both explanations fail to account for the situation that exists in Japan.

III. Why Is Control Important?

Before discussing the differences between Japanese venture capital investments from Silicon Valley practices, its necessary to understand the importance of the role that control plays in venture capital investments throughout most countries.

A. The Two-sided Agency Problem and Control Sharing

Control is vital to any venture capital deal because of the existence of a typical two-sided agency problem.[55] If VCs feel too much risk, they will hesitate to invest their monetary capital. On the other side, 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 that of their

---

[52] *See* Hellmann, *supra* note 8, at 57.

[53] *See supra* notes 17-18 and accompanying text.

[54] *See supra* note 26 and accompanying text.

[55] *See generally,* Sugato Bhattacharyya & Francine Lafontaine, *Double-Sided Moral Hazard and the Nature of Share Contracts*, 26 RAND J. ECON. 761 (1995).

counterpart's, by bargaining for agreements specifying specific control- and value-sharing commitments.[56]

What types of risk do VCs feel?

One thing that many VCs fear off the bat is that entrepreneurs may lack management capability. Even though an entrepreneur may be an excellent engineer, in most cases, he has little business experience and is unable to manage the firm after it grows beyond a certain size.[57] In that case, VCs would usually try to replace the founder CEO with a professional manager more accustomed to handling a larger-sized company.[58] If VCs have no control then the entrepreneur will be able to retain the CEO position, causing a situation in which the firms value may stagnate, or even decrease. If the CEO is uncooperative, it may lead to a disaster for all parties involved.

Another issue for VCs is how to inhibit entrepreneurs from pursuing private benefits, such as a high salary or luxury perks.[59] For example, if VCs have no control they can not stop the entrepreneur from leasing an unaffordable office space or otherwise wasting capital meant for the betterment of the venture on obtaining the trappings of personal wealth and power.

Thirdly, and related to the second issue, is that entrepreneurs may seek continuation of the venture even if the correct business decision is to shut down.[60] Likewise, a venture business may turn into a "plaything" for some entrepreneurs. If VCs have no control, they can do little to nothing to remedy issues such as this, presenting a source of unnecessary costs via risk.

Fourth, entrepreneurs may exit at unfavorable timing for VCs. 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 VCs have already invested money but before the investments have produced any return. Actually, VCs can not avoid this type of risk even through gaining control. Instead, they try to avoid this risk by use of contractual schemes, such as vesting requirements[61] and "drag along" rights.[62]

One other important issue often faced by VCs is where an entrepreneur rejects an IPO proposition or M&A deal that would benefit the VC. It is understandable that entrepreneurs are often against selling off their firms, in many cases to competitors. This is either due to the entrepreneurs' sentimental attachment, or because

---

56 *See* Appendix.

57 *See* Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 NYU L. REV. 967, 989 (2006).

58 *See* Hellmann, *supra* note 9, at 58.

59 *See* Fried & Ganor, *supra* note 57, at 989.

60 *See id.*

61 *See* MICHAEL HALLORAN, ET AL., VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 6-18, 13-1 (3d ed. 2000).

62 *See id.*, at 6-18.

of deemed liquidation clauses that prove unfavorable to entrepreneurs.[63] Notwithstanding this hesitancy, an M&A is an important exit strategy for VCs if an IPO is not achievable. It is also not surprising when entrepreneurs are against an IPO, because they may dislike the cost of disclosure or the risk of possible hostile takeovers after the IPO takes place.[64] Despite these potential conflicts, IPO remains the dominant exit strategy for Japanese VCs both in number and in profitability. IPOs accounted for 44.9% of VC exits, while M&A or resale of control to entrepreneurs were the next most popular methods (with roughly equivalent showings of 16.3% and 13.2%, respectively).[65]

VCs have the ability to reduce or eliminate most of these risks by gaining control. Only the fourth issue, related to early withdraw by the entrepreneur, can not be resolved through VC control. It is now important to ask what are the real and perceived risks that an entrepreneur experiences vis-à-vis VCs ?

First, VCs may behave opportunistically because they are often concerned with only monetary value of a portfolio company. For example, VCs may attempt to squeeze out entrepreneurs or other existing shareholders; VCs may value the company unfavorably for entrepreneurs and other existing shareholders when subsequent rounds of capital are raised; and VCs may also act to benefit their class at the expense of other shareholders as a group, especially when they own preferred stock with special rights.[66]

Second, VCs may exit at unfavorable timing for entrepreneurs. Particularly, venture capitalists tend to choose immediate liquidation events if it appears to present the greatest potential for profit or loss mitigation.[67]

Entrepreneurs can reduce these risks if they are able to maintain control post venture financing.

B. Sharing Cash-Flow Rights and Sweat Equity

Bargaining for cash-flow rights can be complementary to the control sharing agreements.[68] Typical schemes in Silicon Valley involve sweat equity - the profit earned by the entrepreneurs and founding employees when a common stock matures.

