ESSAY

MAKING A PRIVATE EQUITY/VENTURE CAPITAL INVESTMENT IN JAPAN: IMPLEMENTING TECHNIQUES COMMONLY USED IN U.S. TRANSACTIONS

KENNETH J. LEBRUN*

1. INTRODUCTION

Mirroring the dramatic growth of private equity and venture capital activity worldwide, private equity and venture capital activity in Japan has rapidly increased during the past several years, despite recent setbacks relating to the bursting of the Internet/telecommunications bubble. During 2000 alone, private equity and venture capital funds in Japan raised U.S. $2.2 billion, of which 64% (U.S. $1.4 billion) was dedicated to early stage investment. In addition, funds outside of Japan have earmarked significant portions of their global funds for investment in Japanese companies. U.S. and European private equity and venture capital funds have been lured to Japan by several factors. First, Japan’s Internet, telecommunications, and e-commerce markets have been developing at a high speed and show potential for leading the world in several promising technologies (such as mobile Internet platforms). Sec-

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1 2000 Highlights, ASIA PRIVATE EQUITY, Year-End 2000 special issue, at 1.
2 Id.

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ond, the establishment of two new capital markets for venture enterprise listings, MOTHERS ("Market of the High-Tech and Emerging Stocks"), established by the Tokyo Stock Exchange in November 1999, and Nasdaq Japan, established by the National Association of Securities Dealers ("NASD") and Softbank Corporation in May 2000, have encouraged private equity and venture capital funds to invest in Japan by providing additional means to exit from their investments.

A large percentage of private equity and venture capital funds earmarked for investment in Japanese companies are controlled by U.S. and European venture capital firms, private equity firms, and investment banks. In addition to high profile deals such as Ripplewood Holding LLC's acquisition of The Long-Term Credit Bank (renamed Shinsei Bank), firms such as Goldman Sachs, The Carlyle Group, and Newbridge Capital have also been active in venture capital and private equity transactions in Japan.

In the past, most Japanese domestic venture capital transactions were structured and documented quite simply, often taking the form of a common stock investment with the investment agreement only a few pages long. However, U.S. and European venture capital and private equity firms (and increasingly sophisticated Japanese investors such as Softbank and JAFCO as well) generally prefer to structure their investments in a way similar to transactions in the United States, wherein preferred stock, management rights and exit mechanisms provide an investor with substantial control over and protection for its investment.³

Today, U.S. and European investors will find that Japanese corporate law accommodates most, but not all, of the techniques employed in U.S. private equity and venture capital transactions.⁴ Recent amendments to the Commercial Code of Japan, Law No. 48, March 9, 1899, as amended,⁵ (the "Commercial Code" or "Shoho"),

³ Although this Article is limited to the legal considerations concerning Japanese venture capital and private equity transactions, differing expectations as to the volume and complexity of the documentation for a transaction can be one of the greatest roadblocks to completing a deal. Many Japanese companies will resist when presented with a typical U.S.-style purchase agreement and/or shareholders' agreement.

⁴ This Article addresses only the rules applicable to a Japanese stock corporation (kabushiki kaisha), the most common form of business organization in Japan.

have facilitated the implementation of such techniques. Most notable of such amendments are those approved by the Japanese Diet on November 28, 2001 with an effective date of April 1, 2002 (the "November Amendments"; the Commercial Code as so amended is referred to herein as the "Amended Commercial Code" or "Amended Shoho").

The purpose of this Article is to provide an overview of the significant differences between private equity/venture capital investments and documentation in the United States and Japan for the benefit of non-Japanese principals of private equity and venture capital firms and their advisors. More specifically, this Article will consider to what extent the protective provisions commonly used in U.S. private equity and venture capital transactions may be used in structuring and documenting private equity and venture capital transactions in Japan. It will focus on techniques frequently used in minority equity investments in private companies, although many of such techniques may be used in other forms of private equity investments as well.

When making comparisons to U.S. practices, this Article will refer to Delaware law for illustrative purposes, which is the common jurisdiction for the incorporation of businesses in the United States.

2. SUMMARY OF U.S. INVESTMENT TECHNIQUES AND THEIR AVAILABILITY IN JAPAN

In the following table is a list of protective devices commonly requested by investors in U.S. venture capital and private equity transactions. The second column of the table indicates whether or not such provisions may be included in documentation for invest-

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6 The official text of the November Amendments has not yet been published in Japanese or in English. See Official Website of the Japanese Ministry of Justice, at http://www.moj.go.jp/HOUAN/hoan11.html (carrying, in the Japanese language, the full text of the amendments as well as a comparison of the Amended Commercial Code with the pre-amendment Commercial Code) (last visited Mar. 6, 2000).

7 Some might argue that the typical transaction described herein is a venture capital transaction as opposed to a private equity transaction, which traditionally takes the form of a 100% acquisition of an established industrial and consumer products company and is financed by significant amounts of debt. However, many private equity firms engage in Silicon Valley-style venture capital transactions and partial acquisitions in addition to leveraged buy-out transactions. Accordingly, the terms are used interchangeably herein.
ments in Japanese corporations, and the third column describes variations from U.S. law or practice that should be kept in mind when implementing such provisions in Japan. A more comprehensive analysis of whether and how such provisions can be used in Japanese transactions is set forth in the body of this Article.

