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Does Law Matter to Financial Capitalism? The Case of Japanese Entrepreneurs

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ARTICLE

DOES LAW MATTER TO FINANCIAL CAPITALISM?

THE CASE OF JAPANESE ENTREPRENEURS

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INTRODUCTION

Over a decade 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. Early 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 US entrepreneurs abandon control of their companies while

Japanese entrepreneurs do not. Years ago, Bernard Black and Ronald Gilson tried to explain the difference by pointing to the lack of liquid initial public offering ("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 ("VCs")—that agree to invest in the creation of a venture company. If one party bears 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 is 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 in that both parties seek 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

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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. *See* 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 *infra* Appendix for a more comprehensive description of the incentive bargain. *See also* Zenichi Shishido, *The Incentive Bargain of the Firm and Enterprise Law: A Nexus of Contracts, Markets, and Laws, in* ENTERPRISE LAW: CONTRACTS, MARKETS, AND LAWS IN THE U.S. AND JAPAN (Zenichi Shishido ed., forthcoming).

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

There have, however, been remarkable changes in the Japanese venture capital industry in the 2000s. 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 nonprofit organizations ("NPOs") interested in helping entrepreneurs were established 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 and Gilson explain 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;

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6. *See infra* notes 68–74 and accompanying text; Zenichi Shishido, *The Law and Practice of the Venture Industry in Japan: A Period of Transition, in* THE JAPANESE LEGAL SYSTEM: AN ERA OF TRANSITION 193, 194 (Tom Ginsburg & Harry N. Scheiber eds., 2012).

7. *See infra* note 79.

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

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

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 are higher in Japan than in the United States. 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

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10. *See* Steven N. Kaplan & Per Strömberg, *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.

12. *See infra* notes 105–112 and accompanying text.

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 this gives entrepreneurs a reason to believe that 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 US counterparts. Yet, they fail to provide conditions sufficient to entice entrepreneurs to either abandon control or 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, this Article focuses on the 2000s, 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 VCs is not a matter of course, and further reviews the different explanations given by Black and 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.

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13. In syndicate financing, a lead venture capitalist ("VC") heads the group of VCs participating in the same round, under the same contract.

14. *See infra* notes 119–23 and accompanying text.

15. *See infra* notes 124–26 and accompanying text.

I. *CHANGES IN THE JAPANESE VENTURE CAPITAL INDUSTRY IN THE 21ST CENTURY*

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. Japan Exchange Group was established

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 310 (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 (Oct. 30–Nov. 1, 2008) (unpublished working paper) (on file with Colmubia University School of Law).

as a result of the business combination between the Tokyo and Osaka stock exchanges in January 2013. In July of the same year, the Japan Exchange Group moved the JASDAQ market to the Tokyo Stock Exchange as part of the above integration of stock exchanges.

Now, there are several IPO markets for emerging growth companies in Japan, which are competing against each other for new public listings.[18] 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 in the 2000s as well. Although these 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

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18. Mothers: *Criteria for Listing (Mothers)*, TOKYO STOCK EXCHANGE, http://www.tse.or.jp/english/rules/listcriteria/index_mo.html (last visited May 16, 2014); JASDAQ: *Criteria for Listing (JASDAQ)*, TOKYO STOCK EXCHANGE, http://www.tse.or.jp/english/rules/listcriteria/index_jq.html (last visited May 16, 2014); Centrex: NAGOYA STOCK EXCHANGE, http://www.nse.or.jp/system/centrex/ (last visited May 16, 2014); Ambitious: SAPPORO SECURITIES EXCHANGE, http://www.sse.or.jp/sinki/ambi.html (last visited May 16, 2014); Q-Board: FUKUOKA STOCK EXCHANGE, http://www.fse.or.jp/index.html (last visited May 16, 2014); TOKYO PRO Market: TOKYO STOCK EXCHANGE, http://www.tse.or.jp/english/rules/promarket/ (last visited May 16, 2014).

19. *See* Osaki, *supra* note 17, at 9; Ministry of Econ., Trade, & Indus. [METI], Study Group for the Creation and Development of Start-ups Final Report 73 (Apr. 30, 2008), http://www.meti.go.jp/english/report/data/Startups_Finalreport.pdf.

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

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 rights 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 US 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]

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21. Interview with Steve Domenik, Partner, Sevin Rosen Funds, Tokyo, Japan (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 et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

25. *See* Kaplan & Strömberg, *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

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

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

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 an 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.[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

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VENTURE COMPANIES IN JAPAN] 414 (Zenichi Shishido & Venture Law Forum eds., 2010). The Data in Table 1 is from HASEGAWA, *supra*, at 81.

