Japan Corporate & Finance Insights August 2022

Investment in Japanese Startups

By Yusuke Hayashi

August 30, 2022

I. Introduction

In recent years, foreign investors have begun investing in Japanese startups. Because Japanese startup finance practices share many similarities with those in Silicon Valley, the "mecca" of startups, it should be easy for foreign investors to understand them. On the other hand, the startup environment in Japan has some unique features that are attributable to Japanese laws and business practices.

Some say that foreign investors will be hesitant to invest in Japan in the future due to rising interest rates in the U.S. However, we believe that investors will continue to be drawn to promising startups in Japan even under such adverse conditions, and understanding the latest practices in venture financing will become even more important. In this letter, we introduce certain features of Japanese startup finance practices which foreign investors should be aware of, as well as recent amendments to the Foreign Exchange and Foreign Trade Act ("FEFTA") and corporate registry practice in Japan.

II. Investment Flow for Startups in Japan

For a financing in a priced round, outside investors generally invest in Japanese startups in exchange for shares of preferred stock, and the general flow of investment is as follows.
(i) Signing of a non-disclosure agreement
(ii) Negotiation and execution of the term sheet
(iii) Conducting due diligence
(iv) Negotiation and execution of the definitive agreement

The following items are generally included in the definitive agreement.
(1) Proposed amendment to the Articles of Incorporation to set forth the features of preferred stock;

(2) An investment agreement setting forth the provisions for investment;
(3) Shareholders agreement; and
(4) Agreement on the distribution of assets.

In Japan, there is no specific model agreement for startup finance for general use, as is the case with the model agreements published by the NVCA in the U.S. In Japanese startup investment practice, an investor often presents a model investment agreement that stipulates favorable terms for the investor, and the agreement is sometimes concluded without much negotiation especially when the startup is in its early stages.

III. Regulations under the FEFTA

Since investments by foreign investors in startups often fall under the category of "Foreign Direct Investment, etc. ("FDI")," the FEFTA regulations must always be examined prior to these investments.

The following points need to be considered:
(i) Applicability to Foreign Investors
(ii) Applicability to FDI .
(iii) Whether a target startup falls under a Designated Business Sector
(iv) Availability of exemption for prior notification

The term "Foreign Investors" covers (x) non-resident individuals, (y) corporations or other entities established under foreign laws and regulations ("Foreign Entities"), and (z) Japanese entities in which non-resident individuals or Foreign Entities directly or indirectly hold 50% or more of their voting rights. In addition, the acquisition of shares of an unlisted company, even the acquisition of a single share, is considered FDI. Therefore, a Foreign Investor must submit a prior notification or post facto report upon the consummation of FDI, unless certain exceptions apply.

To determine whether or not a prior notification is required, investors must confirm whether or not a target startup engages in a Designated Business Sector. In particular, because the software, information processing/services, and internet support industries have been added to the list of Designated Business Sectors in recent years, the number of tech startups in which a prior notification is required has significantly increased.

Since some of the above considerations require high-level legal analysis, it is advisable to consult a

Japanese attorney, and if necessary, the applicable authorities. For example, if the investee develops or investigates, analyzes, and/or advises with respect to the development of a software, prior notification is required, while if the investee is a software sales company, prior notification is generally not required. As such, there are subtle differences among software companies.

If an investment is subject to prior notification, unless any exemption applies, a prior notification must be filed. The transaction is prohibited for 30 days from the date of filing of the prior notification, although where it is not specifically required to be examined, the period is typically reduced to two weeks. In addition, the Minister of Finance and the Minister having jurisdiction over the business of a startup may recommend that the Foreign Investor who has submitted a prior notification, or is the subject of such notification, modify or discontinue the transaction, order the implementation of subsequent measures, or impose penalties for violations, etc.

Even if prior notification is not required, a post facto report may be required in certain cases.

Note that the following cases may fall under FDI: (a) when a Foreign Investor votes to appoint itself, or its related parties, as directors or corporate auditors (or when a Foreign Investor votes for the appointment of a related party of the other party if the Foreign Investor is obliged to vote for director/corporate auditor candidates nominated by the other party under a shareholders' or joint venture agreement), and (b) when a Foreign Investor provides a monetary loan to a startup company. In these cases, it should be noted that a prior notification or post facto report is required.

In addition to the FEFTA, there are other foreign investment restrictions (e.g., restrictions on the ratio of voting rights of foreign shareholders in broadcasting companies under the Broadcasting Law and the Radio Law). This depends on the type of industry of the startup, so it is advisable to first ask the startup whether any other foreign investment restrictions exist.

IV. Articles of Incorporation

Under Japan's Companies Act, the Articles of Incorporation set forth the basic rules of a stock corporation, and before shares of preferred stock can be issued, the features of preferred stock shall be set forth in the Articles of Incorporation.[1]

---

[1] Japanese Articles of Incorporation include detailed clerical provisions and are not divided up in the way that the Certificate of Incorporation and Bylaws are for Delaware corporations.

