

CONVERTIBLE EQUITY IN THE JAPANESE STARTUP ECOSYSTEM

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ABSTRACT

Convertible equity has become a critical tool for seed-stage startup financings in the United States, and in recent years this type of security has gained increasing importance in the Japanese startup ecosystem as well. However, the legal foundation and structure of convertible equity instruments are markedly different in Japan as compared to the United States. In the U.S., convertible equity is structured as a simple contract between the issuer and the investor, while in Japan it takes the form of a so-called “stock acquisition right,” a formative right detailed in the Companies Act of Japan. This choice of structure has a significant impact on the speed, cost, and complexity of convertible equity financings in Japan.

This article examines the contractual terms and legal framework of the most popular convertible equity instrument in Japan (called the “J-KISS”) and provides a comparative analysis contrasting the J-KISS with the most popular equivalent in the United States (the “Safe”). Through this comparison, this article aims to identify measures for potentially improving the utility of the J-KISS as a financing tool for Japanese startups. In particular, this article identifies several significant procedural disadvantages arising from

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the J-KISS's use of the stock acquisition right structure and concludes that alternative structures merit serious consideration.

KEYWORDS

Japan; venture financing; convertible equity; startups; stock acquisition rights

TABLE OF CONTENTS

1. Introduction.....	197
2. Legal and Commercial Characteristics of the J-KISS.....	199
2.1. <i>General Legal Characteristics of the J-KISS</i>	199
2.2. <i>Japanese Statutory Law Governing SARs</i>	202
2.2.1. <i>Generally</i>	202
2.2.2. <i>Issuance and Approval</i>	202
2.2.3. <i>Commercial Registration</i>	203
2.2.4. <i>Amendments</i>	204
2.2.5. <i>Repurchases</i>	205
2.2.6. <i>Accounting Treatment</i>	206
2.2.7. <i>Other Material Terms</i>	208
2.3. <i>Commercial Terms in the J-KISS Term of Issuance</i>	209
2.3.1. <i>Valuation Cap and Conversion Discount</i>	209
2.3.2. <i>Conversion into Shadow Series</i>	210
2.3.3. <i>Calculation of Fully Diluted Equity</i>	211
2.3.4. <i>Minimum Size Threshold for Next Equity Financing</i>	213
2.4. <i>Other Contractual Terms</i>	214
3. Comparison with the Safe	216
3.1. <i>Provisions Related to Statutory Law for SARs</i>	216
3.2. <i>Other Provisions</i>	218
3.3. <i>Possible Modifications to the J-KISS</i>	219
4. Conclusion	220

1. INTRODUCTION

Convertible equity is an increasingly popular tool for startup seed financing in Japan.¹ Convertible equity is a type of security, created by American lawyers for use in startup financings, that provides the holder with a right to receive shares of capital stock of the issuing corporation (determined based on the amount invested and a possible discount and valuation cap) at the time those shares of capital stock are issued in a future financing round.² In the United States, the most commonly used convertible equity instrument is the “simple agreement for future equity” (the “Safe”), which was initially published by the startup accelerator Y Combinator in 2013 and has undergone several updates since then.³ In Japan, the most frequently used convertible equity instrument is modeled not after the Safe but instead after 500 Startups’ “Keep It Simple Security” (the “KISS”). The KISS was published in 2014 to serve a role similar to that of the Safe for 500 Startups’ American portfolio companies, but the instrument is used in the broader U.S. market significantly less frequently than the Safe.⁴ The KISS’s use in Japan is due largely to 500 Startups’ expansion into Japan and efforts to create and promote a Japanese version of the KISS beginning in 2016.⁵ In Japan, 500 Startups call their new convertible equity security the “J-KISS.”

¹ See VENTURE ENTERPRISE CENTER, JAPAN, VEC Y.B. 2020 II-10 (2021). The responses to a survey by the Venture Enterprise Center of Japan show that during fiscal year 2020, the number of startup financings using a method other than capital shares and convertible bonds increased approximately eighteen percent compared to the prior year, excluding respondents who declined to specify their financing method. *Id.*

² A. Reid Monroe-Sheridan, *Promoting Legal Innovation in Japanese Startup Financing*, 10 GEO. MASON J. INT’L COM. L. 22, 26–27 (2019).

³ See *id.* at 22, 25 (explaining the factors driving the Safe’s popularity); John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 166 (2014) (describing the origin of the Safe); Carolyn Levy, *Safe Financing Documents*, Y COMBINATOR, <https://www.ycombinator.com/documents> [<https://perma.cc/77NE-6KL9>] (last visited Mar. 7, 2023) (listing various versions of Safe documents for both U.S. and non-U.S. companies).

⁴ See John F. Coyle & Joseph M. Green, *The Safe, the Kiss, and the Note: A Survey of Startup Seed Financing Contracts*, 103 MINN. L. REV. HEADNOTES 42, 54 (2018) (showing data on the percentage of startup lawyers who have encountered a Safe or a KISS by state); Monroe-Sheridan, *supra* note 2, at 25; Gregory Raiten, *500 Startups Announces ‘KISS’*, 500 STARTUPS (July 3, 2014), <https://500.co/kiss> [<https://web.archive.org/web/20140705042636/https://500.co/kiss>].

⁵ Monroe-Sheridan, *supra* note 2, at 49–50; see Yohei Sawayama (澤山陽平), *J-KISS: Dare mo ga Jiyū ni Tsukaeru Shido Shikinchohatsu no Tame no Toshikeiyakusho* (誰もが自由に使えるシード資金調達のための投資契約書) [*The J-KISS: An Investment*

The Safe has been adopted by many startups and investors in the United States; as early as 2018, ninety-three percent of startup lawyers in California and seventy-eight percent of those in New York reported having experience with at least one deal involving a Safe.⁶ As the J-KISS continues to grow in popularity and enjoy increased recognition among market players in Japan, it is gradually coming to assume a role in the Japanese startup ecosystem similar to that of the Safe in the United States.⁷ However, very little has been written about the J-KISS in English, nor is there much formal comparative analysis—in English or Japanese—examining how key differences in the Safe and J-KISS may affect Japanese startups' ability to use the J-KISS effectively.⁸

In addition to the different terms incorporated into the J-KISS and the Safe, the instruments function within very different legal frameworks. The Safe is simply a contract between the issuer and the purchaser, while the J-KISS is an investment contract paired with a “stock acquisition right” (“SAR”), a statutory right governed by the Companies Act of Japan.⁹ The Companies Act includes a number of detailed requirements for SARs which directly impact the procedures investors and startups are required to complete in order to consummate a J-KISS investment and the subsequent conversion of a J-KISS into the issuer's capital stock.¹⁰ As a result of the J-KISS's more complex structure, users of the instrument must comply with various time-consuming formalities that dilute some of the key advantages offered by convertible equity in American startup financings.¹¹ Nevertheless, the increasing popularity of the J-KISS indicates that, despite its complexities, it offers sufficient advantages

Contract Anyone Can Use Freely for Seed Fundraising], CORAL (Apr. 28, 2016), <https://coralcap.co/2016/04/j-kiss> [https://web.archive.org/web/20200507064402/https://coralcap.co/2016/04/j-kiss/] (providing an example of a downloadable J-KISS package).

⁶ Coyle & Green, *supra* note 4, at 54.

⁷ See, e.g., KEIZAI SANGYŌ SHŌ (経済産業省) [MINISTRY OF ECON., TRADE & INDUS.], KONBĀTIBURU TŌSHI SHUDAN KATSUYŌ GAIDORAIN (「コンバーティブル投資手段」活用ガイドライン) [GUIDELINES FOR MAKING USE OF CONVERTIBLE INVESTMENT INSTRUMENTS] 42 (2020) (referencing to the J-KISS as the “Japanese version of the Safe” in an explainer on convertible financing methods for startups).