Summary of U.S. Investment Techniques and Their Availability in Japan

<table>
<thead>
<tr>
<th>Provision</th>
<th>Available</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Preferred Stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>Yes</td>
<td>Multiple classes of preferred stock are also allowed.</td>
</tr>
<tr>
<td>Liquidation Preference</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Dividend Preference</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Conversion</td>
<td>Yes</td>
<td>May be subject to post-IPO lock-up restrictions.</td>
</tr>
<tr>
<td>Anti-dilution Conversion Price Adjustment</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Price Protection/Conversion Price Adjustment</td>
<td>Yes</td>
<td>Weighted average and full ratchet adjustment are permissible.</td>
</tr>
<tr>
<td>Pre-emptive Rights</td>
<td>Yes</td>
<td>Statutory pre-emptive rights may apply in certain circumstances.</td>
</tr>
<tr>
<td>B. Management Rights</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Class-Based Voting</td>
<td>No → Yes</td>
<td>Effective April 1, 2002, class voting becomes permissible.</td>
</tr>
<tr>
<td>Super Majority Voting on Extraordinary Corporate Matters</td>
<td>Yes</td>
<td>May specify super majority voting in a company’s articles of incorporation (only monetary damages available if such voting requirements are specified in a shareholders agreement).</td>
</tr>
<tr>
<td>Board Nomination Rights</td>
<td>Yes</td>
<td>Board nomination rights may be stipulated in a shareholders agreement, but such rights may not be specifically enforced (only monetary damages available).</td>
</tr>
<tr>
<td>C. Exit Mechanisms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Redemption</td>
<td>Yes</td>
<td>Subject to limitations based upon the funds otherwise available to a company for dividends or a reduction in capital (requires special approval of the shareholders).</td>
</tr>
<tr>
<td>Registration Rights</td>
<td>N/A</td>
<td>Because a company listing its shares in Japan must register all of its outstanding shares, registration rights are only of use in the case of a demand registration to force the company to proceed with an IPO or, alternatively, to permit the investor to sell its shares in a public offering (i.e., to more than forty-nine investors). Registration rights should be included in documentation if Japanese target company templates listing its shares on a U.S. exchange or over-the-counter market.</td>
</tr>
<tr>
<td>Put Rights</td>
<td>Yes</td>
<td>To avoid unexpected taxes, put rights must be priced at fair value.</td>
</tr>
<tr>
<td>---------------------</td>
<td>-----------</td>
<td>------------------------------------------------------------------</td>
</tr>
<tr>
<td>Tag-along/Drag-along Rights</td>
<td>Yes</td>
<td>Enforceable only against a party to the agreement.</td>
</tr>
<tr>
<td>Transfer Restrictions (including rights of first refusal)</td>
<td>Yes</td>
<td>May not be specifically enforced (only monetary damages available).</td>
</tr>
</tbody>
</table>

3. **Convertible Preferred Stock: Downside Protection and Upside Opportunity**

Newly-established technology or other growth companies are typically established based upon a model in which the founders of the company supply the business plan, and the investors supply the capital necessary to execute that plan. An integral part of this model is that the founders pay a substantially lower price for their equity than the subsequent investors. This price difference gives rise to two major problems if both the founders and the investors receive common stock. First, in both the United States and Japan, founders who pay a lower price for their common stock in comparison to their contemporaneous financial investors may incur significant tax liabilities for purchasing “bargain stock.” Second, according to the corporate laws of both the United States and Japan, if a company runs into difficulties and, for example, is liquidated, the assets of the company, after settling debts to creditors, would be distributed to the common stockholders on a pro rata basis, thereby allowing the founders to walk away with a disproportionate (as compared to their initial monetary investment) amount of the company’s liquidated assets.

In the United States, the two problems described above are typically addressed by having the founding shareholders receive common stock and financial investors receive convertible preferred stock, almost the universal security of choice for venture capital firms investing in U.S. start-up companies. Preferred stock, which by virtue of its preferences and other rights can be valued differently than common stock, generally avoids the imposition of tax on the founders of a company who pay substantially less per share than financial investors.\(^8\) Preferred stock also allows for various protective features which can insure that investors receive their money back before founders if a company runs into difficulties.

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\(^8\) See I.R.C. § 83(a) (1990).
Such protective features typically include liquidation and dividend preferences vis-à-vis the common stock and price protection (through adjustment of the preferred stock’s conversion price in the event of issuances of common or preferred stock for a price lower than the price originally paid for the preferred stock). Finally, the conversion feature insures that financial investors, by converting their preferred stock to common stock, can fully participate in the appreciation of a company’s value in the event that the company succeeds. An additional advantage of preferred stock (although unrelated to the tax and liquidation problems described above) is that it allows for special voting and management rights, discussed separately in Section 3 below.

Convertible preferred stock is also available as a vehicle for investment in Japanese corporations and, as in the United States, can be used to address the taxation and downside risk issues discussed above. Article 222, paragraph 1 of the Commercial Code provides that a company may issue two or more classes of stock which differ as to their particulars concerning the distribution of profits, interest or surplus assets, or the redemption of shares by profits.9 After implementation of the November Amendments on April 1, 2002, classes of stock will also be able to differ with respect to voting rights.10

Until recently, Japanese venture capital and private equity investors invested in common stock more frequently in Japan than the United States. Japanese investors may have been willing to forgo the protections commonly demanded by U.S. investors because their investments carried a much lower risk profile. Rather than investing in start-up companies that were developing unproven (but possibly rewarding) new technologies, Japanese venture capitalists focused their investments on companies with lengthy operating histories (ten-plus years) in traditional sectors of the economy such as manufacturing, wholesale and retail distribution, consumer products, and services.11

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9 It is notable, however, that before the implementation of the November Amendments, in contrast to the United States, a Japanese company could not have multiple classes of common stock.

10 See AMENDED SHOHO, art. 222.

Although preferred stock has come to be commonly used during the past several years for venture capital transactions in Japan, it differs from preferred stock in the United States in several notable respects.

3.1. Dividend and Liquidation Preferences

As in the United States, preferred stock in Japan may be designated as participating or non-participating and as bearing cumulative or non-cumulative dividends.12 Preferred stock may also have a preference over common stock upon liquidation.13

"Deemed liquidation" provisions (i.e., provisions stating that a preferred shareholder will receive its liquidation preference upon a sale, merger or other change of control of the company as if the company were being liquidated), although legal, are not specifically authorized by the Commercial Code and therefore should be set forth in a shareholders' agreement as opposed to a company's articles of incorporation. A deemed liquidation provision, of course, would not be enforceable against any shareholder who is not party to the shareholders' agreement containing such provision.