27. *See* Allen Miner & Kosuke Sato, *Bencha Kigyo Ikusei no tame no Seitaikei* [*Venture Habitat*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 130.

28. Kaisha-ho [Companies Act], Law No. 86 of 2005, arts. 425, 426, 427 (Japan) [hereinafter Companies Act], *translated at* http://www.acga-asia.org/public/files/English%20translation%20of%20Companies%20Act.pdf.

increase in the number of such lawsuits.[29] Prior to the 2001 reform, some court decisions had ordered a number of 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 cannot be agreed to ex ante for non-outside (executive) directors, but can be allowed ex post either by a two-thirds vote of a shareholder meeting or by agreement of the board of directors if so provided in the charter.[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, at most they choose to send observers.[35]

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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, 1721 HANREI JIHO 3 (Osaka Dist. Ct., Sept. 20, 1999); 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 (Del. Ch. 1996), had in the United States.

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

32. *See* Companies Act, *supra* note 28, arts. 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. *See* Companies Act art. 2(xv). Therefore, it should be noted that the meaning of "outside director" is not the same as "independent director" in the United States. The requirements for outside directors are, however, planned to be revised to be closer to US requirements in 2014.

34. *See* Companies Act, *supra* note 28, art. 427.

35. *See infra* note 95 and accompanying text.

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. Over the last decade, 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 United States.[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

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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 [COM. L. REV.] 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. *See* Kenjiro Egashira, *Kaisha-ho Seitei no Rinen to Kaishahosei Minaoshi no Yukue* [*The Philosophy of Legislating the Companies 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 of contract under the legal framework. The Japanese LLC allows for almost perfect freedom of contract. *See* Shishido, *supra* note 36, at 23.

38. John Sasaki, *Shirikonbare niokeru Yusenkabushiki Keiyaku no Hensen* [*Historical Changes in Preferred Stock Contracts in Silicon Valley*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 296.

venture communities have seen gradual development 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

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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. *See* NIPPON ANGELS FORUM, Nippon Angels Forum (Pamphlet) (Apr. 1, 2004) (in Japanese) (on file with author).

41. *See* BUS. VETERANS GROUP, http://www.veteran.jp (last visited May 16, 2014).

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. *See* JAPAN VENTURE CAPITAL ASS'N, http://www.jvca.jp (last visited May 16, 2014).

44. See, for example, 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).

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 United States, it has been vital to the financing of certain biotechnology start-up companies.[48]

There is no doubt that the current situation of Japan's venture industry in 2014 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?*

Even in the United States, entrepreneurs occasionally attempt to keep control from falling into participating VCs' hands. Fifteen years ago, there were serious debates on why entrepreneurs often abandoned their control, particularly in the Silicon Valley model. It is clear that US 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 and 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

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

49. *See infra* notes 115–126 and accompanying text.

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. L. ECON. & ORG. 247, 256 (1994); *see also* Black & Gilson, *supra* note 1, at 258.

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

C. *Why Not in Japan?*

Both the explanation given by Black and 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 to abandon control to VCs.

When Black and Gilson published their Article fifteen years ago, there were no liquid IPO markets and the Silicon Valley

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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.

52. *See* Hellmann, *supra* note 9, at 57.

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 and Gilson's argument that the call option for entrepreneurs could not work in Japan because of the lack of a liquid IPO market and convertible preferred stock 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 fifteen 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 and Silicon Valley practices, it is 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 counterparts, by bargaining for agreements specifying specific control- and value-sharing commitments.[56]

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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).

56. *See infra* Appendix.

1. 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 firm's 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 cannot 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 cannot avoid this type of risk even through gaining control.

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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.*

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 mergers and acquisitions ("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 of deemed liquidation clauses that prove unfavorable to entrepreneurs.[63] Notwithstanding this hesitancy, an M&A deal is an important exit strategy for VCs if an IPO is not achievable. It is also not surprising that when entrepreneurs are against an IPO, it is 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, the 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 deals 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 withdrawal by the entrepreneur, cannot be resolved through VC control.

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.

63. *See* Fried & Ganor, *supra* note 57, at 993. As a typical case of conflict of interests derived from deemed liquidation clauses, see *in re* Trados Incorporated Shareholder Litigation, C.A. No. 1512-VCL (Del. Ch. Aug. 16, 2013).