Usually, the first transaction between the entrepreneur and the VC is a second stage financing. The first stage is typically a smaller infusion of seed capital, perhaps a “friends & family” or “angel” round. When

---

[63] *See* Fried & Ganor, *supra* note 57, at 993.
[64] As a recent phenomenon, disclosure regulations in the United States and Japan nicknamed SOX and J-SOX have substantially increased the cost of reaching IPO and being listed.
[65] Venture Enterprise Center, *Survey on Current Status of Investment of Venture Capitals and Other Funds*, Dec. 2007. *See also* METI, *supra* note 19, at 90. However, because of the troubled economic market, IPOs accounted for just 9.9% in fiscal year 2008. *See* Venture Enterprise Center, *Survey on Current Status of Investment of Venture Capitals and Other Funds*, Jan. 2010.
[66] *See* Fried & Ganor, *supra* note 57, at 993.
[67] *See id.* at 994. .
[68] *See* Appendix.

the VC 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.[69] 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.[70] 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.[71] These terms are fairly typical of a second-round investment. They also reflect 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 pre-chosen its remedy for bad outcomes (a liquidation preference) as well as set up its control and participation rights for good outcomes.

A feature that underlies the incentive bargain 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 stock and the preferred stock have comparable value if the venture is a success. In other words, 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 VCs in Silicon Valley invest through preferred stock is for tax reasons.[72] The argument is that the common stock acquired by the entrepreneurs, and the preferred stock acquired by the VCs, are wholly different stock, so their price difference is reasonable. The value of the common stock builds over time with the efforts expended by the entrepreneur input to reach a profitable exit.

As a result, entrepreneurs and managers of start-up companies can avoid current taxation and enjoy tax deferral and reduced tax rates under capital gains rules. It has been an established IRS practice not to challenge most sweat equity schemes,[73] although the climate looks to be changing and IRS regulations under IRC Section 409A, which became effective as of January 1, 2009, point toward a less lenient taxation trend.[74]

---

[69] HALLORAN, ET AL., *supra* note 61, at 6-11.

[70] Example taken from HALLORAN, ET AL., *supra* note 61, at 6-12.

[71] *Id.*, at 6-6, 6-11.

[72] *See* Ronald Gilson & David Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 889 (2003).

[73] The IRS loosely follows what is casually known as the 10-to-1 rule. It is not a written rule but a tax practice, to which venture communities in the United States are accustomed. *See* Gilson & Schizer, *supra* note 72, at 892, 898, 900; 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS 82-83 (2d ed. 1995).

[74] Under the final regulation 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 be effective - at least for 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 the Sho Sato Conference at UC Berkeley Law School, March 9-10, 2009 *available at*

IV. Ways that Venture Capitalists Gain Control

In Silicon Valley, the two sided agency problem is resolved by making entrepreneurs abandon control to VCs.[75]

Methods by which control is captured by VCs can be divided into formal ways of gaining control and indirect ways of gaining control. Formal methods require either obtaining stock majority or obtaining board majority. The indirect methods incorporate either through staged financing or specific agreement (monitoring contracts).[76]

A. Control via Stock Acquisition

First and foremost, VCs obtain control by gaining a stock majority in the venture capital industry at large. This is not the case in Japan however. Although the equity ratio of VCs has gradually increased, the average ratio at IPO in 2008 was still 17.50%.[77] As mentioned previously, Japanese entrepreneurs keep stock majority even after IPO in many cases (*see* Table 2).[78]

Table 2: Founder Family Shareholding at IPO (average)

	JASDAQ/NEO	**Mothers**	**Hercules, and others**
2008	**66.4%**	**50.4%**	**59.0%**
2007	**63.3%**	**53.7%**	**55.2%**
2006	**66.5%**	**59.0%**	**54.8%**
2005	**57.3%**	**58.0%**	**60.6%**

(Data by PRONEXUS)

http://www.law.berkeley.edu/8364.htm).

[75] In Silicon Valley, the reputational market plays an important role for filling the risk gap faced by entrepreneurs who abandon control to venture capitalists.

[76] *See* Appendix.

[77] Hirokazu Hasegawa, *Bencha Kigyo no Genjo* [*The Current Situation of Venture Companies*], in BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 49, 54.

[78] Takahiro Takahara, *Fifty One Percent Problem* (*51% Mondai*), in BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 420, 421.

1. Reasons behind an Entrepreneur's Ability to Maintain Stock Majority in Japan.

In Silicon Valley, entrepreneurs are usually forced to abandon control of their venture capital financers because they require an amount of money that can only be provided by risk-taking VCs. Japanese entrepreneurs keep stock majority because they seek to raise relatively small amounts of money from VCs. In fact, Japanese VCs invest less than 100 million yen in a venture start-up company on average, which is less than one-tenth of the American average.[79]

There are three hypotheses that are used to explain why Japanese entrepreneurs raise smaller amounts of money from VCs.