⁸ See Monroe-Sheridan, *supra* note 2, at 59, 61–62 (comparing the Safe and the J-KISS).

⁹ See *infra* Part 2.1.

¹⁰ *Id.*

¹¹ See *infra* Part 2.2.

over alternative financing methods and remains useful for Japanese startups and investors in a variety of situations.

This article assesses the J-KISS from two perspectives: first, this article examines in detail the Japanese legal framework governing the instrument, with a particular focus on statutory provisions governing SARs; second, this article considers the terms of the J-KISS that are unrelated to the SAR statutory framework and compares the terms to those incorporated into the Safe. Building on this examination and comparison, this article then analyzes how key differences in the J-KISS and the Safe may affect the utility of the J-KISS for Japanese startups. Finally, the conclusion proposes some alternative seed financing practices that could increase the practicality and utility of convertible equity instruments for Japanese startups.

2. LEGAL AND COMMERCIAL CHARACTERISTICS OF THE J-KISS

2.1. General Legal Characteristics of the J-KISS

As described above, the J-KISS is comprised principally of an SAR and an investment contract. The key piece of statutorily required documentation for the SAR is the “terms of issuance” (*hakkō yōkō*).¹² The terms of issuance are required for any SAR pursuant to Article 236 of the Companies Act, which provides a detailed list of terms that must be fixed in connection with the

¹² Yohei Sawayama (澤山陽平), J-KISS 2.0 (Post Cap J-KISS) wo Kōkai Shimashita (J-KISS 2.0 (Post Cap J-KISS) を公開しました) [*We Have Released J-KISS 2.0 (A Post-Cap J-KISS)*], CORAL (Apr. 13, 2022), <https://coralcap.co/2022/04/j-kiss-2> [<https://perma.cc/BS7P-9PDN>] (providing the full set of J-KISS documentation). This documentation includes *PostCap_J-KISS_v2.0_ja.docx* [hereinafter *J-KISS Investment Contract*] and *1-2_besshi1_hakkōyōkō.doc* [hereinafter *J-KISS Terms of Issuance*]. The prior version of the J-KISS is available at Yohei Sawayama (澤山陽平), J-KISS ni yoru Chōtatsu de Hitsuyōna Tetsutzuki Shorui Setto “J-KISS Pakkēji” (J-KISS による調達で必要な手続き書類セット「J-KISS パッケージ」) [*The J-KISS Package: A Set of the Documentation Required for Financing via J-KISS*], CORAL (Apr. 25, 2019), <https://coralcap.co/2019/04/j-kiss-package> [<https://perma.cc/R4UE-8EQB>]. The prior package also includes *wabun]-KISStōshikeiyaku_v1.1clean.doc* [hereinafter *J-KISS 1.0 Investment Contract*] and *1-2_besshi1_hakkōyōkō.doc* [hereinafter *J-KISS 1.0 Terms of Issuance*].

issuance of any SAR.¹³ In addition to some basic terms such as the name of the issuer and the date of issuance, the J-KISS terms of issuance set forth the conversion mechanics of the J-KISS, including events that may trigger a voluntary or involuntary conversion,¹⁴ the valuation cap, the valuation discount, and the precise definitions used to calculate the number of shares of common stock or preferred stock which the holder of the J-KISS will acquire upon conversion of the J-KISS.¹⁵

Separate from the terms of issuance, the investment contract includes the other key business terms for the investment, such as a most-favored nation provision, information and participation rights for major investors, transfer restrictions, the procedure for amendments to the investment contract, and the priority of the J-KISS relative to the issuer's other equity and debt, as well as the representations and warranties of the issuer and the investor.¹⁶ Many of these provisions have analogues in the Safe, though the standard Safe does not include information rights and the representations and warranties in the Safe are more limited.¹⁷ Although key provisions of the J-KISS terms of issuance are also generally analogous to certain terms in the Safe, because the terms of issuance are structured to fulfill statutory requirements, they

¹³ Kaishahō [Companies Act], Law No. 86 of 2005, art. 236 (Japan); *see id.* art. 238 (setting forth the formal approvals necessary for the issuance of an SAR, which includes approval of the detailed terms described in Article 236).

¹⁴ *J-KISS Terms of Issuance*, *supra* note 12, §§ 5(1), 5(3). For clarity and simplicity, this Article refers to both the exercise and repurchase of the J-KISS as a 'conversion' of the J-KISS. Technically, an exercise of the J-KISS is an investment of a nominal amount by the J-KISS holder in exchange for shares of common or classified stock. In contrast, if the holder of the J-KISS fails to exercise the J-KISS when required in connection with a conversion event, the Company effectively converts the J-KISS into the applicable shares of common or classified stock by automatically acquiring the J-KISS in exchange for the shares. *See id.* § 5(6).

¹⁵ *Id.* §§ 1 (regarding issuer name), 4 (regarding issuance date and payment date), 5(5) (regarding conditions for voluntary exercise), 5(6) (regarding conditions for involuntary exercise), 5(2)(a) (regarding valuation cap and discount and certain definitions used in their calculation).

¹⁶ *J-KISS Investment Contract*, *supra* note 12, §§ 5.1 (regarding most-favored nation provision), 5.2 (regarding major investor rights), 5.3 (regarding restrictions on transfer), 5.13 (regarding procedure for amendments), 5.14 (regarding priority of the J-KISS), 3 (regarding issuer's representations and warranties), 4 (regarding investor's representations and warranties).

¹⁷ *See Levy*, *supra* note 3 (providing links to various Safe documentation).

necessarily include additional details that do not directly relate to the agreed terms of the investment.¹⁸

The J-KISS investment contract and the Safe are roughly equivalent in terms of legal status, in that both documents are negotiated corporate contracts with agreed investment terms. If a party fails to comply with its obligations under the contract, in theory the counterparty can bring a breach of contract claim against the non-compliant party. The SAR, however, has a different status under Japanese law. It is a so-called “formative right” (*keiseiken*) because the holder of the SAR can, by exercising the SAR, become a shareholder of the issuer without any cooperation on the part of the issuer.¹⁹ This key legal difference significantly strengthens the position of an investor in the event of a dispute with the issuer. If there is a dispute following an SAR exercise trigger event, rather than threatening an uncooperative issuer with a breach of contract claim, the investor can act unilaterally to make itself a shareholder of the issuer and continue to pursue the dispute as one of the issuer’s shareholders.²⁰ This characteristic of the SAR is particularly important because Japanese corporate law is generally very protective of shareholder rights, at least as compared to U.S. law.²¹ Furthermore, Japanese law requires precise adherence to statutory formalities (some of which are significantly investor-favorable) when an issuer seeks to mandatorily convert the SAR into capital stock in connection with an equity financing or exit event.²² This also strengthens the investor’s position by making it more difficult for the issuer to force the investor to convert its J-KISS into classified stock in an equity financing.

¹⁸ See, e.g., *J-KISS Terms of Issuance*, *supra* note 12, § 9 (noting the allocation to registered corporate capital and capital reserve of the SAR investment amount upon exercise of the SAR). The concepts of registered corporate capital and capital reserve do not have analogues under Delaware law (Delaware corporations are the typical entity and jurisdictional choices for startups seeking venture capital financing). See *Model Legal Documents*, NAT’L VENTURE CAP. ASS’N, <https://nvca.org/model-legal-documents/> [<https://perma.cc/64Y2-EZWR>] (last visited Sept. 16, 2021) (listing many different types of model agreements that state Delaware as the place of incorporation).