3.2. Mandatory/Optional Conversion

Documentation for preferred stock investments in the United States and in Japan typically includes provisions for the conversion of the preferred stock to common stock either at the option of the holder ("optional conversion") or upon the occurrence of certain events ("mandatory conversion").14 Although the right of optional conversion of preferred stock seldom becomes a controversial issue, there is a natural tension between founders/management and preferred stock investors with respect to mandatory conversion.

12 See SHOHO, art. 222, para. 1.
13 Id.
14 After the implementation of the November Amendments to the Commercial Code on April 1, 2002, the terms and conditions of convertible stock, including any events requiring conversion, will be required to be set forth in a company's articles of incorporation. See AMENDED SHOHO, art. 222-8. In addition, the terminology for convertible stock (until now referred to as tenkan kabushiki) in the Commercial Code will, after the implementation of the November Amendments, be bifurcated into "stock with a convertible option" (tenkan yoyaku ken-tsuki kabushiki), AMENDED SHOHO, art. 222-3, and "stock with a mandatory conversion provision" (tenkan yoyaku joko tsuki kabushiki), AMENDED SHOHO, art. 222-8.
This tension arises because the founders and other common shareholders will want the preferred stock to be converted as soon as possible in order to eliminate the preferences, privileges, and rights attaching to the preferred stock (thereby increasing the value of the common stock), whereas the preferred shareholders will want to delay conversion in order to preserve such preferences, privileges, and rights.

Despite this tension, in almost every venture investment completed in the United States, both the company and the investors find it beneficial to stipulate that all preferred stock will be automatically converted to common stock upon the company’s initial public offering (“IPO”) (or, more specifically in the United States, upon the closing of a public offering of the company’s common stock with a minimum aggregate offering and price per share over a specified amount). From the company’s perspective, conversion of the preferred stock immediately prior to an IPO increases the market’s reception of the common shares to be issued in the offering (by eliminating the senior security). From the investor’s perspective, conversion immediately prior to an IPO is usually acceptable because the completion of the IPO is objective evidence of both the investment’s success and a reasonable likelihood that the investor will soon be able to exit the investment through a sale of its common stock in the public market (although such an exit may be subject to an underwriter’s lock-up, the availability of exemptions for the sale of restricted securities under the Securities Act, and any registration rights which may have been negotiated by the investor).

It is interesting to note that, although most venture companies in the United States use mandatory conversion provisions to convert preferred stock to common stock immediately prior to an IPO, there is no U.S. government regulation, stock exchange, or over-the-market listing rule that requires preferred stock to be converted prior to an IPO. Provided that the terms of the preferred stock are adequately disclosed in the company’s disclosure documentation (Form S-1), a company could conclude a public offering in the United States with a class or classes of preferred stock outstanding (whether an IPO with venture capital-style preferred stock outstanding would be acceptable to either the market or the underwriters, however, is another issue).

Until the fall of 2001, it was an unwritten rule of all Japanese stock exchanges and over-the-counter markets that all convertible
preferred stock of a company be converted prior to the full fiscal year immediately preceding the company's listing on an exchange or over-the-counter market. According to conversations with various Japanese attorneys, this unwritten rule or market practice stemmed from the listing rule, common to all Japanese stock exchanges and over-the-counter markets, that no convertible warrant-bonds be outstanding during the fiscal year immediately preceding a company's listing.15

By requiring holders of preferred stock to convert their preferred stock to common stock and forego all of the protections of the preferred stock at least one year prior to a company's IPO, this unwritten rule forced an investor to trade its existing and hard-negotiated preferred stock rights for the chance that the company would successfully complete its IPO one year later. As has often been the case during the past year, if the company postponed or canceled its plans for an IPO, the shareholder was left "naked" with common stock for an indefinite period (during which additional financing or even liquidation of the company could occur).

In lieu of the outright prohibition on holding convertible stock or warrants prior to an IPO, the Tokyo and Osaka stock exchanges have recently implemented mandatory post-IPO lock-up periods (i.e., periods during which an investor may not sell its shares) for holders of convertible stock or warrants under certain circumstances.

For example, under the newly adopted Tokyo Stock Exchange rules, convertible stock issued before the first full fiscal year prior to a company's IPO (the period from the beginning of such full fiscal year until approval of the listing application being referred to as the "restricted period") may be held as convertible stock during the restricted period and, after approval of the company's listing application, converted into common stock and freely sold in the market. Convertible stock issued during the restricted period is subject to a lock-up period extending until the latter of six months after an IPO or the one year anniversary of the issuance of the shares (a similar rule exists for common shares issued during this period).

The new rules contain one illogical aspect of which investors should be aware. Although an investor which owns convertible stock prior to the restricted period could convert its preferred stock immediately after the expiration of the restricted period and then sell the resulting common stock in the public market after the IPO, if the investor converts the convertible stock during the restricted period, the resulting common stock becomes subject to the lock-up restrictions. As the end result under both scenarios (i.e., the sale of common stock to the public post-IPO) is identical, it is difficult to understand the rationale for imposing a lock-up based upon when the preferred stock is converted.

3.3. Conversion Price Adjustments

The “conversion price” of preferred stock determines the number of shares of common stock into which one share of preferred stock may be converted. Generally, the initial conversion price of newly issued preferred stock is such that one share of preferred stock is convertible into one share of common stock. Thereafter, if the conversion price is adjusted downward, for example, the number of shares of common stock the holder of the preferred stock will receive upon conversion will correspondingly increase.

In the United States, there are two principal types of adjustments to the conversion price: “anti-dilution” adjustments that maintain the current conversion ratio in the event of stock splits, reverse stock splits, stock dividends, and similar re-capitalizations; and “price-protection” adjustments which protect the holder against future issuances of common or preferred stock by the company at a price per share that is less than the conversion price of the preferred stock.