One hypothesis is that Japanese entrepreneurs do not perceive a need to raise a large amount of capital. Most Japanese start-up companies are either in the software industry or in the service industry, which are not considered cash demanding industries.[80] This is supported by the fact that even Japanese entrepreneurs are forced to abandon control in the biotech/pharmaceutical industry, which requires huge amounts of financing to reach a favorable result (see Table 3).[81]

Table 3 : VC Investment and IPO Pricing by Sector (all amounts are millions of Yen)

Company Type	Total financing (median)	VC investment	IPO financing	Total market valuation at IPO	Total pre-IPO market valuation	PER at IPO	Number of VCs investing	VC equity ratio (%)	Years before IPO
Telecom	419	89	287	3,544	1,799	25.17	3	14.28	7
Services	280	72	227	3,143	2,277	14.33	1	5.32	23
Pharma.	2,989	2,690	623	5,282	6,372	- 2.31	21	55.79	11
All companies	401	72	248	3,165	2,796	12	2	11	17

(Japan Venture Research Monthly Report, January 2009, at 6)

79 *See* METI, *supra* note 19, at 61.

80 *See* HASEGAWA, *supra* note 26, at 60.

81 *See* KNELLER, *supra* note 47, at 170. Japanese entrepreneurs rely on both government funding and private venture capital to finance technology ventures. Government funding accounts for about 20% of average R&D expenses, but comprises a significantly higher proportion among firms that receive government grants. The liberalization of listing requirements for Japanese equity markets in the late 1990s enabled entrepreneurs to decrease their reliance on government funding and raise pre-IPO equity capital from Japanese VCs. *Id.*

Some VCs point out that Japanese entrepreneurs generally have small dreams, when comparing them to their American counterparts. While American entrepreneurs try to dominate world markets as soon as possible, Japanese entrepreneurs tend to aim only for the domestic market.[82] Many would attribute this difference to the different atmospheres of risk and its acceptability in the US compared to Japan.

The second hypothesis is that individual Japanese venture capitalists are risk averse to a point which stifles their ability to match American VC investment standards. Most of them are "salary men" of banks, securities firms, insurance companies, and manufacturing companies without much experience or appetite for truly risky ventures. Additionally, they lack an equity incentive to invest in most cases. It is economically reasonable for them to not invest a large amount of money in a single company; instead, they prefer making a wide range of portfolio investments, as would any investor attempting to mitigate potential loss through diversification.[83]

The third and final hypothesis is that debt financing can be complementary for Japanese start-up companies, including government loans. In the Japanese capital market, debt financing plays a major role, especially for venture financing in its early history.[84] Still today, the share of debt financing in start-up companies in Japan is much higher than it is in the US.[85]

2. Reasons for Entrepreneurs' Adherence to Stock Majority

Why do Japanese entrepreneurs insist on retaining stock majority?

First, there is a cultural aspect which helps explain the situation. Japanese entrepreneurs may not be genuinely equity-oriented and they place importance on other issues which are considered "more than money." The most important thing for them is to keep control of their company.[86] Such behavior looks very much like

[82] Presentation by Allen Miner (CEO, SunBridge) at Venture Law Forum (*see supra* note 39) (Sept. 25, 2007).

[83] *See infra* notes 114-117 and accompanying text. *See also* Allen Miner & Kosuke Sato, *Bencha Kigyo Ikusei no tameno Seitaikei* [*Venture Habitats*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 98, 103.

[84] *See e.g.*, YUICHIRO ITAKURA, SHACHO SHIKKAKU [A FAILED CEO] (1998). *See also* Milhaupt, *supra* note 3, at 878.

[85] It may be influential that governmental agencies provide start-up loans and start-up guarantees in Japan. *See* HIROKAZU HASEGAWA, BENCHA MANEJIMENTO NYUMON [INTRODUCTION TO VENTURE MANAGEMENT] 159 (2010).

[86] It turns out that one reason Japanese entrepreneurs have historically resisted selling their companies is because of unfavorable tax treatment (vis-à-vis IPOs), as a result there is only a limited M&A market in Japan. Michael Korver, *Egujitto toshite no M&A* [*M&A as an Exit*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 465, 466, 473. In other words, the exit strategy for venture capitalists is often limited to IPOs. *See* HASEGAWA, *supra* note 26, at 111.

that of family company owners and what is commonly termed "founder's syndrome." A proposition of Hellmann's logic is that VCs and entrepreneurs share the same goal - to maximize their own return on investment. This proposition looks to hold much less sway within Japan.

Second, there is another obstacle applying Hellmann's logic to the Japanese situation. One of Hellmann's propositions is that entrepreneurs have the ability to retain a larger equity share as a complement of giving up control. But, Japanese tax law is unfriendly to the method of using equity as an incentive. Particularly, the Japanese National Tax Agency challenges the sweat equity practice as a virtual gift and thus, recipients are required to pay gift tax at a prohibitively high rate.[87] As a result, the sharing of cash-flow rights has not become a complementary way to bargain for control sharing.