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 Initial Public Offering ("IPO") and being listed. *See* Zenichi Shishido & Sadakazu Osaki, *Reverse Engineering SOX versus J-SOX: A Lesson in Legislative Policy, in* ENTERPRISE LAW: CONTRACTS, MARKETS, AND LAWS IN THE U.S. AND JAPAN, *supra* note 5.

65. Venture Enter. Ctr., *Survey on Current Status of Investment of Venture Capitals and Other Funds* (Jan. 2010), http://www.vec.or.jp/wordpress/wp-content/files/survey-21j-5.pdf; *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 Enter. Ctr., *supra*.

2. What Types of Risk Do Entrepreneurs Feel?

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 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 US$2.00 per share to the

66. *See* Fried & Ganor, *supra* note 57, at 993. As a typical example of opportunistic behavior by VCs, see Carsanaro v. Bloodhound Technologies, Inc., 2013 WL 1104901 (Del. Ch., Mar. 15, 2013).

67. *See id.* at 994.

68. *See infra* Appendix.

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

venture capitalist, while the price of the common stock issued to the founder was US$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

70. *Id.* at 6-12.

71. *Id.* at 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).

schemes,[73] although the climate looks to be changing and Internal Revenue Service ("IRS") regulations under Internal Revenue Code ("IRC") Section 409A, which became effective as of January 1, 2009, point toward a less lenient taxation trend.[74]

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, however, is not the case in Japan. 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]

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73. The US Internal Revenue Service ("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 id.* at 892, 900; 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 ten times the value of the common stock. *See* Zenichi Shishido, *Sweat Equity as a Gift* (Sho Sato Conference at UC Berkeley Law School) (unpublished working paper, 2009), *available at* 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 infra* 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, *51% Mondai* [*51% Problem*], *in* BENCHA KIGYO NO HOMU ZAIMU SENRYAKU [LAW AND FINANCE OF VENTURE COMPANIES IN JAPAN], *supra* note 26, at 420, 421; Shishido, *supra* note 6, at 197. Data by PRONEXUS.

TABLE 2: Founder Family Shareholding at IPO (average)

	JASDAQ/NEO	Mothers	Hercules, and others
2009	72.1%	58.8%	N/A
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%

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 JPY¥100 million in a venture start-up company on average, which is less than one-tenth of the US 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

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

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]

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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. *See id.* Data in TABLE 3 from Japan Venture Research Monthly Report, January 2009, at 6.

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
Telecom	419	89	287	3,544
Services	280	72	227	3,143
Pharma.	2,989	2,690	623	5,282
All companies	401	72	248	3,165

Company Type	Total pre-IPO market valuation	PER at IPO	Number of VCs investing	VC equity ratio (%)	Years before IPO
Telecom	1,799	25.17	3	14.28	7
Services	2,277	14.33	1	5.32	23
Pharma.	6,372	- 2.31	21	55.79	11
All companies	2,796	12	2	11	17

Some VCs point out that Japanese entrepreneurs generally have small dreams in comparison to their US counterparts.

While US 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 United States compared to Japan.

The second hypothesis is that individual Japanese venture capitalists are risk averse to a point, stifling 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 United States.[85]

2. Reasons for Entrepreneurs' Adherence to Stock Majority in Japan

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

82. See Presentation by Allen Miner (CEO, SunBridge) at Venture Law Forum, *supra* note 42, on September 25, 2007.

83. *See infra* notes 115–123 and accompanying text; *see also* Miner & Sato, *supra* note 27, 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).

thing for them is to keep control of their company.[86] Such behavior looks very much like 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

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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 mergers and acquisitions ("M&A") market in Japan. *See* 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.

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. After serious negotiations between the Ministry of Economy, Trade and Industry ("METI") and the National Tax Agency, in October 2011, a footnote was included on the website of METI that states, in effect, that the exercise of a qualified stock option for common stock could be based on the value of the company's common stock and need not be based on the price of preferred stock issued before the stock option. It is a small but significant step toward the establishment of the practice of issuing sweat equity in Japan. *See* Shishido, *supra* note 6, at 201.

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

capital market situation as a whole. In Japan, stock ownership of publicly held corporations has been stabilized through bank-centered cross shareholding. Black and Gilson presume the existence of a Berle and 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 attitudes 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 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

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

90. For more on the significance of the reputational market, see *infra* Appendix.

91. *See infra* notes 101–103 and accompanying text; *see also* Shishido, *supra* note 6, at 199.

92. Companies Act, *supra* note 28, art. 295; *see also* KENJIRO EGASHIRA, KABUSHIKI-KAISHA HO [LAWS OF STOCK CORPORATIONS] 296–97 (4th ed. 2011). 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).