Both “anti-dilution” and “price-protection” conversion price adjustments (whether on a weighted average or full ratchet basis) may be implemented in Japan. The Commercial Code contains two rules relevant to conversion price adjustment provisions: (1) the issue price of the new shares must be equal to the issue price of the convertible shares\(^{16}\) and (2) during the time between incorporation and conversion, a company is required to reserve a sufficient number of shares of each class of stock to be issued upon conversion.\(^{17}\)

\(^{16}\) See SHOHO, art. 222-3.

\(^{17}\) See SHOHO, art. 222-2, para. 3.
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3.4. Pre-emptive Rights

In both the United States and Japan, investors often use pre-emptive rights—the right to participate in future equity offerings to the extent necessary to preserve an investor's percentage equity stake in a company—to prevent their ownership stake in a company from being diluted by future issuances of equity securities. As in the United States, pre-emptive rights in Japan may be based upon a specific provision in a company's articles of incorporation or upon a contractual arrangement separate from the company's charter documents.

It is important to note that in Japan, even if pre-emptive rights are not contractually provided for or in a company's articles of incorporation, shareholders may have statutory Pre-emptive rights in certain circumstances. Such statutory Pre-emptive rights arise in circumstances where (1) the articles of incorporation provide that transfers of shares by shareholders must be approved by the company's board of directors, (which is a common provision in the articles of incorporation of closely-held Japanese corporations); and (2) the issuance of new shares is not approved by a special resolution of the shareholders (i.e., approved by two-thirds of the shareholders in attendance at a meeting of the shareholders).18

4. PROTECTING AN INVESTMENT THROUGH MANAGEMENT RIGHTS

Although liquidation preferences, conversion price adjustments, and other rights described above can be quite important in protecting an investment, investors often take the most comfort in their own ability to steer a company away from disaster and towards profitability. Yet venture capital investments are almost always for less than a majority and usually for less than one-third of the voting stock of a company. An investor holding a minority stake is only entitled to negative control over certain extraordinary corporate actions, as stipulated by applicable corporate law. For example, the sale of all of a company's assets must be approved by two-thirds of the shareholders attending a special meeting of the shareholders under Japanese law19 and by a majority of the shareholders entitled to vote under Delaware law.20 Accordingly, a

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18 See SHOHO, art. 280-5-2.
19 See SHOHO, art. 245.
venture capital investor holding at least two-thirds of a Japanese company’s outstanding shares would have a veto right with respect to such sales.

Dissatisfied with the limited management rights available to minority investors under applicable corporate laws, venture capital and private equity investors often attempt to secure additional rights through amendment of a company’s charter documents or through contractual arrangements.

4.1. Charter Documents

4.1.1. Class Voting Rights

In U.S. transactions, venture capital and private equity investors often secure management rights by amending a subject company’s articles of incorporation to require the separate approval of the holders of a majority (or super majority) of its preferred stock (or of each class or even each series of its preferred stock) for certain matters submitted to a vote of its shareholders or for the election of one or more directors.21 This can either guarantee the holders of preferred stock representation on the board of directors or provide the holders of the preferred stock a de facto veto right with respect to matters requiring the separate approval of a class or series of preferred stock which such shareholders would not have been able to control if they voted with the common stock as a single class. In addition, if class voting is set forth in a company’s certificate of incorporation, in the event that a company acts without first obtaining the required approvals, its preferred shareholders can apply to a court for equitable relief.22 Investors in the United States also use voting provisions in shareholders’ agreements, either in addition to or instead of class voting arrangements, to achieve control over key decisions and the election of directors. However, whether a shareholder will be able to obtain specific enforcement, as opposed to monetary damages, for the violation of voting provisions in a shareholders’ agreement

21 For example, Section 151(a) of the Delaware Code provides that each class or series of stock may have “such voting powers, full or limited, or no voting powers,” as are stipulated in a company’s certificate of incorporation. See id. § 151(a).

22 See id. § 111.
(whether at the shareholders or board of directors level) is not as clear-cut.23

Until the April 2002 implementation of the November Amendments described below, the Japanese Commercial Code had not provided companies and investors with similar flexibility in allocating management rights among shareholders. Article 241 of the Commercial Code states that, consistent with the general Japanese legal principle of equality among shareholders, each shareholder shall have one vote for each share. That class-based voting is not allowed is further clarified by Article 222(1) of the Commercial Code. Article 222(1), which specifically enumerates the particulars by which two shares of stock can differ, does not list voting rights.24

Under the pre-amendment Commercial Code, there are only two exceptions to the one-share/one-vote rule. The first exception permits non-voting stock, subject to certain limitations. A company may issue preferred stock with no voting rights, provided that such stock constitutes no more than one-third of the company’s capital stock.25 This exception is of limited utility in most venture capital transactions, where investors desire preferred distributions and special voting rights.

The second exception (which remains unchanged under the November Amendments) to the one-share/one-vote rule is that class-based voting is mandatory with respect to any amendment to a company’s articles of incorporation that may be considered prejudicial to a specific class of shareholders.26 This provides important protection to preferred shareholders with respect to certain

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23 In Delaware, specific enforcement of voting agreements appears to be available under Section 218(c) of the Delaware Code which states that an agreement between two or more stockholders may provide that “the shares held by them shall be voted as provided by the agreement.” However, such an agreement binds only the shareholders party thereto, whereas the certificate of incorporation binds a company and all of its shareholders. Id. § 218(c).

24 Article 222-1 of the Commercial Code provides that a company “may issue two or more classes of shares which differ with respect to their particulars concerning the distribution of profits, interest or surplus assets, or the redemption of shares by profits.” See SHOHO, art. 222-1.

25 See SHOHO, art. 242, para. 3. Voting rights are reinstated if the right to receive a preferred distribution is suspended by a resolution at a general meeting of the shareholders. Id. para. 1-2. After implementation of the Amended Commercial Code, the limitation on the number of shares with restricted voting rights is relaxed to one-half of a company’s capital stock. See AMENDED SHOHO, art. 222-5.

26 See SHOHO, art. 345.
decisions, such as the creation of new classes of preferred stock with rights preferential to the existing preferred stock. However, it does not allow preferred shareholders to exert control over matters not requiring amendments to the company's articles of incorporation (such as the issuance of new shares of common stock, the incurrence of debt, or significant acquisitions) or matters that are not deemed to be prejudicial to preferred shareholders under Japanese law (such as increasing the number of a company's authorized shares of common stock).