¹⁹ EGASHIRA KENJIRO (江頭憲治郎), *KABUSHIKIGAISHAHŌ* (株式会社法) [LAWS OF STOCK CORPORATIONS] 805 (7th ed. 2017) (citing *Kaishahō* [Companies Act], Law No. 86 of 2005, art. 282 (Japan)).

²⁰ *Id.*

²¹ See, e.g., Gen Goto, *Legally “Strong” Shareholders of Japan*, 3 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 125, 129–30 (2014) (analyzing the differences in shareholder rights under Japanese and U.S. law).

²² See *infra* Part 2.2.5.

2.2. Japanese Statutory Law Governing SARs

2.2.1. Generally

Fundamentally, an SAR is “a right for the holder to acquire a certain number of shares of the issuing company during a predetermined period at a predetermined price by paying such price to the issuing company.”²³ Notably, these characteristics are very similar to those of a stock option or warrant. In fact, SARs are precisely the legal mechanism that Japanese companies use to grant stock option-type incentives to employees.²⁴ As discussed above, an SAR is a formative right under Japanese law, meaning that the holder of the SAR has a unilateral right to become a shareholder of the issuer upon exercise of the SAR in accordance with its terms.²⁵

2.2.2. Issuance and Approval

In principle, the issuance of an SAR requires that the issuer’s shareholders pass a special resolution (*tokubetsu ketsugi*) with the consent of the holders of at least two-thirds of the shares entitled to vote on the matter.²⁶ Although this approval threshold can be raised by a provision to that effect in the issuer’s articles of incorporation, it cannot be relaxed to a level lower than two-thirds.²⁷ The specific matters that must be approved by the shareholders include the terms of issuance of the SAR, the number of SARs to be issued, the issuance price (or method of calculating the issuance price) of the SARs, the SAR allotment date (if determined), and the deadline for payment by the party purchasing the SAR.²⁸ Although certain limited determinations can be delegated to the board of directors by

²³ EGASHIRA, *supra* note 19, at 788. All Japanese-language sources have been translated into English by the author unless otherwise noted.

²⁴ TANAKA WATARU (田中亘), KAISHAHŌ (会社法) [CORPORATE LAW] 504 (4th ed. 2018).

²⁵ EGASHIRA, *supra* note 19, at 805.

²⁶ Kaishahō [Companies Act], Law No. 86 of 2005, art. 309(2)(vi) (Japan).

²⁷ *Id.* art. 309(2).

²⁸ EGASHIRA, *supra* note 19, at 795 (citing Kaishahō [Companies Act], Law No. 86 of 2005, arts. 238(1)(1), 246(1), 238(1)(3), 238(1)(4), 238(1)(5) (Japan)).

shareholder resolution,²⁹ given the level of detail incorporated into the SAR terms of issuance and the requirement for approval by two-thirds of the issuer's shareholders, these obligations place a considerable procedural burden on the issuer. Adding to the onerous nature of the issuance process is the requirement that each recipient of an SAR, as well as the number of SARs issued to that recipient, be approved by resolution of the issuer's shareholders.³⁰

The payment obligation requirements applicable to the SAR holder leave little room for error. If the recipient fails to make payment by the SAR's payment deadline, the SAR may not be exercised.³¹ Once the SAR is no longer exercisable, the SAR itself is automatically extinguished by statute.³² This means that the issuer is not able to allow an investor any leeway for delayed payment in the event of a miscommunication or failed wire transfer. Instead, the SAR will need to be reissued—and the issuer will need to complete the onerous issuance procedures once again—if the investor inadvertently misses the payment deadline.

2.2.3. Commercial Registration

Separate from the detailed procedures necessary to issue a valid SAR, the SAR is also subject to a commercial registration obligation.³³ The Japanese commercial registration system has no close analogues under U.S. law.³⁴ To complete this process, the key

²⁹ Kaishahō [Companies Act], Law No. 86 of 2005, art. 239(1) (Japan).

³⁰ *Id.* art. 243(2). Technically this requirement applies to companies that have restrictions on share transfers in their articles of incorporation and in cases where the SARs are subject to transfer restrictions. *Id.* arts. 243(2)(i), 243(2)(ii). It is extremely likely that the issuer would have restrictions on share transfers in its articles of incorporation because doing so offers a number of advantages under the Companies Act, such as allowing the issuer to avoid establishing a board of directors and relaxing certain rules regarding the treatment of shareholders. *Id.* arts. 109(2), 215, 327, 332. This obligation can be delegated to the board of directors for companies that have established a board. *Id.*

³¹ EGASHIRA, *supra* note 19, at 802 (citing Kaishahō [Companies Act], Law No. 86 of 2005, art. 246(3) (Japan)).

³² Kaishahō [Companies Act], Law No. 86 of 2005, art. 287 (Japan).

³³ *Id.* art. 911(3)(xii).

³⁴ See Kaishahō [Companies Act], Law No. 86 of 2005, arts. 911(3)(v), 911(3)(xii) (Japan). In Delaware, the typical jurisdiction of choice for startups seeking venture financing, companies are not required to register with the Secretary of State the issuance of capital stock or convertible equity, whereas the registration of such transactions is required in Japan. See *id.*; PRACTICAL LAW CORPORATE &

terms of the SAR must be registered with the local Legal Affairs Bureau and will become publicly accessible information.³⁵ This registration process not only makes the key financing terms used in the SAR available to the public (typically an undesirable result for both the startup and the investor), it also creates an additional, significant procedural burden for the issuer. For example, as part of the registration process, the issuer must submit to the Legal Affairs Bureau both the original minutes of the shareholder meeting approving the SAR issuance³⁶ and also, typically, a document proving that the recipient of the SAR made payment prior to the payment deadline.³⁷ The commercial registration process must be completed within two weeks of the end of the month in which the SAR was issued.³⁸

2.2.4. Amendments

Amending an SAR requires essentially the same onerous procedures as issuing the SAR in the first place.³⁹ The J-KISS

SECURITIES, STARTUP SEED FINANCING PROCESS: CONVERTIBLE NOTES AND SAFES ¶¶ 2-6 (2023), Westlaw W-000-6519, <https://us.practicallaw.thomsonreuters.com/w-000-6519> [<https://perma.cc/9PMQ-9RK4>] (discussing procedures for a Delaware corporation to authorize capital stock and convertible equity, which do not include public disclosure to the Secretary of State).

³⁵ Monroe-Sheridan, *supra* note 2, at 45–46 (citing Machida Yukihito (町田行人), *Shinkabuyoyakukentsukishasai no Katsuyō ni Tsuite no Ikkōsatsu (jō)* (新株予約権付社債の活用についての一考察 (上)) [*Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part 1 of 2)*], 2139 SHŌJI HŌMU (商事法務) [JAPANESE INST. BUS. L.] 20, 22–23 (2017); Takeuchi Nobuki (竹内信紀) & Ogawa Shūya (小川周哉), *Shōki Raundo ni Okeru Shikin Chōtatsu no Jitsumu to Kadai* (初期ラウンドにおける資金調達の実務と課題) [*Issues and Practice Relating to Initial Fundraising Rounds*], 2087 SHŌJI HŌMU 37, 43 (2015).

³⁶ Shōgyōtōkihō [Commercial Registration Act], Law No. 125 of 1963, art. 46(2) (Japan).

³⁷ *Id.* art. 65(2).

³⁸ Kaishahō [Companies Act], Law No. 86 of 2005, art. 915(3)(i) (Japan).