Third, influences still remain from the extensively bank-centered capital market present in Japan.[88] This is a path-dependent factor because the venture capital industry does not 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 through bank-centered cross shareholding. Black & Gilson's presume the existence of a Berle & Means world, where management maintains control through dispersed stock ownership,[89] but that proposition is lacking in the Japanese stock market for companies after IPO.

Fourth, the reputational market for VCs has yet to evolve in Japan. VCs are not trusted by entrepreneurs and although this obstacle has seen improvement over the last ten years, venture communities are still not mature. There is no mechanism in Japan for filling the risk gaps created for entrepreneurs who must make deals with VCs that lack a readily available reputation.[90]

The competing legal systems also play an important role in creating the different attitude toward stock majority observed by entrepreneurs in both countries. Japanese corporate law is based on the shareholder choice doctrine, while American corporate law is based on the management choice doctrine.[91] In Japan, shareholder meetings are used as a tool to decide almost all issues faced by the company. This includes charter amendments, regardless of whether the board of directors cooperates.[92] In addition to this, there was no class voting system in

[87] There are several possible reasons for such unfriendly tax treatment of sweat equity by the Japanese tax agency. *See* Shishido, *supra* note 74; 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); Tatsuaki Kitachi, Masahiko Kitazume & Yoshichika Matsushita, *Zeimu jou no Ronten* [*Tax Issues*], in BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 366, 375.

[88] *See* Black & Gilson, *supra* note 1, at 243; Milhaupt, *supra* note 3, at 897.

[89] *See* Black & Gilson, *supra* note 1, at 243.

[90] For more on the significance of the reputational market, see Appendix.

[91] *See infra* notes 101-103 and accompanying text.

[92] Corporate Code § 295. *See* KENJIRO EGASHIRA, KABUSHIKI-KAISHA HO [LAWS OF STOCK CORPORATIONS] 294 (3d ed. 2009). Under Delaware law, only the election of directors and amendment of the bylaws do not require board approval before shareholder meetings decide. *See* STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 54 (2008).

Japan until 2001. Even after preferred stock was deregulated and class voting became available, class voting has remained rare, even within companies that have issued preferred stock.[93] That means, in most venture companies in Japan, directors can only be elected by the shareholders as a whole. Clearly, stock majority plays a very important role, enough to have Japanese entrepreneurs insist on maintaining stock majority.

B. Control via Board

The second way VCs can obtain control is by gaining a board majority.[94] Again, this is not the case in Japan. Japanese VCs almost never gain or even attempt to gain board control. In many instances they agree to have no board seat at all, preferring instead to send observers to the board.[95] Observation rights allow the VCs to keep an eye on the workings of the board while maintaining a liability buffer. They can also be used to help VCs make determinations on whether or not to make use of a "stock buy-back" clause imbedded in the venture agreement.[96]

Simply put, Japanese VCs make conscious decisions not to control a company's board because the perceived benefit does not outweigh the perceived liability of directorship in Japan. The modern Japanese legal system is ambiguous in regards to negligent directors. Some courts having found liability to third-parties (i.e. creditors) for negligence of supervision at a bar far lower than that seen in the US.[97]

1. Smaller Benefit

As pointed out, board control is less important in Japan than in the US. Shareholder meetings are used in Japan, where, board meetings are typically more influential in the United States.[98] Furthermore, VCs choose to avoid investing through preferred stock in most cases.[99] Accordingly, the VCs are less worried about bad behavior by common shareholders because of the lower risk of conflicts of interest arising.[100]

Interestingly, when looking at the role of the board, Japanese law is less regulatory than American law. Merely a result of the fact that Japanese law is based on the shareholder choice doctrine, whereas American law

---

[93] The infrequent use of class voting is probably due to the strict legal rule which abolishes class voting arrangements altogether if shareholders cannot elect the required number of directors through a class vote. *See* Hajime Tanahashi, *Shurui-kabushiki no Tsukaikata* [*Ways of Using Different Types of Stocks*] *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 290.

[94] *See* Kaplan & Stromberg, *supra* note 10, at 290.

[95] Presentation by Tatsuhiro Takahara (Partner, TMI Law Firm) at Venture Law Forum on April 7, 2008; Tatsuhiro Takahara, *Torishimariyaku no Sennin Kengen no Bunpai to Torishimariyaku no Sekinin* [*Sharing Directors' Electing Rights and Directors' Liability*], i*n* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 405, 406.

[96] *See infra* note 124 and accompanying text.

[97] *In re* Maruzen Inc., 27-5 Minshu 655 (Sup. Ct., May 22, 1973).

[98] *See* Bainbridge, supra note 92, at 53; Fried & Ganor, *supra* note 53, at 976.

[99] *See* Hasegawa, *supra* note 26, at 64.