The limits on class voting under the pre-amendment Commercial Code largely disappear upon the implementation of the Amended Commercial Code on April 1, 2002. Article 222-7 of the Amended Commercial Code permits a company to issue a class of stock with the right to vote as a class on any or all matters requiring a vote of a meeting of the shareholders or the board of directors.\(^{27}\) The matters requiring approval of a given class of shares must be set forth in a company's articles of incorporation.\(^{28}\) It appears that such matters may include the election of directors.

4.1.2. Super Majority Voting

Another way in which investors in the United States use charter amendments to secure management rights is to provide that certain corporate actions (such as the incurrence of indebtedness over a certain threshold or the establishment of a subsidiary) require the special approval of either the shareholders or the board of directors of a company. In each case, an investor will try to set the voting requirement of such approval at a level requiring its approval, thereby giving the investor a de facto veto right with respect to the specified corporate action. The Delaware Code provides investors the flexibility to raise the voting requirements for actions of either the board of directors\(^{29}\) or the shareholders.\(^{30}\)

\(^{27}\) Several class-based voting techniques remain unavailable. For example, in contrast to the rules for Japanese limited liability companies (yugen gaisha), even after the implementation of the Amended Commercial Code, a stock corporation (kabushiki kaisha) may not have a class of stock with multiple votes per share. See Amended Shoho, art. 222-7.

\(^{28}\) See AMENDED SHOHO, art. 222-7.

\(^{29}\) See tit. 8, § 141(b).

\(^{30}\) See id. § 216.
In Japan, super majority requirements at both the board of directors and shareholders level (subject to the gray area discussed further below) may be included in a company’s articles of incorporation. The Commercial Code expressly allows a company’s articles of incorporation to stipulate quorum and voting requirements for a company’s board of directors which are more stringent than the default rule (which requires, unless otherwise provided by the company’s articles of incorporation or the Commercial Code, all resolutions to be adopted by a majority vote of the directors present at a meeting attended by at least a majority of the directors). When drafting such provisions, however, quorum and voting requirements should be stated generally in terms of the number of directors required to form a quorum or to approve a resolution. Most practitioners doubt that a provision requiring the approval of a particular director (identified either by name or by his nominating party) would be enforceable if challenged.

The default quorum and voting requirements for actions to be approved by shareholders are set forth in Article 239 of the Commercial Code, which states that, “except as otherwise provided for by this Code or by the articles of incorporation, all resolutions of a shareholders’ general meeting shall be adopted by a majority of votes of the shareholders present who hold shares representing more than one-half of the total number of the issued shares.” The phrase “except as otherwise provided for . . . by the articles of incorporation” has been construed as permitting more stringent or relaxed quorum and voting requirements to be included in the articles of incorporation.

With respect to certain extraordinary corporate events specified in the Commercial Code, such as amendment of the articles of incorporation, merger, or dissolution, the Commercial Code itself requires more stringent quorum and voting requirements (a vote of two-thirds or more of the shareholders who are present and who hold shares representing more than one-half of the total number of the issued shares). In these instances, the Commercial Code does not expressly permit more stringent requirements to be included in

31 See SHOHO, art. 260-2(1).
32 See SHINPAN CHUSHAKU KAISHAHO NEW EDITION ANNOTATED COMPANY LAW 113-14 (Katsuro Kamiyanagi et al. eds., 1987).
33 See SHOHO, art. 239.
34 See SHOHO, art. 343.
a company's articles of incorporation, and some practitioners feel that such a provision would be void.\textsuperscript{35}

4.2. Contractual Arrangements

In addition to requiring class-based voting or super majority voting rights to be incorporated into a company's charter documents, investors in U.S. venture capital transactions often use shareholder agreements to secure management rights in the company. Use of such shareholder agreements is sanctioned by Section 218(c) of the Delaware Code, which provides that an agreement between two or more shareholders may provide that, "the shares held by them shall be voted as provided by the agreement."\textsuperscript{36} In contrast, Japan has no similar statutory provision blessing the use of contractual arrangements among shareholders to govern the exercise of voting rights. The absence of statutory guidance on this issue in Japan leads to several notable differences from U.S. transactions with respect to the effectiveness of including management rights in shareholders' agreements.

4.2.1. Director Nomination Rights

Private equity and venture capital investors in the U.S. commonly demand representation on a company's board of directors. Board representation is assured either through the class-voting mechanism described above or by including in a shareholders agreement among the investor and the other shareholders, a provision obligating the other shareholders to vote the shares held by them to elect to the board of directors a nominee selected by the investor. If a shareholder breaches its obligations under such a shareholders agreement by voting its shares for a different candidate, the investor would be able to petition the appropriate U.S. state court for an injunction ordering the shareholder to vote its shares in accordance with the shareholders agreement.

In Japan, although a provision to vote for specified nominees to the board of directors appears to be valid, there is a consensus among scholars and practitioners that if a shareholder votes its


\textsuperscript{36} See tit. 8, § 218(c).
shares in violation of the agreement, the votes are valid as cast (i.e., the provision may be valid but is not enforceable through specific performance). Accordingly, an aggrieved investor’s only recourse would be to sue the breaching shareholder for monetary damages (which are difficult to prove in the case of failure to elect a director). One method that has been used to give such provisions “teeth” is to require a shareholder to pay liquidated damages or a penalty upon failure to vote for an investor’s nominee.

4.2.2. Super Majority Voting

U.S. investors sometimes rely upon provisions in shareholder agreements (as opposed to a company’s charter documents) to secure veto rights over certain extraordinary corporate actions. Such provisions are typically structured as covenants by the shareholders party to the shareholders agreement to vote their shares (or to cause the director nominated by them to vote) in favor of a particular corporate action only with the prior approval of the investor. For most investors, however, including such provisions in a shareholders’ agreement rather than in the company’s charter documents is less desirable because such provisions are unenforceable in certain states and, even if such provisions are valid as between the shareholders, they may not be enforceable directly against the company.