³⁹ Ijima Takahiro (飯島隆博), *Konbātiburu Ekuiti to Konbātiburu Nōto no Guitaiteki na Sekkei (7) - Tenkankigen* (コンバーティブル・エクイティとコンバーティブル・ノートの具体的な設計 (7) - 転換期限) [*Specific Structuring of Convertible Equity and Convertible Notes (7) - The Conversion Deadline*], BUS. LAWS. (May 11, 2021), <https://www.businesslawyers.jp/practices/1351> [<https://perma.cc/79VN-LBMS>] (citing Ōta Yō (太田洋), YAMAMOTO NORIMITSU (山本憲光) & SHIBATA HIROKO (柴田寛子), *SHINKABUYOYAKUKEN HANDOBUKKA* (新株予約権ハンドブック) [THE STOCK ACQUISITION RIGHT HANDBOOK] 83–4 (4th ed. 2018)).

investment contract includes an undertaking from the investors that they will cooperate in effecting amendments to the J-KISS that are agreed by the issuer and the holders of J-KISSes of the same series amounting to a majority of the total face amount issued in the series, with certain exceptions.⁴⁰ However, this contractual undertaking does not obviate the need for compliance with the underlying statutory SAR framework; in the event that an investor refuses to comply with statutory formalities required to effectuate an agreed amendment to the SAR, the issuer may have grounds for pursuing a breach of contract claim against the refusing investor but would still not be able to effect the amendment of the J-KISS absent the investor's cooperation.⁴¹

2.2.5. Repurchases

The procedures for repurchasing an SAR are particularly important in the context of the J-KISS because the J-KISS relies on a repurchase mechanism to effect automatic conversion of the instrument in the event that the J-KISS holder does not timely exercise its SAR.⁴² Specifically, the J-KISS provides that, if the J-KISS holder has not exercised its J-KISS at least one day prior to the scheduled date for consummation of the next equity financing,⁴³ the issuer will repurchase the J-KISS.⁴⁴ As consideration for the repurchase, the issuer will pay the J-KISS holder the number of shares into which the J-KISS would have converted had the holder exercised it at that time.⁴⁵ This effectively forces conversion of the

⁴⁰ *J-KISS Investment Contract*, *supra* note 13, § 5.13(2).

⁴¹ ŌTA YŌ, (太田洋), YAMAMOTO NORIMITSU (山本憲光) & SHIBATA HIROKO (柴田寛子), *SHINKABUYOYAKUKEN HANDOBUKKA* (新株予約権ハンドブック) [THE STOCK ACQUISITION RIGHT HANDBOOK] 642 (4th ed. 2018).

⁴² *J-KISS Terms of Issuance*, *supra* note 12, § 5(6).

⁴³ *Id.* § 5(2)(a)(x). This is a defined term in the J-KISS (*jikai kabushiki shikin chōtatsu*) referring to financing through one or a series of equity issuances with the purpose of raising capital in excess of a certain threshold).

⁴⁴ *Id.* § 5(6)(a).

⁴⁵ The provisions of the J-KISS do not provide for this explicitly but nonetheless have this effect by setting the repurchase price for the J-KISS to the conversion price (*tenkan kagaku*) that would determine the shares issuable to the J-KISS holder in the next equity financing if the holder were to exercise the J-KISS. See *id.* §§ 5(2)(a), (6)(a) (explaining how the repurchase price for the J-KISS is determined).

SAR as part of the next equity financing if the SAR has not already been exercised.

By statute, any unilateral SAR repurchase right must be specified in the SAR's terms of issuance, including the consideration to be paid in connection with the repurchase.⁴⁶ The provisions for this right are indeed included in the J-KISS's terms of issuance.⁴⁷ In order to repurchase an SAR, the issuer must provide no less than two weeks' notice of the repurchase date to the SAR holder.⁴⁸

Because the issuer must rely on this repurchase mechanism to effect a mandatory conversion of the J-KISS, it is technically impossible for a startup to fully conclude a financing transaction in less than two weeks if the financing requires the startup's J-KISSes to convert and even a single J-KISS investor is unreachable or refuses to cooperate in exercising its J-KISS. The J-KISS terms of issuance further require that the notice of repurchase also include the terms of the classified stock to be issued to the investor as consideration for the purchase of the J-KISS.⁴⁹ Accordingly, because there will necessarily be additional time consumed by negotiations between the new investors and the startup before finalization of all the material terms of the classified stock to be issued in the new investment, it would likely take a startup significantly longer than two weeks to consummate a subsequent equity financing, even after reaching an agreement on key terms, if just one J-KISS holder refuses to cooperate.

2.2.6. Accounting Treatment

Following the issuer's sale of an SAR to a third party, the SAR is recorded on the issuer's balance sheet under a specific line item ("stock acquisition rights"), which is an asset under Japanese accounting rules.⁵⁰ The fact that the J-KISS does not require repayment and is not classified as debt on the balance sheet is a significant advantage in comparison to convertible debt for Japanese

⁴⁶ EGASHIRA, *supra* note 19, at 806 (citing Kaishahō [Companies Act], Law No. 86 of 2005, art. 236(1)(vii) (Japan)).

⁴⁷ *J-KISS Terms of Issuance*, *supra* note 12, § 5(6)(a).

⁴⁸ Kaishahō [Companies Act], Law No. 86 of 2005, art. 273(2) (Japan).

⁴⁹ *J-KISS Terms of Issuance*, *supra* note 12, § 5(6)(b).

⁵⁰ ŌTA, YAMAMOTO & SHIBATA, *supra* note 41.

startups.⁵¹ This is because some companies in Japan view substantial indebtedness as a negative indicator of a startup's financial health, even if the debt is the result of equity-like convertible debt financings, and these conservative businesses may hesitate to enter into transactions with a startup that they judge to be overly debt-burdened.⁵²

Under Japanese accounting rules, once an SAR is exercised, the amount under the SAR line item on the issuer's balance sheet representing the exercised SAR is transferred to the registered corporate capital and capital reserve line items.⁵³ As a rule, at least fifty percent of the cost of the SAR must be transferred to corporate capital, while the remainder is then transferred to capital reserve.⁵⁴ The issuer will likely want the minimum amount possible to be transferred to corporate capital because this amount is subject to a 0.7% tax.⁵⁵ In keeping with this approach, the J-KISS provides that upon exercise, the issuer's corporate capital will increase by the minimum fifty percent required amount of the investment.⁵⁶ In fact, the Companies Act requires that the terms of issuance for an SAR specify the portion of the investment amount that will be transferred to corporate capital and capital reserve upon the exercise of the SAR.⁵⁷ If the SAR expires without being exercised, the amount on the issuer's balance sheet under the SAR line item relating to the expired SAR will be recorded as profit in the year of expiration.⁵⁸

⁵¹ See Monroe-Sheridan, *supra* note 2, at 46 (explaining that one disadvantage of convertible notes lies in its indebtedness); Sutātoappu no Shikinshōtatsushudan—Konbātiburu Tōshishudan wo Fumaete (北浜法律事務所: スタートアップの資金調達手段—コンバーティブル投資手段を踏まえて) [*Sources of Startup Financing—Based on Convertible Instruments*], KAISHAHŌ SHŌKENSHIJŌ NYŪSURETĀ (会社法・証券市場ニューズレター) [KITAHAMA PARTNERS: CORP. L. & SECURITIES MKT. NEWSL.], July 2011, at 1, 6, <https://www.kitahama.or.jp/english/wp-content/uploads/2021/07/Newsletter-on-Corporate-Law-and-Securities-Market-Vol.18.pdf> [<https://perma.cc/7UJM-9ZV6>] (listing the merits of J-KISS and the demerits of convertible debts).

⁵² See Monroe-Sheridan, *supra* note 2, at 47 (noting that some Japanese companies may be reluctant to do business with a startup because of a high level of debt on the startup's balance sheet caused by convertible note seed financings).

⁵³ ŌTA, YAMAMOTO & SHIBATA, *supra* note 41, at 642–43.