In addition to being included in the Articles of Incorporation, the features of the preferred stock are registered and disclosed in the commercial register, for anyone's verification. The following is a summary of what features preferred stock may have.

Economic Matters	
Preferred Dividend	・ It is permitted to provide for the distribution of surplus to preferred stock in preference to common stock. ・ Even where a preferred dividend provision is included, the preferred dividend is rarely paid.
Preferred Distribution of Residual Assets	・ In the event of dissolution or liquidation of a startup, it is common practice to provide for the distribution of residual assets to preferred shareholders in preference to common shareholders. ・ In addition, it is common to provide for a Deemed Liquidation Preference, which states that in the event of an M&A transaction, the consideration therefor will be distributed preferentially to the preferred shareholders. This provision is usually stipulated in the shareholders' agreement (or agreement on the distribution of assets) as well. ・ If there are residual assets after the preferred distribution is made, usually one times the amount paid in (1X), it is common to grant preferred shareholders the right to receive a second distribution together with common shareholders (right of participation).
Conversion; Antidilution Adjustments; Put Option	・ It is common practice to provide that preferred shareholders may request a startup to convert their shares of preferred stock into shares of common stock without any trigger. In Japan, this right is mainly used in the process of converting all shares of preferred stock into shares of common stock prior to an IPO, since, in principle, shares of preferred stock cannot be listed. ・ In order to prevent dilution, mechanism of adjustment of conversion price is often included, which is triggered by the issuance of shares at a price lower than the price per share for the previous round. In Japan, it is common to use a narrow-based adjustment, which is more favorable to investors participating in the round than the type of broad-based adjustment common in Silicon Valley. ・ Startups sometimes provide that a preferred shareholder may convert its shares of preferred stock into cash, subject to the occurrence of an M&A transaction such as a business transfer (*Jigyou Jouto*) or corporate split (*Kaisha Bunkatsu*) for which consideration is delivered to the startup.

Right to Acquisition	・ It is common for startups to provide that they may acquire shares of preferred stock and convert them into shares of common stock upon a board resolution for the application of an IPO, or upon request of the lead managing underwriter.
Governance Matters	
Voting Rights	・ It is common to provide that preferred stock has the same voting rights as common stock, i.e., one voting right per share
Restriction on Transfer	・ It is common to provide that the transfer of shares of preferred stock requires stockholder or board consent.
Veto Rights	・ Startups may provide that any matter to be resolved at a general meeting of shareholders (or at a meeting of the Board of Directors, etc.) shall require, in addition to the general resolution, another resolution of the preferred shareholders. ・ This being said, veto rights are not often set as a feature of the preferred stock themselves because obtaining a resolution of the preferred shareholders is burdensome and would require disclosure of the matters subject to the veto right through statutory registration. Thus, startups are more likely to include the veto right in the shareholders' agreement.
Right to Appoint Directors and Corporate Auditors	・ Startups may provide that preferred shareholders appoint directors or corporate auditors. ・ This, however, is not often included in the articles of incorporation, and it is common to grant certain investors the right to appoint directors and/or corporate auditors as a contractual right in the shareholders' agreement.

V. Investment Agreement

An investment agreement is an agreement between an investor and a startup that mainly stipulates the economic terms of the investment, investment preconditions, covenants, representations and warranties ("R&Ws"), and a party's measures to be taken in the event of the other party's breach of that agreement. In many cases, in addition to the investor and the startup, the management shareholders (*Keiei Kabunushi*) of the startup are also parties to the investment agreement. The main purpose of this is to make the management shareholders jointly and severally liable for any breach of covenants or representations and warranties by the startup under the investment agreement.

In particular, investment agreements often provide not only indemnification obligations but also put

options on the shares held by the investor, triggered by a breach of covenants or R&Ws[2] [3], and stipulate that the management shareholders are jointly and severally liable for the purchase obligation of the startup. However, in light of the fact that this type of management shareholder liability is not common from a global perspective and the fact that it disincentivizes entrepreneurship and corporate management members, a government agency in Japan has recently published guidelines stating that it is desirable, in the event of breach of agreement, to limit the investors' right to demand purchase of their shares to the startup only and not to individuals such as the management shareholders.

In Japan, a startup shall apply for registration soon after issuing new shares and then shall pay a registration and license tax of 0.7% (*Touroku Menkyo Zei*) of the amount of increase in capital (however, the minimum amount is 150,000 yen). In addition, if a startup raises funds by way of executing a total number underwriting agreement (*Sousuu Hikiuke Keiyaku*), it is necessary to execute such agreement between each investor and the startup, and to make an approval shareholders resolution (or if the startup has a board of directors, the board of directors). This agreement is required for registration, but note that, due to a recent change in the operation of the Legal Affairs Bureau, it does not matter whether or not the total number underwriting agreement is stamped.