In Japan, super majority provisions in shareholder agreements have been similarly difficult or impossible to enforce. In the event voting provisions in a shareholders’ agreement are breached, the non-breaching shareholder(s) would be unable to obtain injunctive relief from a court ordering the breaching shareholder to vote its shares in compliance with the shareholders agreement. Again, liquidated damages may assist the investor in encouraging the other shareholders not to purposefully breach such a provision.

37 See Swisher, supra note 35, at 164.
38 See MINPO, art. 420 (permitting parties to contract for liquidated damages).
40 See AMENDED SHoho, supra note 10.
41 See DOING BUSINESS IN JAPAN, supra note 4, § 9.15[2].
4.3. Additional Practical Difficulties in Exercising Management Rights in Japan

One of the primary obstacles to a foreign investor’s active participation in the management of a Japanese company is geographic, many investors being a full day’s travel from Japan. Although shareholders of a Japanese company may currently participate in a shareholders’ meeting by proxy, the November Amendments further facilitate a non-resident investor’s ability to exercise his voting rights. After the implementation of the November Amendments on April 1, 2002, a company’s board of directors may provide by resolution that shareholders may exercise their voting rights (and be counted for the purposes of constituting a quorum) in a shareholders’ meeting by written instructions delivered to the company at least one day prior to such a meeting. Furthermore, such written instructions may, if permitted by the company’s board, be provided by electronic means such as e-mail.43

In contrast to the exercise of voting rights as a shareholder, representation on the board of directors of a Japanese company presents several practical difficulties for venture capital and private equity firms that do not have representatives who reside in Japan. First, the Commercial Code does not allow board members to attend meetings of the board of directors other than in person. Although it is generally accepted that directors may attend meetings via video conference (i.e., the participants must be both seen and heard), neither actions by unanimous written consent nor participation in board meetings by telephone is allowed. Thus, notice periods for meetings of the board of directors should be determined such that any non-resident director will have adequate time to arrange travel to Japan. In addition, Article 260 of the Commercial Code requires a board of directors to meet at least on a quarterly basis.44

5. Exit Strategies

The first question most U.S. private equity and venture capital investors ask when considering whether to make an investment is how they can exit the investment. Such “exit strategies” may in-

42 See AMENDED SHOHO, art. 239-2.
43 See id. art. 239-2(3).
44 See AMENDED SHOHO, art. 260.
clude the sale of the investor's shares to the public (in or after an IPO), to a potential acquirer of the company or to the company itself or its other shareholders. Implementing such exit strategies can be greatly facilitated by negotiating certain contractual provisions and preferred stock features when initially structuring an investment. In the United States, such contractual/preferred stock rights often include registration rights, redemption rights and various put, tag-along (or co-sale), and drag-along rights.

5.1. Registration Rights

The preferred exit for most investors, and the exit which typically provides the highest return on their investment, is the sale of their stock in the public market after (and sometimes as part of) a company's IPO. Under U.S. securities laws, however, a pre-IPO investor may sell its unregistered shares on the public markets after an IPO only subject to the rules of Rule 144 of the United States Securities Act of 1933, as amended. Under Rule 144, a pre-IPO investor may not sell the subject securities without registration or another exemption from the federal securities laws until the later of one year from the date of acquisition of such securities or ninety days after the issuer becomes a reporting company. During the second year after the date of acquisition for an investor other than an "affiliate" of the issuer, (i.e., an officer, director or owner of more than ten percent of the outstanding shares) such investor may sell limited amounts of its shares (during any three month period, up to the greater of one percent of the outstanding stock or the average weekly trading volume during the preceding four weeks).

Following the two-year anniversary of the acquisition of the securities, non-affiliate investors may sell such shares in the public market free of these volume limitations. With respect to an investor which is an affiliate of the issuer, sales of stock by such investor remain subject to the volume limitations described above indefi-

45 Allowing shareholders to sell their shares as part of a company's IPO is generally discouraged by the underwriters for several reasons, including: (1) the perception by the market that in certain cases such sales signify that the existing shareholders do not believe that the company will be successful after the IPO, and (2) the fact that the company will not receive the proceeds of the sale.

necessarily after the one-year anniversary of such investor’s acquisition of shares. Accordingly, venture capital investors which acquire shares shortly before an IPO or which own more than ten percent of a company’s shares will be subject to the restrictions of Rule 144 following an IPO. In order to sell a number of shares exceeding the limits of Rule 144, an investor will need to register its shares or sell its shares pursuant to another exemption under the Securities Act.

Because it is difficult, if not impossible, for an investor to register its shares of a company in the United States without the cooperation of the company, most investors negotiate in advance the right to require the company to register their stock. Such rights are typically in the form of demand rights (the right to cause the company to register the investor’s stock at the time chosen by the investors), piggyback rights (the right to participate in an offering initiated by the company), or shelf rights (the right to cause the company to register the investor’s stock pursuant to Form S-3 (for foreign issuers, Form F-3), an abbreviated—and much cheaper to prepare—form which may be used by companies with a significant public float).

Traditionally, investors in Japanese private companies have not requested registration rights. One reason for this may be that, although Japanese securities laws also require that stock be registered before being sold to the public, the listing rules for Japanese stock exchanges and over-the-counter markets require that a company register and list all of its shares, in contrast to the United States, where only shares included in a particular offering are registered. Accordingly, registration rights, with the exceptions noted below, are not necessary for companies intending to list in Japan because all of the shares owned by an investor would be registered at the time of the IPO and, subject to the mandatory lock-up period for newly-issued or converted stock discussed in Section 3.2 above and any underwriter’s lock-up or similar contractual arrangement, immediately saleable in the public market.