⁵⁴ *Id.*

⁵⁵ Tōroku Menkyo Zeihō [Registration and License Tax Act], Law No. 35 of 1967, art. 24(1)(4), annex tbl.1 (Japan).

⁵⁶ *J-KISS Terms of Issuance*, *supra* note 12, § 5(9)(a)–(b).

⁵⁷ Kaishahō [Companies Act], Law No. 86 of 2005, art. 236(1)(v) (Japan).

⁵⁸ EGASHIRA, *supra* note 19, at 802.

2.2.7. Other Material Terms

Separate from the requirements discussed above, there are additional statutory formalities required to validly exercise an SAR. The exercising party must make clear the terms and number of the SARs being exercised, as well as the date of exercise.⁵⁹ Additionally, if the SAR is certificated (i.e., represented by a physical certificate), the SAR certificate must be tendered to the issuer at the time of exercise.⁶⁰ When the SAR requires payment for exercise, the exercising party must make the payment in full on the exercise date to a bank determined by the issuer.⁶¹ Although the J-KISS requires only a nominal payment of ¥1 per SAR to be exercised,⁶² due to this statutory requirement, a failure to make the payment will render a purported exercise of the J-KISS ineffective.⁶³ In fact, the failure to fulfill any of the statutory requirements for exercise will cause an attempted exercise of an SAR to be invalid.⁶⁴ In such case, the holder of the SAR will simply continue to hold the SAR without acquiring any of the shares that are subject of the SAR.⁶⁵

By default, SARs are transferable upon the agreement of the holder and the prospective transferee.⁶⁶ If the issuer incorporates restrictions on the transfer of an SAR, those restrictions must be included within the SAR's terms of issuance.⁶⁷ The J-KISS does include such a restriction, providing that transfer of the J-KISS requires the consent of a general meeting of the issuer's shareholders (or the board of directors, for companies that have established a board of directors).⁶⁸ These restrictions are particularly important

⁵⁹ Kaishahō [Companies Act], Law No. 86 of 2005, art. 280(1) (Japan).

⁶⁰ *Id.* art. 280(2). The J-KISS is not certificated because the J-KISS terms of issuance do not specify that it is a certificated instrument. *See id.* art. 236(1)(x) (requiring that, if an SAR is to be certificated, the terms of the SAR contain a statement to that effect).

⁶¹ *Id.* art. 281(1).

⁶² *J-KISS Terms of Issuance*, *supra* note 12, § 5(3).

⁶³ EGASHIRA, *supra* note 19, at 808.

⁶⁴ *Id.*

⁶⁵ *Id.* at 810.

⁶⁶ *Id.* at 804.

⁶⁷ Kaishahō [Companies Act], Law No. 86 of 2005, art. 236(1)(vi) (Japan).

⁶⁸ *J-KISS Terms of Issuance*, *supra* note 13, § 5(8). Because the SAR is a formative right, even if the shares underlying the SAR are themselves transfer-restricted, the holder of the SAR does not need consent from the issuer to exercise the SAR and become a shareholder. EGASHIRA, *supra* note 19, at 805 (citing Kaishahō [Companies Act], Law No. 86 of 2005, art. 282 (Japan)). Accordingly, if an issuer wishes to

because, as the holder of a formative right, any transferee who holds a J-KISS can unilaterally acquire shares of the issuer upon valid exercise of the J-KISS, even if the issuer did not intend for the transferee to become a J-KISS holder or a shareholder.⁶⁹

2.3. Commercial Terms in the J-KISS Term of Issuance

The J-KISS terms of issuance include several important provisions, in addition to those already discussed above, that are not statutorily required but must be included in the J-KISS terms of issuance rather than the investment contract because they directly impact the terms of the SAR. These provisions are discussed in the following sections. They are, namely, (1) the J-KISS valuation cap and discount, (2) the conversion into a “shadow series” of classified stock for J-KISSes that convert at a discount or valuation cap, (3) the calculation of fully diluted equity used for conversions at the valuation cap, and (4) the minimum size threshold for the next equity financing necessary to trigger a conversion of the J-KISS.⁷⁰

2.3.1. Valuation Cap and Conversion Discount

The valuation cap and discount are the two principal financial terms of the J-KISS.⁷¹ The valuation cap compensates J-KISS holders for the additional risk of early investment in the issuer by setting a ceiling price for the conversion of their J-KISSes into classified stock in a subsequent financing round.⁷² Specifically, if the issuer receives

restrict its potential ultimate shareholders, it needs to ensure that its SARs include transfer restrictions in their terms of issuance. *Id.*

⁶⁹ EGASHIRA, *supra* note 19, at 805.

⁷⁰ See, e.g., Kaishahō [Companies Act], Law No. 86 of 2005, arts. 236(1)(i), 236(1)(vii)(a) (requiring the terms of an SAR to include the number of the shares or the method for calculating that number and repurchase trigger events, respectively).

⁷¹ See *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a) (including a default discount of 20% and a blank that must be filled in to set the cap of the J-KISS).

⁷² See Coyle & Green, *supra* note 3, 163–64 (“The conversion price cap imposed a ceiling on the price at which a seed note would convert into the equity security sold at the next equity financing.”); Monroe-Sheridan, *supra* note 2, at 26–27 (“[A] conversion discount and conversion cap sweeten the deal for seed investors to compensate them for the increased risk of a pre-Series A investment . . .”).

a valuation greater than the ceiling price (i.e., the valuation cap) in its next classified stock round, the amount the early investors invested via their J-KISSEs converts at the valuation cap rather than at the higher classified stock valuation.⁷³

The J-KISS terms of issuance include a conversion discount in addition to the valuation cap, but the discount and the valuation cap are alternatives and do not apply simultaneously.⁷⁴ Specifically, the conversion discount takes effect when the discounted conversion would provide the investor with a more favorable outcome than conversion at the valuation cap.⁷⁵ By default, the discount included in the J-KISS terms of issuance is twenty percent lower than the price paid by investors in the next equity financing.⁷⁶ In contrast to the discount, the J-KISS terms of issuance do not provide a suggested number for the valuation cap.⁷⁷

2.3.2. Conversion into Shadow Series

The terms of issuance provide that, if the J-KISS ultimately converts into classified stock sold at a price higher than the conversion price (because the J-KISS conversion price was reduced by a valuation cap or discount), then the liquidation preference and common stock conversion ratio for the shares issued to the J-KISS holder will be adjusted appropriately.⁷⁸ This so-called “shadow

⁷³ *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a)(y).

⁷⁴ *Id.* § 5(2)(a)(x).

⁷⁵ *See id.* § 5(2)(a) (specifying that the conversion price for the J-KISS will be the lower (i.e., more favorable to the investor) of the valuation cap or discount). This is basically identical to the mechanism used in the form Safe that includes both a conversion discount and valuation cap. *See Safe User Guide*, Y COMBINATOR, <https://www.ycombinator.com/assets/ycdc/Primer%20for%20post-money%20safe%20v1.1-2af8129e12effd9638eeab383b7309142c8f415e5cdb0bc210d573f779177a1c.pdf> [https://perma.cc/8T4R-959A] (last visited Jan. 3, 2022) (“Either the Post-Money Valuation Cap or the Discount Rate applies when converting this safe into shares of Safe Preferred Stock in an Equity Financing, depending on which calculation is most advantageous to the Investor.”).

⁷⁶ More specifically, the discounted conversion is calculated as 80% of the price paid in the next equity financing. *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a)(x).

⁷⁷ *Id.* § 5(2)(a)(y).