[100] *See* Fried & Ganor, *supra* note 57, at 977.

is based on the management choice doctrine.[101]

In the US, several business decisions must be made by the board and even amendment to bylaws can not grant the shareholders such decision making powers. The board manages the business and affairs of the company, initiates charter amendments, and completes fundamental transactions, such as mergers, IPOs and liquidations. Shareholders, on the other hand, usually can not initiate fundamental transactions even when their approval is required to effectuate the transaction.[102] In Japan, shareholder meetings are the tool used to make decisions in areas including dividends and executive compensation - issues outside of the control of shareholders in the US. Shareholders can even initiate charter amendments and mergers.[103] Not only Japanese but also US corporate law allows the shareholders to decide almost everything, as long as the charter so provides. It is difficult to imagine a venture company which has such provisions in its charter because venture companies generally see themselves as future public companies. The default rules are hard to deviate from and are usually influential to the incentive of the parties.

This analysis shows a clear difference in the levels of importance granted to the board in the two countries.

2. Higher Costs

The risk to Japanese VCs does not require board control, but is incurred if even a single board member is sent.

There is no significant difference in director liability to the company between the two countries under the current legal system. Companies can set a cap on liability for outside directors through provisions in the articles of incorporation.[104] D&O insurance will cover most costs incurred if liability is found, unless there is gross negligence. The shareholder derivative action systems are not exactly the same but are more similar than not.

There is one important difference when considering venture capital directors in particular. The problem is that in venture capital backed firms, there are many conflicting interest situations among shareholders. Most conspicuous of these conflict existing between the entrepreneur and venture capitalists. Issues arise when both sides meet to discuss and eventually determine important factors including company valuation, decision to sell the venture, liquidations, mergers, and so on. The question becomes whether venture capital directors can use their voice to cast a vote that favors the venture capital interest without violating the

---

[101] *See* Bainbridge, *supra* note 92, at 53; MITSUHIRO FUKAO, FINANCIAL INTEGRATION, CORPORATE GOVERNANCE, AND THE PERFORMANCE OF MULTINATIONAL COMPANIES 4 (1995); Shishido, *supra* note 23, at 198.

[102] DEL. CODE ANN. Tit. 8, § 141(a) (2001); CAL. CORP. CODE § 3000(a) (West 1990); Revised Model Bus. Corp. Act § 8.01 (1984). *See* Fried & Ganor, *supra* note 57, at 976.

[103] Corporate Code §§ 295, 466, 783.

[104] *See supra* notes 33-34 and accompanying text.

fiduciary duties attendant to their directorship positions within one of their fund's portfolio firms.

Japanese written law plainly states that directors have fiduciary duties to the company and requires directors elected by class-voting to be loyal to the company, not to their electing body.[105] Some Japanese lawyers may be concerned about the possible fiduciary duty violation by their venture capitalist clients, who inevitably have conflicting interests, and courts may recognize their gross negligence, although there has been no such legal case so far.[106]

In answer to this problem, Delaware courts have adopted a "control-contingent" approach to fiduciary duties.[107] When venture capitalists control the board, they are not required to serve the interests of common shareholders, and may act to reduce the value of the common stock. This precedent provides the parties with an additional economic incentive to give venture capitalists board control.[108] Other than for tax reasons, using preferred stock allows venture capitalists that invest in Delaware corporations, the ability to mostly avoid fiduciary duty litigations even when venture capital directors clearly pursue venture capitalist interests.

The bigger difference between US and Japanese law exists when considering the potential for liability to third parties, i.e. creditors.

Japanese written law dictates that directors are liable for damages to a third party which are caused as a result of their gross negligence in the course of executing their duty to the company.[109] Actually, there are many cases in which directors have been ordered to pay damages of creditors - particularly in bankruptcy cases - for reasons including insufficient oversight.[110] There is no such law or precedent in the US, and only in the case of fraud to creditors, will a director face the possibility of being held personally liable.[111] Because of this corporate law statute and its case law, it continues to be a risky venture to take on a directorship at a start-up company, which generally has a higher risk of bankruptcy and thus potential liability claims by third party creditors.

C. Control via Staged Financing

105 Corporate Code § 355.

106 *See* Takahara, *supra* note 26, at 408.

107 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 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 57, 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).

108 Fried & Ganor, *supra* note 57, at 993.

109 Corporate Code § 429.

110 *See* EGASHIRA *supra* note 92, at 464.

111 *But see*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Comme'ns Corp., No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). *See* Fried & Ganor, *supra* note 57, at 978.

Many commentators have pointed out that the most significant scheme by which VCs gain substantial control in Silicon Valley is through staged financing.[112] Japanese VCs use this staged financing method far less frequently than the US where it is all but omnipresent for successful early stage start-ups.[113] From analysis of the table below, two characteristics of Japanese venture capital investments can be observed (*see* Table 4).