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* Companies Act, *supra* note 28, art. 112; *see also* 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.

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 have found liability to third-parties (i.e. creditors) for negligence of supervision at a bar far lower than that seen in the United States.[97]

1. Smaller Benefit

As pointed out, board control is less important in Japan than in the United States. 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

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94. *See* Kaplan & Strömberg, *supra* note 10, at 290.

95. See Presentation by Tatsuhiro Takahara (Partner, TMI Law Firm) at Venture Law Forum, *supra* note 42, on April 7, 2008; *see also* Takahara, *supra* note 26, at 405, 406.

96. *See infra* note 124–125 and accompanying text.

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

98. *See generally* BAINBRIDGE, *supra* note 92, at 53; Fried & Ganor, *supra* note 57, at 976.

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

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 US law. This is merely a result of the fact that Japanese law is based on the shareholder choice doctrine, whereas US law is based on the management choice doctrine.[101]

In the United States, several business decisions must be made by the board and even amendment to bylaws cannot grant the shareholders such decision making powers. The board manages the business and affairs of the company, initiates charter amendments, and fundamental transactions, such as mergers, IPOs and liquidations. Shareholders, on the other hand, usually cannot 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 United States. Shareholders can even initiate charter amendments.[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, however, 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.

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

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; Shishido, *supra* note 6, at 199.

103. Companies Act, *supra* note 28, art. 295, 466.

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] Director and Officer ("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 the conflicts are those 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 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 once adopted a "control-contingent" approach to fiduciary duties.[107] This

104. *See supra* notes 33–34 and accompanying text.

105. Companies Act, *supra* note 28, art. 355.

106. *See* Takahara, *supra* note 78, at 408; Shishido, *supra* note 6, at 200.

107. Fried & Ganor summarized the case law as follows: "[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* generally 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).

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. However, it appears that recent Delaware cases changed this precedent and the situation is now unclear.[109]

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 that are caused as a result of their gross negligence in the course of executing their duty to the company.[110] 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.[111] There is no such law or precedent in the United States, and only in the case of fraud to creditors, will a director face the possibility of being held personally liable.[112] 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*

Many commentators have pointed out that the most significant scheme by which VCs gain substantial control in

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

109. *In re* Trados Incorporated Shareholder Litigation, C.A. No. 1512-VCL, slip op. at 35–36, 42 n.16 (Del. Ch. Aug. 16, 2013) (denying the control-contingent approach in a footnote).

110. Companies Act, *supra* note 28, art. 429; *see* Shishido, *supra* note 6, at 200.

111. *See* EGASHIRA *supra* note 92, at 469–76.

112. *See generally* JAMES D. COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW 236 (3d ed. 2011) (debating over whether directors owe a duty to creditors in the case of insolvency or near insolvency); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 WL 277613 (Del. Ch. 1991) (deciding there is no claim by creditors in the zone of insolvency and no direct claim (but a possible derivative claim) by creditors in insolvency); *see* N. Am. Catholic Educ. Programming Fdn., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Silicon Valley is through staged financing.[113] Japanese VCs use this staged financing method far less frequently than in the United States, where it is all but omnipresent for successful early stage start-ups.[114] 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%

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 United States.[115] Bank-affiliated VCs and securities

113. *See, e.g.,* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 171 (2d ed. 2004).

114. *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. The Data in TABLE 4 is from HASEGAWA, *supra* note 26, at 81.

115. *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

firm-affiliated VCs make one-shot portfolio investments in most cases, although small numbers of independent venture capitalists try to take advantage of staged financing when dealing with their hands-on investments.[116] 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, multiple VCs will make portfolio investments during the same round, with little cooperation or communication between the different VCs (*see* TABLE 4 above).[117] 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 internal rate of return ("IRR") in Japan, which is opposite the case of the United States.[118]

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.[119] As mentioned 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.

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 to 2005).

116. 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* HASEGAWA, *supra* note 26, at 51.

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

118. *See id.* at 92.

119. *See id.* at 65; Shishido, *supra* note 6, at 197.

They do not care about the financial return of funds as much as US Investors to VCs do.[120] Moreover, the share of capital being invested by pension funds' is still negligible.[121] As a result, low IRR funds can and do survive.[122] Third, this type of venture capitalist 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.[123]

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 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

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120. *See* HASEGAWA, *supra* note 26, 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.

121. *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.

122. The average IRR of Japanese VCs is much lower than that of their US and European counterparts. *See* METI, *supra* note 19, at 63.