⁷⁸ *See id.* § 5(1) (describing the adjustments to be made if the stock is sold at a price different from the conversion price).

series⁷⁹ mechanism is also included in the standard form of Safe.⁸⁰ The idea behind this provision is that, if the J-KISS investor receives the benefit of a valuation-capped or discounted conversion, the liquidation preference and ratio of conversion of the investor's classified shares to common stock should reflect the actual dollar (or yen) amount invested to purchase the J-KISS rather than the amount that *would* have been required to purchase the classified shares if the investor had not received the benefit of the valuation cap or discount.⁸¹ Without this mechanism, J-KISS investors whose J-KISSes convert at a valuation cap or discount would effectively receive a "free" liquidation preference in excess of the actual amount they invested.⁸²

2.3.3. Calculation of Fully Diluted Equity

The terms of issuance also include a definition of the issuer's "fully diluted equity" (*kanzen kishakukago kabushikisū*).⁸³ The fully diluted equity of the issuer is a key part of the calculation used when the J-KISS converts into stock at the valuation cap. In that case, as described in Part 2.3.1. above, the J-KISS investment amount, when compared to the valuation cap, is the basis for calculating the percentage ownership of the issuer that the investor should hold following the conversion of the J-KISS (but prior to the dilution caused by the new funds invested for the next equity financing).⁸⁴ However, even when the expected percentage ownership into which a convertible equity instrument should convert is clear, the

⁷⁹ Danielle Naftulin, *Understanding the Valuation Cap*, COOLEYGO, <https://www.cooleygo.com/understanding-the-valuation-cap> [https://perma.cc/XRQ6-WYM6] (last visited Jan. 21, 2022); *J-KISS Investment Contract*, *supra* note 12, ch. 3. For an example usage of this term, see *Simple Agreement for Future Equity*, Y COMBINATOR (Mar. 2021), <https://www.ycombinator.com/assets/ycdc/Postmoney%20Safe%20-%20Valuation%20Cap%20Only%20v1.1-cb4934724e32a5864fd43ca894e51c8c081ecef136409c2e94f00d92168230ec.docx> [https://perma.cc/CLK6-UBPL].

⁸⁰ See *Simple Agreement for Future Equity*, *supra* note 79, § 2 (providing the definition of "Safe Preferred Stock").

⁸¹ See Coyle & Green, *supra* note 3, at n.153 (explaining the rationale behind the adjustments made to liquidation preference).

⁸² *Id.*

⁸³ *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a)(y).

⁸⁴ *Id.* §§ 5(1), 5(2)(a)(y).

appropriate number of total issuer shares to use in calculating the number of shares to issue to the investor is not always clear.⁸⁵ For example, should outstanding but unexercised stock options and warrants be assumed to be exercised for the purposes of the calculation? What about other convertible instruments that are also converting in the equity financing? The more inclusive the definition of “fully diluted equity,” the more favorable the conversion calculations will be to the investor, because the investor will be receiving its percentage ownership based on a larger number of assumed issuer shares.

The initial J-KISS terms of issuance took a so-called “pre-money” approach to this calculation, but the J-KISS 2.0 (an update to the J-KISS released on April 12, 2022) introduced a “post-money” calculation mechanism, which is conceptually consistent with the current Safe forms that Y Combinator makes available.⁸⁶ A post-money valuation cap in this context refers to a valuation cap where the investor does not bear dilution from additional convertible instrument issuances in calculating the investor’s ownership share at the time of conversion.⁸⁷ For example, if the investor invests \$1 million using a convertible instrument with a \$10 million post-money valuation cap and the issuer later raises a Series A financing round, the investor’s investment will convert into an approximately ten percent ownership share of the issuer’s equity (not including the dilution caused by the Series A financing) regardless of how much additional funding the issuer has raised using convertible instruments. In the J-KISS, the issuer’s fully diluted equity is defined (with certain exceptions and limitations) to include generally all issued and outstanding common stock and classified stock, all issued or granted SARs and any other rights to acquire the

⁸⁵ For example, if a J-KISS converts at the valuation cap such that the investor will own 5% of the issuer’s equity (prior to the dilution caused by the new equity financing), the J-KISS investor should end up owning a number of classified shares of issuer capital stock equal to 5% of the issuer’s total capital stock (excluding shares issued in the new equity financing and possibly some other shares). In this situation, the definition of “total capital stock” (often called “fully diluted equity”) becomes important as it may, depending on the instrument used, include or exclude convertible securities, un-exercised or unissued stock options, the converting J-KISS itself, and similar instruments. See *Safe User Guide*, *supra* note 75, at 3–6 (providing a detailed discussion of this issue and how it can impact conversion calculations).

⁸⁶ See *J-KISS Investment Contract*, *supra* note 12 (noting the change in the J-KISS 2.0 to a post-money valuation cap).

⁸⁷ See Levy, *supra* note 3, (explaining that “post-money” means that Safe holder ownership is measured after “all the safe money is accounted for” and “before the new money in the priced round that converts and dilutes the safes”).

issuer's capital stock, as well as any "planned" (*yotei shite iru*) but unissued SARs (including the issuer's stock option pool but excluding any increase in the stock option pool in connection with the equity financing) and the J-KISS itself and other J-KISSES of the same series, assuming the conversion of classified shares to common shares if applicable and the exercise of rights to acquire shares, without double-counting shares.⁸⁸

2.3.4. Minimum Size Threshold for Next Equity Financing

The fundraising trigger for automatic conversion of the J-KISS into stock is subject to a minimum threshold: the J-KISS terms of issuance provide that only an equity financing that raises at least ¥100 million (approximately \$745,000 as of this writing) will trigger the automatic conversion of the J-KISS into the issuer's stock.⁸⁹ This minimum size requirement prevents the J-KISS from converting as part of an extremely small equity financing round, which might have unusual terms or reflect an attempt by the issuer to force conversion of its J-KISS holders through a small equity issuance that is not a bona fide financing round.

⁸⁸ See *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a)(y) (the new definition of "fully diluted equity"). This definition is a significant improvement over the definition in the initial J-KISS. The definition in the initial J-KISS included less detail regarding the "planned" SARs that would be included in the calculation and did not clearly capture outstanding classified stock that is not convertible into common stock. *J-KISS 1.0 Terms of Issuance*, *supra* note 12, § 5(2)(a)(y). The wording used to capture planned SARs in the initial J-KISS (SARs that were "determined" (*kettei*) to be issued but not yet issued) was vague enough to create the potential for disputes, as the J-KISS did not specify if the "determination" at issue must be the result of a formal process such as a resolution of the board of directors. It may be that this wording was intended to protect J-KISS investors from dilution caused by an increase in the size of the issuer's stock option pool, which might occur as part of the next equity financing that triggers the J-KISS conversion. However, due to the ambiguous diction in this provision, in the event that a company were to issue new SARs a few weeks after a J-KISS has converted, the former J-KISS holder could theoretically take an aggressive stance and argue that, at the time of the J-KISS's conversion, the issuer had in fact already determined to issue the new SARs and accordingly the former J-KISS holder should receive more shares of classified stock to reflect the additional dilution caused by the new SARs. See *id.* (providing the initial definition of "fully diluted equity").

⁸⁹ *J-KISS Terms of Issuance*, *supra* note 12, § 5(2)(a)(x).