VI. Shareholders' Agreement and Agreement on Distribution of Assets

Shareholders' agreements are made by and between investors, a startup and management shareholders, mainly for the purpose of agreeing on matters related to the management of the startup, investor's right such as veto rights and a right to request the Company's information, disposal of shares, and other matters regarding the handling of shares of the startup held by the investors.

In the case of startup investments, there are many cases where an IPO effort obligation is stipulated in the shareholders' agreement in order to increase the commitment to an IPO by the startup. Although that is an effort obligation, some shareholders' agreements stipulate that the startup shall purchase the shares held by the investor at a predetermined price in the event of a breach of the obligation

---

[2] The R&Ws in the investment agreement also have the function of providing information on the startup company to investors, to supplement the investors' due diligence.

[3] One of the characteristics of investment agreements is that they require R&Ws regarding Anti-Social Forces (*Han-Shakaiteki Seiryoku*). Anti-Social Forces refers to organized crime groups (Japanese Mafia, "*Bouryokudan*") and their members, corporate racketeers, and any other similar organization that have the potential for violence or social unrest.

("Put Option"). However, even in such cases, such option will be exercised only if the manner and degree of the breach is extremely malicious.

Typical provisions in shareholders' agreements regarding the disposition of shares include the Right of First Refusal ("ROFR") and the Co-Sale Right. A ROFR, also called preemption right, is a right of a shareholder to purchase the shares to be transferred if another shareholder wishes to transfer his/her shares to a third party.[4] A Co-Sale Right, also called a tag-along right, is a right to require a shareholder, before selling any shares to a third party (but after going through the ROFR procedures), to allow shareholders the opportunity to participate in the sale in proportion to the number of shares held by them.

In many cases, an agreement on distribution of assets is executed separately from a shareholders' agreement to provide that, in the event of an M&A transaction such as a merger, other reorganization or a share transfer, the consideration for the M&A transaction will be distributed to shareholders by applying mutatis mutandis the provisions for distribution of residual assets in the Articles of Incorporation, as if the startup were being liquidated. Since the main purpose of a shareholders' agreement is to provide for the involvement of specific investors in the management of the company, it is not necessary to include all shareholders as parties, whereas an agreement on distribution of assets provides rules for the distribution of M&A consideration among shareholders and, in order to ensure the effectiveness of such an agreement, all shareholders (including not only management shareholders and investors but also individual shareholders) should be as parties to it.

VII. Convertible Equity – J-KISS

Recently, the use of the so-called "J-KISS" has been increasingly used by startups in their early stages as one method for bridge financing. The J-KISS is created based on the "KISS" (Keep It Simple Securities), which was proposed and published by the U.S. accelerator 500 Startups as a so-called convertible equity method. The intention behind the J-KISS was to develop a convertible equity instrument in Japan. The template is open to the public for free. In the case of the issuance of a J-KISS, the number of stock acquisition rights to be issued is determined at the general shareholders meeting of the startup and is allocated to investors. For example, an investor acquires one stock acquisition right in exchange for an investment of JPY 10 million, but at the investment phase, it is not decided how many shares each stock acquisition right will be worth. Although this appears to be

[4] In Japan, due to strict share repurchase regulations, there are very few cases where the startup has a right of first refusal.

disadvantageous to the investor, it also includes investor protections such as “valuation caps” and “discounts” at the time of conversion in exchange.

In the case of investments using convertible equity, valuations do not need to be obtained, and the cost of negotiations and legal review are generally smaller. This results in faster funding and lower costs. Furthermore, since the template is fair to a certain degree for both the startup and the investors, there are significant advantages for the startup, especially in cases where there are many players with experience in using it. In fact, in countries with leading venture investment practices, such as in the U.S., the SAFE (Simple Agreement for Future Equity) has become popular as a low-cost procurement method. However, since the J-KISS is not yet widely used in Japan and the number of experts who can handle legal reviews of J-KISS investments is small, it is not always possible to issue one at as low a cost.

Note that the J-KISS is supposed to allow founders to raise funds at a more favorable share price because it allows valuations to be delayed, if the valuation cap is too low, seed investors will take a larger share at a low price, and the founders will lose their advantage.

Proper allocation of risk and realization of simple and concise investments are issues which must be addressed for the further development of the Japanese startup ecosystem in the future.

* * *

If you have any questions regarding the matters covered in this memorandum, please reach out to your usual TMI contact or the attorney listed below.

Author

Yusuke Hayashi
Attorney-at-law
Admitted in Japan and California

TMI Associates Kyoto Office

Phone: +81 75 256 5551

Email: yhayashi@tmi.gr.jp

© TMI Associates | 23rd Floor, Roppongi Hills Mori Tower | 6-10-1 Roppongi | Minato-ku, Tokyo 106-6123

All rights reserved. This memorandum is an attorney advertisement which is for informational purposes only and does not contain any legal advice. Transmission of this memorandum is not considered to create, and receipt hereof does not establish, an attorney-client relationship. Legal advice of any nature should be sought from legal counsel.