Table 4: Various Methods of Venture Investment

	1 (negative)	2 (rather negative)	3 (neutral)	4 (rather positive)	5 (positive)
Do you make syndicated loans with other VCs?	22%	7%	12%	39%	20%
Do you make staged financing by setting milestones?	23%	19%	14%	29%	14%
Are there systems to pay performance bonuses to individual VCs?	52%	3%	4%	12%	29%

(Hasegawa, *supra* note 25, at 81)

1. Reasons for Less Staged Financing in Japan

First, the rate of continuous investments over different rounds by the same VC is much lower in Japan than in the US.[114] Bank-affiliated VCs and securities firm-affiliated VCs make one-shot portfolio investments in most cases, although a small numbers of independent venture capitalists try to take advantage of staged financing when dealing with their hands-on investments.[115] This typical Japanese practice gives entrepreneurs little to no incentive to follow the potentially beneficial directions of a VC.

Second, syndicate financing organized by a lead investor is not the standard in Japan. instead,

[112] *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 139 (1999).

[113] *See* Tatsuaki Takahara, *Dankaiteki Toshi* [*Staged Financing*], in BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 422, 424.

[114] *See* HASEGAWA, *supra* note 26, at 129; See also Kenta Funaoka, Shinki Kokai-ji no Bencha Kyapitaru no Yakuwari (The Role of Venture Capitals at IPO) 41 (2007). The statistics gathered for this publication show that of the 165 start-up companies questioned, 119 appear to have only received one round of venture capital backed financing prior to reaching IPO (data gathered from 2000-2005).

[115] 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.

multiple VCs will make portfolio investments during the same round, with little cooperation or communication between the different VCs (*see again* Table 4 above).[116] Each VC makes a different investment contract with the start-up company. This practice gives entrepreneurs substantial bargaining power in the deal because they can often make VCs compete against one another. Statistics show that more venture capitalists in the same round lead to overall lower IRR in Japan, which is opposite the case of the US.[117]

2. The Corporate Governance Problems of Venture Capital Funds

Why do these practices continue in Japan, even where shown to be hostile to the venture capital industry? Mainly because of the many corporate governance problems evident within the venture capital funds themselves. First, most venture capitalists have no equity incentive.[118] As mention previously, many of them are "salary-men," such as bank and insurance company employees. Second, most VC fund investors are not genuinely equity-oriented. They are generally either the VC companies' parent financial institutions, or business firms, which are often their cross-shareholding partner companies. They do not care about the financial return of funds as much as American Investors to VCs do.[119] Moreover, the share of capital being invested by pension funds' is still negligible.[120] As a result, low IRR funds can and do survive.[121] Third, this type of venture capitalists has no incentive to follow up with a specific start-up company or organize a syndicate with other venture capitalists to increase the size of the round. It is safer for them to make many portfolio investments to minimize risk and avoid involvement with potential competitors. And fourth, the small size of VC funds in Japan reinforces this risk-averse portfolio investment policy.[122]

D. Control via Agreement

Even Japanese VCs 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 as well as acquiring

---

116 *See id.*, at 65, 105, 132.

117 *See id.*, at 92.

118 *See id.*, at 65.

119 *See id.*, at 75. A 2007 METI study indicates that 60.2% of Japanese venture capital investments were financial institution-affiliated, while independent VCs only made up 12.9% of investments; in contrast, independent VCs made 83.9% of all venture capital investments, while financial institution-affiliated investments accounted for only 8.8% of total investments made in the United States. METI, *supra* note 19, at 61.

120 *See* HASEGAWA *supra* note 26, at 57; METI, *supra* note 19, at 65. Kneller reports that although private pension funds have been free to invest in ventures since 1999, the percentage of pension assets invested in pre-IPO ventures in Japan is only a small fraction of pension assets invested in the United States. KNELLER, *supra* note 47, at 171. According to the Venture Enterprise Center (VEC), pension funds' share was only 1.5% in fiscal year 2008.

121 The average IRR of Japanese VCs is much lower than that of American and Europe counterparts. *See* METI, *supra* note 19, at 63.

122 Average accumulated investment per fund is 16.8 million dollars for government backed VC funds, 13.1 million dollars for securities firm backed VC funds, 13.4 million dollars for insurance company backed VC funds, 7.9 million dollars for independent VC funds, 6.6 million dollars for business company backed VC funds, 6.2 million dollars for foreign VC funds, and only 1.8 million dollars for bank backed VC funds. *See* Hirokazu Hasegawa, *Bencha Kyapital no Genjo* [*The Current Situation of Venture Capital*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 64, 72.

some type of observation rights.