2.4. Other Contractual Terms

In addition to the J-KISS terms discussed above that are either relevant to the statutory regime for SARs or otherwise included within the J-KISS terms of issuance, the J-KISS investment contract includes certain other important provisions. The issuer's representations and warranties in the J-KISS investment contract, for example, are significantly more detailed than those included in the Safe and incorporate provisions regarding intellectual property and litigation, as well as a full disclosure provision.⁹⁰ By default, the J-KISS investment contract also includes a most-favored nation provision⁹¹ and provides major investors⁹² with the right to receive certain financial and business information from the issuer.⁹³ It also includes a so-called "pro rata right" (or "preemptive right") for major investors⁹⁴ and an undertaking by the company to ensure that the J-KISS major investors continue to receive major investor rights following the issuer's next equity financing.⁹⁵

Under the J-KISS investment contract, the investor has the right to transfer the J-KISS to a "related party" (*kankeisha*).⁹⁶ By itself, this right would be unremarkable. However, because the transfer of an

⁹⁰ *J-KISS Investment Contract*, *supra* note 12, ch. 3; *Simple Agreement for Future Equity*, *supra* note 80, § 3. The "full disclosure" representation in the J-KISS states that the representations and warranties in the J-KISS and information provided by the issuer to the investor "do not lack in any material respect any facts necessary to avoid any misapprehensions in the [i]nvestor's investment decision." *J-KISS Investment Contract*, *supra* note 12, ch. 3(9). As compared to the Safe, this clause significantly shifts the risk of a due diligence deficiency from the investor to the startup.

⁹¹ Although there is a form of Safe that includes a most-favored nation provision, it is not a standard provision in every form. See Levy, *supra* note 3 (listing different kinds of Safe with or without the most-favored nation provision).

⁹² "Major investors" are defined in the form J-KISS as investors who purchase more than 50% of the aggregate issue price for a series of J-KISSes. *J-KISS Investment Contract*, *supra* note 12, art. 1.1(5).

⁹³ *Id.* arts. 5.1-5.2.

⁹⁴ This right allows each major investor to maintain its ownership share of the issuer by providing the investor with a preferential right to acquire the portion of new share issuances necessary to maintain that ownership share. See *J-KISS Investment Contract*, *supra* note 12, art. 5.2(2) (setting forth rights of major investors). Although the standard forms of Safe do not include a pro rata right for the investor, Y Combinator does also make available a side letter that provides the investors with pro rata rights. See Levy, *supra* note 3 (providing an optional "Pro Rata Side Letter" for use by US companies).

⁹⁵ *J-KISS Investment Contract*, *supra* note 12, art. 5.2.

⁹⁶ *Id.* art. 5.3(2).

SAR is subject to onerous procedural requirements under the Companies Act, as discussed in Part 2.2.7. above, such a transfer requires the consent of the issuer's shareholders (or the board of directors if the issuer has a board of directors). To address this requirement, the issuer undertakes in the J-KISS investment contract to obtain approval for the transfer from the board of directors or shareholders, as necessary.⁹⁷ The issuer is unlikely to have any means to compel its shareholders to consent to a transfer, so in the event that a significant number of shareholders are uncooperative with an issuer's request to approve an investor's transfer of its J-KISS, the issuer may end up breaching the J-KISS investment contract by failing to secure the required shareholder approval.

All J-KISSes in a series may be amended by agreement of the issuer and investors holding J-KISSes representing a majority of the aggregate amount invested via all the J-KISSes in the series.⁹⁸ Although the amendment procedures for SARs are cumbersome, as discussed in Part 2.2.4. above, because the issuer and the J-KISS investors are all party to J-KISS investment contracts obliging their cooperation with such amendments, this provision should function reasonably well in theory.⁹⁹ In contrast to the provisions regarding transfer of the J-KISS, the amendment provision does not explicitly incorporate an obligation on the part of the issuer to procure the completion of the requisite corporate formalities, so there appears to be less risk that the issuer may find itself in violation of the amendment provision due to a lack of cooperation from third parties.¹⁰⁰ Finally, the J-KISS purports to be *pari passu* with all other general obligations to the issuer's creditors, including other SARs and convertible bonds.¹⁰¹

⁹⁷ *Id.* art. 5.3(3).

⁹⁸ *Id.* art. 5.13(2). The provisions that may be amended are subject to certain limited exceptions. *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* art. 5.14.

3. COMPARISON WITH THE SAFE

3.1. Provisions Related to Statutory Law for SARs

The corporate formalities required for the issuance of a J-KISS (described in Part 2.2.2. above) are far more onerous than those required for the issuance of a Safe. In contrast to the detailed special shareholder resolution (*tokubetsu ketsugi*) and inflexible payment deadline required for the issuance of an effective J-KISS, the Safe is simply a contract to be executed by the issuer and the investor.¹⁰² It is customary for the issuer's board of directors to approve the issuance of Safes, but a simple board approval (which may take the form of a written consent) is likely to be far easier and faster to complete than a special shareholder resolution.¹⁰³ Similarly, Y Combinator's forms of Safe describe the date of payment as "on or about" the date specified in the contract, leaving room for error if payment is unexpectedly delayed.¹⁰⁴

The commercial registration requirement is an additional disadvantage of the J-KISS as compared to the Safe. While Japan's commercial registration system requires the registration of any SAR issuance and a wide variety of equity issuances in a publicly accessible database,¹⁰⁵ Delaware¹⁰⁶ has no such system (and, in any event, the Safe is not an SAR). Accordingly, an issuer raising funds

¹⁰² See Coyle & Green, *supra* note 4, at 46 ("The SAFE is best conceptualized as an equity derivative contract by which the investor commits capital to the company today in exchange for the right to receive stock in the company in a future financing if certain contractual conditions are met.").

¹⁰³ See, e.g., Practical Law Corporate & Securities, SAFE Financing Checklist ¶ 9 (2023), Westlaw W-001-3333, <https://us.practicallaw.thomsonreuters.com/w-001-3333> [<https://perma.cc/2D7Z-SXEC>] (stating that Safe financings "usually include . . . a board action, either by unanimous written consent or at a meeting recorded in board minutes, reflecting the board's approval of the SAFE financing transaction and issuance of the SAFEs").

¹⁰⁴ *Simple Agreement for Future Equity*, *supra* note 79, at 1.

¹⁰⁵ See, e.g., MATSUI NOBUKAZU (松井信憲), SHÖGYÖ TÖKI HANDOBUKUU (商業登記ハンドブック) [COMMERCIAL REGISTRATION HANDBOOK], 275, 293, 334 (4th ed. 2021) (citing Kaishahō [Companies Act], Law No. 86 of 2005, art. 915(1) (Japan), which describes certain types of stock and SAR issuances that require commercial registration).

¹⁰⁶ The comparison in this article is limited to Delaware as Delaware is the typical jurisdiction of choice for U.S.-based startups seeking venture financing. See text accompanying *supra* note 18 (stating that "Delaware corporations are the typical entity and jurisdictional choices for startups seeking venture capital financing").

via the Safe need not comply with any sort of commercial registration formalities for the issuance, including the preparation of detailed attachments to the registration filings, as would be required for a J-KISS issuer in Japan, and there is no need to make the terms of the transaction publicly accessible.¹⁰⁷

Amending a Safe is also much simpler than amending a J-KISS. As discussed in Part 2.4., the J-KISS investment contract does contain a provision allowing a majority in interest of a J-KISS series to amend the entire series, and the Safe includes a similar provision.¹⁰⁸ However, because amending an SAR requires completion of essentially the same onerous procedures necessary to issue the SAR in the first place, the issuer is required to return to its stockholders for approval of an amendment of any provision in the J-KISS terms of issuance.¹⁰⁹ In contrast, because the Safe is an ordinary contract, its amendment does not require stockholder approval, and by its terms any individual Safe can be easily amended simply by the agreement of the issuer and the investor.¹¹⁰

The automatic conversion (technically, repurchase) mechanism in the J-KISS is significantly more cumbersome than the analogous provision in the Safe. The Safe provides that it will automatically convert upon the issuer's next equity financing, and the investor is obligated to execute the applicable transaction documentation, with certain limitations.¹¹¹ Once the Safe automatically converts, the instrument terminates by its own terms.¹¹² This mechanism provides the issuer flexibility to quickly consummate a subsequent financing round even if a few Safe holders are difficult to contact or uncooperative; their Safes will automatically convert immediately, with no action on their part, and they will be contractually obligated to execute the legal documentation for the new financing. The J-KISS, on the other hand, requires that all non-exercising J-KISS holders receive at least two weeks' prior notice to the conversion (repurchase) of their J-KISSes for compliance with statutory

¹⁰⁷ See *supra* Part 2.2.3..