123 . Average accumulated investment per fund is US$16.8 million for government backed VC funds, US$13.1 million for securities firm backed VC funds, US$13.4 million for insurance company backed VC funds, US$7.9 million for independent VC funds, US$6.6 million for business company backed VC funds, US$6.2 million for foreign VC funds, and only US$1.8 million for bank backed VC funds. *See* Hasegawa, *supra* note 77, at 64, 72.

many cases.[124] 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.[125] 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.[126] The ubiquity of this contractual practice is one of the reasons why Japanese venture capitalists are not trusted by entrepreneurs.

CONCLUSION

There seems to be a relentless cycle involved in the Japanese venture capital market. Although venture capitalists gain some informal control, they cannot 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

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124. Among the subjects of preliminary consultation, there are not only shareholder's meeting matters and board meeting matters, but also often include an annual business plan and an annual budget plan. *See* Takahara, *supra* note 78, at 415.

125. *See id.* According to research by METI, 70% of investment contracts include such a stock buy-back agreement, while 7% of them were actually executed. *See* METI, *supra* note 19, at 93, 95–96.

126. 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 "zombie corporation." 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 deductions in Japan. *See* Miner & Sato, *supra* note 27, at 129; METI, *supra* note 19, at 57–58.

availability of financing for Japanese venture companies, leading both entrepreneurs and venture capitalists to accept a reality where smaller successes have become the 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 and Gilson's logic does not explain the Japanese situation because their proposition requires the existence of a Berle and Means world where management can maintain control based on dispersed ownership of the stock, 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.[127] Likewise, Hellmann's logic does not explain the Japanese situation because his propositions require 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

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127. Recently, banks have unwound their cross-shareholding positions, but cross-shareholding still remains common among business companies. *See generally* Hideaki Miyajima & Fumiaki Kuroki, *The Unwinding of Cross-shareholding in Japan: Causes, Effects, and Implications*, *in* CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 72 (Masahiko Aoki et al. eds., 2007).

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 one hundred percent 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 the use of defensive monitoring contracts.[128] These can be structured so that *A* will have information rights that help *A* make sure *B* does not extract value from the joint project improperly. Similarly, obtaining board representation or veto rights over certain decisions will

128. 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 *B* to undertake some action. A paradigmatic example would be granting *A* the right to purchase a majority stock position or buy out *B*.

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 incentivized 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.[129] The interplay of

129. Contingent contracts, accompanied by legal enforcement, can decrease the risk of uncooperative behavior. The comprehensiveness of contingent contracts depend 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 cannot be resolved through contingent contracts.

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.

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

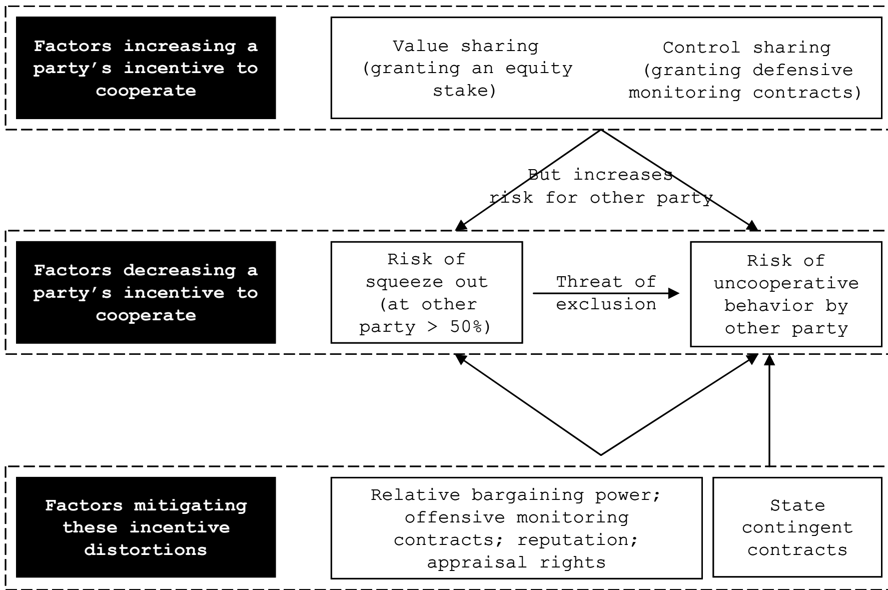
If neither party enjoys a sterling reputation nor operates in an industry where reputation is particularly important, then neither party can be expected to make significant investments based upon reliance on the other party's reputation. How effectively the reputational mechanism works depends on the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