These shareholder agreements consist of two parts. The first part consists of a preliminary consultation agreement in which entrepreneurs agree to consult with VCs before the board decides certain subjects, including business judgment matters in many cases.[123] The second part is a stock buy-back agreement, a promise by the entrepreneurs to buy back the VCs' stock at cost, personally in cases of breach of the shareholder agreements, and, in some cases, if no IPO occurs within a certain time period.[124] VCs do not necessarily intend to monitor the entrepreneurs they support, but intend to avoid downside risk, an act similar to that taken by most Japanese banks.[125] The ubiquity of this contractual practice is one of the reasons why Japanese venture capitalists are not trusted by entrepreneurs.

Conclusions

There seems to be a relentless cycle involved in the Japanese venture capital market. Although venture capitalists gain some informal control, they can not gain enough control to reduce the risk of venture investments. Therefore, venture capitalists are unable to invest larger sums of money in a single start-up. Instead, they are forced to spread their risks by investing small amounts in many companies, acting more like a bank.

Entrepreneurs are not willing to forego formal control because they do not trust venture capitalists and find it difficult to find third-party references for reassurance. This may simply be because the venture community in Japan has not yet matured enough to organize into a Silicon Valley-type reputational market. Also, entrepreneurs do not have sufficient cash-flow incentive to cause them to abandon control, partly because the tax law is prohibitively restrictive when it comes to the use of sweat equity. This persistent problem limits the overall availability of financing for Japanese venture companies, leading both entrepreneurs and venture capitalists to accept a reality where smaller successes have become to expected norm.

In Silicon Valley, the two-sided agency problem has been solved by making entrepreneurs cede control to VCs. Why is this resolution not applicable to Japan? The reasons why Japanese entrepreneurs refuse to cede control are complementary to one another.

Black & Gilson's logic does not explain the Japanese situation because their proposition requires the

---

[123] Among the subjects of preliminary consultation, there are not only shareholders meeting matters and board meeting matters, but also often include an annual business plan and an annual budget plan. *See* Takahara, *supra* note 26, at 415.

[124] *See* Takahara, *supra* note 26, at 415. According to research by METI, 70% investment contracts include such a stock buy-back agreement, while 7% of them were actually executed. *See* METI, *supra* note 19, at 93, 95.

[125] Such a practice elucidates the bank-centered capital market influence. Japanese venture capitalists can trace this practice to similar practices by "main banks". Another possible reason for this practice is different tax treatment of the "living dead." In the United States, investors can deduct certain investments if the portfolio company is doubtful as a going concern. Investors have to actually sell the stock for deduction in Japan. *See* Miner & Sato, *supra* note 27, at 129; METI, *supra* note 19, at 57.

existence of a Berle & Means world, which is lacking in the Japanese stock market. In Japan, stock ownership of publicly held corporations has traditionally been stabilized by bank centered cross shareholding.[126] Likewise, Hellmann's logic does not explain the Japanese situation because his propositions requires economically reasonable entrepreneurs and sweat equity as a complement to abandoning control, which do not exist in Japan.

Although the situation is due in part to the unique culture, capital market, and reputational market present in Japan, the legal system clearly plays an important role as well. Japanese corporate law is based on the shareholder choice doctrine and stock majority is more important than in the United States. This results in Japanese entrepreneurs that are very insistent upon maintaining stock majority of their companies. Board majority is less important in Japan and directorship entails a sufficiently high risk of liability to dissuade VCs from taking board positions. Therefore, the system does not provide a strong enough incentive to gain board control and so VCs are often averse to it. Moreover, Japanese tax law is unfriendly to the use of equity as an incentive. Sharing cash-flow rights cannot be complementary to sharing control because of the possible gift tax on sweat equity. The combination of these factors leads Japanese entrepreneurs to desire to maintain control of their venture-backed start-ups.

Appendix:

Double Moral Hazard and the Incentive Bargain

The incentives at play in the venture company context are ripe for game theoretic analysis. The ultimate objective for the parties involved in venture capital investments is to try and 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 can be descriptively called the "risk of squeeze-out." The other type of risk concerns the reliability of the promises to cooperate with each other, or the "risk of uncooperative behavior." Within a 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 its own interest, a party must not only reduce the risk it faces, but also reduce the risk the other party faces in order to induce cooperative behavior.

Figure 1 (shown below) maps out these incentive effects. For discussion purposes, imagine a venture company, in which *A (venture capitalist)* and *B (entrepreneur)* are the parties. The interaction begins by using the mechanisms that 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* will invest optimally in the joint enterprise (notice that only at 100% ownership is *A*'s incentive

[126] Recently, banks have unwound their cross-shareholding positions, but cross-shareholding still remains common among business companies. *See* Hideaki Miyajima and Fumiaki Kuroki, *The Unwinding of Cross-shareholding in Japan: Causes, Effects, and Implications*, in CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY (Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima eds., 2007).

perfectly optimal). Control sharing involves giving *A* rights within the organization that can be used to limit *B*'s actions. One notable example is the use of defensive monitoring contracts.[127] These can be structured so that *A* will have information rights that help *A* make sure *B* does 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 make sure it shares in the profits of the venture at parity with *B*.