¹⁰⁸ See *Simple Agreement for Future Equity*, *supra* note 79, § 5(a) (allowing a "majority-in-interest" of Safe-holders to amend all the Safes in the applicable series).

¹⁰⁹ See Ijima, *supra* note 39.

¹¹⁰ See *Simple Agreement for Future Equity*, *supra* note 79, § 5(a) (allowing the issuer and investor to amend the Safe).

¹¹¹ See *id.* § 1(a) ("[T]he Investor will execute and deliver to the Company all of the transaction documents related to the Equity Financing.").

¹¹² *Id.* § 1(e).

obligations relating to SAR repurchases.¹¹³ In practice, this notice can only be effected after the material terms of the classified stock are finalized,¹¹⁴ significantly limiting a startup's ability to immediately close a financing round if any J-KISS investors are unreachable or not cooperative. Finally, the requirement of nominal payment and other formalities for exercise of the J-KISS create yet another administrative burden that is absent when investment is made via a Safe.¹¹⁵

3.2. Other Provisions

In contrast to the provisions of the J-KISS related to statutory requirements for SARs, the commercial terms of the instrument are broadly in line with those of the Safe. Like the J-KISS, the Safe may include a conversion cap and a discount, and it includes certain representations and warranties.¹¹⁶ The Safe may also include a most-favored nation provision, although it is not included by default in every form of Safe.¹¹⁷ Y Combinator provides a side letter (a separate, very short contract in the form of a letter) pursuant to which the issuer can provide the investor with pro-rata rights, which are included by default in the J-KISS.¹¹⁸ Notably, none of the forms of Safe provided by Y Combinator include the information rights for major investors that are included in the J-KISS.¹¹⁹ The Safe, like the J-KISS, includes provisions allowing the investor to assign the instrument to an affiliate¹²⁰ and allowing a majority-in-interest of the investors for each series of Safe to amend all instruments in the series, with certain limited exceptions.¹²¹ In short, although the

¹¹³ See *supra* Part 2.2.5.

¹¹⁴ *Id.*

¹¹⁵ See *supra* Part 2.2.7.

¹¹⁶ Levy, *supra* note 3.

¹¹⁷ *Id.* (providing various forms of SAFE documents, only one of which includes a most favored nation provision).

¹¹⁸ *Pro Rata Side Letter, Y COMBINATOR*, <https://www.ycombinator.com/assets/ycdc/Pro%20Rata%20Side%20Letter-d6dd8d827741862b18fba0f658da17fb4e787e5f2dda49584b9caea89bf42302> [https://perma.cc/6GUT-Z8RQ] (last visited Mar. 7, 2023).

¹¹⁹ See Levy, *supra* note 3 (showing no inclusion of information rights in the forms provided by Safe).

¹²⁰ See *Simple Agreement for Future Equity*, *supra* note 79, § 5(d) (providing a description of how the Safe and/or its rights may be assigned).

¹²¹ *Id.* § 5(a).

provisions of the J-KISS that are unrelated to SAR compliance are more investor-favorable than those of the Safe, the difference is one of degree rather than kind. The non-statutory rights that an investor might request based on the standard forms are roughly consistent across the two instruments, except that a J-KISS investor is likely to receive more of these rights than a Safe investor because more of the rights are incorporated into the single J-KISS form, while Y Combinator offers different forms of Safe that do not include all the rights in a single document.

3.3. Possible Modifications to the J-KISS

Given the similarity in non-statutory terms between the J-KISS and the Safe, it is not clear that modification to those J-KISS terms would have an appreciable impact on the ease of use of the instrument for Japanese startups or investors. However, as discussed in Part 2.2. above, the same is not true for the statutory requirements related to SARs. These requirements plainly present a significant additional burden for startups fundraising via the J-KISS in Japan as compared to those doing so using the Safe in the United States.

Considering the costs of using an SAR framework, why does the J-KISS utilize this structure rather than a simple contract or other instrument necessitating fewer burdensome formalities? Following the introduction of convertible equity for startup financings in the United States in 2012, Masakazu Masujima, a partner at a large Tokyo law firm and the principal architect of the J-KISS, created various iterations of convertible equity-type instruments to be used in Japanese startup financings.¹²² Ultimately, he determined that the SAR was the tool best suited to adapt 500 Startups' KISS to the Japanese startup ecosystem because the SAR would allow startups and investors to avoid negotiating a valuation and interest rate, permit the inclusion of a valuation cap and conversion discount, and ensure that startups would not have to worry about repaying the instrument at maturity.¹²³ Although capturing these critical advantages of convertible equity in an increasingly well-known instrument offers significant benefits to the Japanese startup community, this article highlights potentially major additional

¹²² Monroe-Sheridan, *supra* note 2, at 48–49.

¹²³ *Id.* at 49–50.

efficiencies that could be unlocked by shifting away from the SAR structure toward an alternative such as the simple contract structure used by the Safe.

Nevertheless, that the Safe (and, increasingly, the J-KISS) are well known in their respective local markets appears to be an important advantage for these instruments.¹²⁴ A new, Safe-like instrument in Japan would need to build market awareness before it could benefit from broad investor acceptance and offer efficiencies such as reduced negotiation time and lower legal fees.¹²⁵ Furthermore, it would likely take some time for startups and investors to become comfortable with other legal characteristics of the instrument, such as tax treatment and enforceability. The Safe in particular has benefitted from Y Combinator's excellent reputation in the U.S. venture capital space, necessitating that seed and early-stage venture capital investors familiarize themselves with the instrument if they wish to invest in companies that have graduated Y Combinator and have already raised funding using the Safe.¹²⁶ Accordingly, it is important to recognize that any new instrument in the Japanese market would likely only begin to offer real advantages if it were actively promoted by an influential startup incubator or investor, and even then such benefits would likely take time to materialize as familiarity with the new instrument gradually increased throughout the market. Nonetheless, considering the significant disadvantages of the current SAR-based convertible equity structure, such an effort appears worthwhile.

4. CONCLUSION

The growing adoption of the J-KISS in Japan demonstrates that its streamlined approach offers meaningful advantages over alternative methods of seed financing such as common stock, preferred stock, and convertible debt. However, despite these advantages, the J-KISS's cumbersome legal framework is far from ideal for seed-stage startups typically short on time and money. In

¹²⁴ *Id.* at 37-38.

¹²⁵ It may be possible to accelerate this process by retaining, to the extent possible, the terms of the J-KISS that are not directly related to the statutory framework for SARs, allowing market participants to feel comfortable that they are already familiar with the instrument's allocation of risk between issuer and investor (other than risks directly related to holding—or not holding—an SAR).

¹²⁶ Monroe-Sheridan, *supra* note 2, at 36.

contrast, an instrument with largely identical terms but a more flexible legal structure could offer an attractive alternative, taking advantage of the Japanese market's increasing familiarity with the terms of the J-KISS while reducing the costs and delays associated with SARs that benefit neither the startup nor the investor.¹²⁷ Although the development of such an instrument would be a significant undertaking and its broad adoption in the market could take years, such an exercise has the potential to significantly strengthen the Japanese startup ecosystem by offering a faster and easier path to financing at a time when many startups need it most.

¹²⁷ Notably, however, such a structure would not offer the investor a formative right because the investment instrument would not be structured as an SAR. *See supra* Part 2.1.