Nevertheless, certain situations may warrant negotiating registration rights with respect to a Japanese company, including: (1) when investors wish to be able to force a company (through the exercise of a demand right) to initiate an IPO in Japan in the first instance, (2) when investors wish to be able to sell a portion of their shares (through the exercise of piggyback rights) as part of an IPO.

\[47 \text{TSE INVESTIGATION STANDARDS, supra note 15, § 4(1)(a).}\]
in Japan initiated by a company, and (3) under circumstances in which a Japanese company is contemplating an IPO in the United States, its investors wish to be able to sell their shares free of the restrictions of Rule 144. In addition, although not strictly speaking a "registration right" (because all of a company's outstanding shares will have been registered at the time of an IPO in Japan), an investor may wish to secure a company's cooperation in the marketing of a post-IPO secondary sale of a large block of such investor's shares (i.e., the company's participation in road shows).

The use of a demand right to force an IPO is fiercely opposed by most companies and is often excluded from demand rights in the documentation for U.S. venture capital transactions. When accepted by a company, the use of a demand right to force an IPO is often conditioned upon the passage of time (typically three to five years), or the achievement of certain minimum revenue, or net income targets indicating that the company has some likelihood of completing a successful offering.

The use of piggyback rights in connection with an IPO can also be controversial, as underwriters may be reluctant to include the shares of shareholders in an IPO because of a possible negative impact on the marketability of the offering.

After observing several Japanese companies, including Crayfish and Internet Initiative Japan, successfully complete IPOs on the U.S. Nasdaq market, many investors in Japanese companies have begun to include registration rights in documentation in Japan. Such registration rights provisions in Japanese shareholder agreements typically state that they are equally applicable to listings in the United States or Japan.

It is also important to note, as described above, that the listing standards of Japanese stock exchanges and over-the-counter markets (1) impose a mandatory lock-up period for shares purchased during the first full fiscal year immediately preceding an IPO, and (2) prohibit a company from issuing any shares (other than on a pro rata basis to existing shareholders) during the period commencing on the first day of the fiscal year during which the company is to complete its IPO and ending on the date of the IPO. For example, the Tokyo Stock Exchange rules provide that, in the event

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48 The use of both demand rights and piggyback rights in connection with an IPO are commonly carved out of demand and piggyback rights in U.S. transactions unless an investor is in a particularly strong bargaining position vis-à-vis a company.
that an investor subscribes for new shares during the one year period ending on the last day of the fiscal year immediately prior to the fiscal year in which the company completes its IPO, the investor must agree not to sell or transfer such shares for a period ending on the latter of six months after the IPO or one year after the investor’s purchase of such shares. 49

5.2. Redemption

Some U.S. investors require that their preferred stock include a feature allowing the investor to redeem (i.e., to cause the company to repurchase and cancel) the preferred stock at the investor’s option. Such redemption rights are usually exercisable for only a limited period commencing several years after the original purchase of the preferred stock. Such preferred shares are typically redeemable at a purchase price equal to the original purchase price plus a reasonable rate of return.

For two reasons, however, redemption is not a universal feature of preferred stock in the United States. First, optional redemption rights can be quite onerous to the issuing company because they may require the company to pay out a substantial amount of cash regardless of the company’s cash flow situation. Second, from the investor’s perspective, redemption rights are often rendered meaningless because the applicable corporate law often prohibits the issuing company from redeeming its shares in the circumstances in which the investor is most likely to desire to exercise its option to redeem (i.e., when the company is doing poorly). Section 160(a) of the Delaware Code, for example, prohibits the redemption of shares when “such purchase or redemption would cause any impairment of the capital of the corporation.” 50 “Impairment of capital” has been defined by the Delaware courts as “the reduction of the amount of the assets of the company below the amount represented by the aggregate outstanding shares of the capital stock of the company.” 51 In other words, a corpora-

49 See TSE INVESTIGATION STANDARDS, supra note 15, § 17 and Rule 15(2)(1) of the interpretive rules thereunder.
50 See tit. 8, § 160(a).
51 In re Int’l Radiator Co., 92 A. 255, 256 (Del. Ch. 1914).
tion may only use surplus capital to repurchase its own shares, which is the same as the rule for declaring and paying dividends.

A company's redemption of shares is similarly restricted in Japan. Section 210 of the Commercial Code permits a company to acquire its own shares with the approval of the shareholders at an ordinary meeting of the shareholders. The redemption price for such shares, however, must be less than the total amount of funds available to a company for distribution as dividends.

Generally speaking, an investor is unlikely to desire to redeem its shares in circumstances where the company is earning sufficient profits to redeem shares out of profits available for dividends (because it signifies that the company is successful and that the investor's shares will continue to appreciate in value). Accordingly, in most circumstances an investor hoping to bail out of an unsuccessful investment would be forced to rely on redemption by means of a reduction of capital.

5.3. Put Rights, Tag-Along Rights, and Drag-Along Rights

A third way in which investors in the United States secure an exit from their investment is by obtaining certain contractual rights which facilitate the investors' sale of their shares of a company in a private sale (i.e., not in a sale via the public market as a part of or after an IPO). These rights include the following:

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53 See tit. 8, § 170.
54 Until the enactment of recent amendments to the Commercial Code on October 1, 2001, the redemption of shares was prohibited as a general principle, with limited exceptions for, among other things, fractional shares, appraisal rights, and employee stock incentive plans. See Shoho, art. 210. In the venture capital context, preferred shares could only be redeemed if they were to be immediately cancelled in accordance with the provisions relating to the reduction of capital, or where such cancellation was to be effected out of profits which were otherwise available to be paid to the shareholders as dividends. See Shoho, art. 212. Furthermore, under Japanese law, a reduction of capital must be approved by shareholders holding more than two-thirds of the issued and outstanding shares present at a meeting attended by more than one-half of the outstanding shares. Because such a resolution may not be approved in advance (i.e., at the time the preferred shares are issued) and because, as discussed above, a covenant by the shareholders to vote to approve such a resolution in the future cannot be enforced through specific performance, redemption by means of reduction of capital always remained subject to the approval of the shareholders.
56 Id. art. 210-3.
(1) **put rights**—the right of an investor to require other shareholders to purchase its shares at a certain price.