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 incentivize to 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 occurs because the other party faces the risk of being squeezed out of the joint project at a later time if it does not behave cooperatively. In this way, the risk of squeeze-out monitors the promise to cooperate.

A minority shareholding party always faces a risk of squeeze-out by the controller. A minority shareholding party also faces the risk of uncooperative behavior by the controller. This combination understandably leads to underinvestment by minority parties.

The majority party that 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 still be expected to under-invest in the venture. Thus, the asymmetry affecting this equilibrium is that when a majority party has an absolute right to squeeze out a minority, the majority party will have optimal investment incentives but the minority party will under-invest.

Methods to decrease these risks are limited to activities like equity sharing, board sharing, monitoring contracts, reputation, bargaining power, and contingent contracts.[128] 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.

---

[127] 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*.

[128] Contingent contracts, accompanied by 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, some issues can not be resolved through contingent contracts.

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

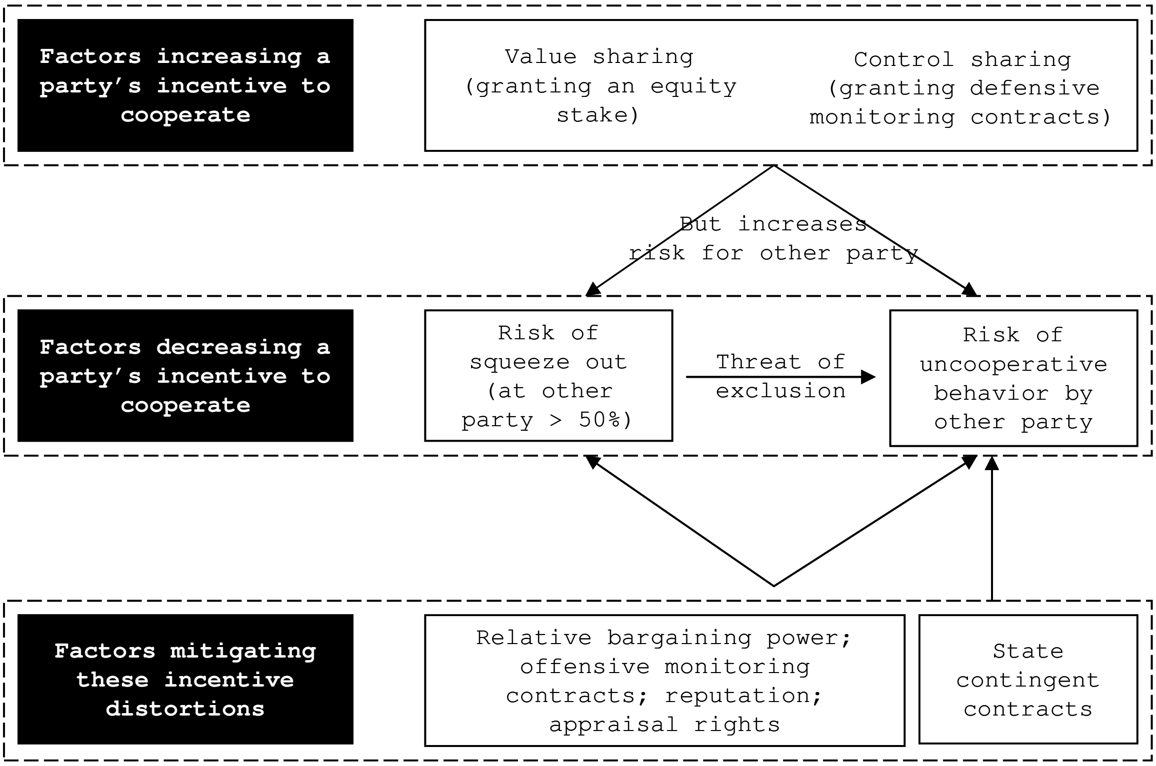
If neither party enjoys a sterling reputation nor operates in an industry where reputation is particularly important, then neither party can be expected to make significant investments based upon reliance on the other party's reputation. How effectively the reputational mechanism works depends on the reputational market. A reputational market is an integral infrastructure of the incentive bargain.

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 essentially be forced to rely only on bargained-for contractual rights and votes attached to equity investments. This is the reason why venture capitalists invest using staged financing. If venture capitalists made their investment all at once, they would loose significant bargaining power against entrepreneurs. Although in most cases the relative bargaining power of the parties is apparent, venture capitalists can gain additional bargaining power through staged financing arrangements, even without 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
Value sharing (granting an equity stake)
Control sharing (granting defensive monitoring contracts)
But increases risk for other party
Factors decreasing a party's incentive to cooperate
Risk of squeeze out (at other party > 50%)
Threat of exclusion
Risk of uncooperative behavior by other party
Factors mitigating these incentive distortions
Relative bargaining power; offensive monitoring contracts; reputation; appraisal rights
State contingent contracts