(2) **tag-along or co-sale rights**—the right of an investor to require other shareholders (usually founders or majority shareholders) who desire to sell their shares to a third party to require, as a condition to such sale, the third party to also purchase the investors' shares for the same price per share.

(3) **drag-along rights**—the right of an investor, in the event that such investor identifies a purchaser who desires to purchase 100% of the company, to require the other shareholders to also sell their shares to the purchaser (thereby allowing the investor to initiate the sale of 100% of the company).

Although contractual provisions for put rights, tag-along rights, and drag-along rights are generally enforceable in Japan, there are two issues to consider when drafting such provisions.

First, the articles of incorporation of many private Japanese companies require all transfers of shares to be approved by the board of directors of the company. If a company's articles of incorporation contain such a restriction, any transfer made pursuant to such a put right, tag-along right, or drag-along right would be subject to such board approval. In the event that the board of directors does not approve a proposed transfer of shares by a shareholder, the board must designate an alternative purchaser of such shares or, if the board is unable to designate an alternative purchaser (which may include the company), the shareholder may transfer the shares to the originally proposed purchaser.

The second issue concerns the price paid for shares transferred pursuant to a put option (for reasons described below, tag-along and drag-along rights are not affected). In the United States, the purchase price for shares sold pursuant to a put right is often designated in a shareholders agreement not as the fair market value of such shares, but rather as an amount equal to some multiple of the original purchase price or other calculation of the investor's desired return on their investment. In Japan, however, if the purchase price is not equal to the fair market value of the shares at the time of transfer, there is some risk that the seller or the purchaser would be liable for taxes with respect to the difference between the

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57 Article 204 of the Commercial Code provides that the articles of incorporation may stipulate that the transfer of shares requires the approval of the board of directors. See SHOHO, art. 204.

58 Id. art. 204-2, para. 3.
purchase price and the fair market value of the shares (the form and applicable rate of the tax may differ depending upon the identity of the seller and the purchaser).

6. TRANSFER RESTRICTIONS

Documentation for U.S. venture capital and private equity transactions often includes restrictions concerning the transfer of shares. Although their purpose is generally the same (i.e., to control the identity of a company’s shareholders), such transfer restrictions may be divided into two categories: (1) flat prohibitions on transfers designed to maintain certain current shareholders as shareholders of the company, and (2) transfer restrictions which exclude unknown or undesirable third parties from becoming shareholders.

Unconditional prohibitions on transfers are most often used to restrict sales of shares by founders or key management. In the United States, one of the key considerations of venture capital investors in determining whether to invest in a company is the retention of the company’s founders and top management who, by terminating their employment and selling their shares in the company, might be able to retire in luxury or move on to start a new business. Because employees cannot be compelled to work despite the existence of an employment agreement (even in Silicon Valley involuntary servitude is illegal), investors instead focus on tying, pursuant to transfer restrictions in a shareholder agreement, the founders and management to the company’s fortune by prohibiting them from selling their shares for a certain period after the investor’s investment or the company’s IPO. If the greater part of the founders’ and management’s net worth is tied up in shares of a company, it is presumed that they will continue to exert their best efforts as employees of the company.

The other category of transfer restrictions used in the United States (i.e., restrictions which deter undesirable third parties from becoming shareholders of the company) commonly takes the form of “rights of first refusal.” Rights of first refusal provide that in the event a shareholder desires to sell its shares to a third party, the other shareholders will have the right to purchase such shares first. A right of first refusal provision in a shareholder agreement allows the non-selling shareholders to keep the shares of a company “all in the family” by purchasing the exiting shareholder’s shares.
Both unconditional prohibitions on transfer and rights of first refusal are treated similarly under Japanese law. Generally speaking, such transfer restrictions, when included in a shareholders agreement to which a transferring shareholder is a party, are valid. However, if a transferring shareholder transfers his shares in breach of a shareholders agreement and the transferee legally acquires such shares, the transfer would be valid.\textsuperscript{59} Legends on share certificates indicating that the shares are subject to transfer restrictions set forth in a shareholders' agreement, a technique commonly used in the United States to put potential transferees of such shares on notice of such restrictions, are without legal effect in Japan.\textsuperscript{60} Accordingly, while a shareholder who transfers his shares in violation of transfer restrictions in a shareholder agreement would be liable to the other shareholders for monetary damages (which could be extremely difficult to calculate and collect), such shareholder's transfer of its shares would not be unwound.

In addition to rights of first refusal, a Japanese company may have an additional method of controlling who becomes a shareholder. As discussed above in connection with put rights, tag-along rights, and drag-along rights, a Japanese company may specify in its articles of incorporation that all transfers of shares must, as a condition of their transfer, be approved by the board of directors.\textsuperscript{61}

7. Conclusion

With careful attention to the differences between U.S. and Japanese law, a private equity or venture capital investor can successfully negotiate and document an investment in a Japanese company which will have most, if not all, of the standard protections and exit strategies typically provided to investors in U.S.

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\textsuperscript{59} See DOING BUSINESS IN JAPAN, supra note 5, § 9.04[10].

\textsuperscript{60} Share certificates in Japan may bear a legend stating that transfers are subject to the approval of the company's board of directors, provided that such restriction is also included in the company's articles of incorporation and that such articles are registered with the relevant legal affairs bureau. See SHOHO, arts. 188(II)(3), 204, 225-8. The legend may not include more specifically tailored prohibitions, such as limits on transfers to competitors only. In addition, in cases where a board of directors does not approve a proposed transfer, the Commercial Code requires the Company to find an alternative purchaser. See id. art. 204-2. Accordingly, both the flexibility and the effectiveness of such a legend in Japan is limited in comparison to the United States.

\textsuperscript{61} See id. art. 204-1.
companies. While this Article is intended to serve as a checklist to ensure that such investor protections and exit strategies are correctly analyzed and provided for, it would be prudent to confer with Japanese counsel regarding any subsequent changes to the Commercial Code and accepted business practices in Japan.