

# PANORAMIC

# VENTURE CAPITAL 2024

Contributing Editor

Curtis L. Mo

DLA Piper



LEXOLOGY

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Quick reference guide enabling side-by-side comparison of local insights, including into the general role of venture capital and market conditions; parties and deal structures; process; due diligence; financial terms; control rights; public offerings and listings; sale transactions; disputes; foreign investment considerations; and recent trends.

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## MARKET AND PURPOSE

### General role and purpose

- 1 | How would you describe the role of venture capital in the financing markets in your jurisdiction?

Venture capital has been a hot topic in corporate Japan for the past couple of decades and its prominence in the capital markets and the popular imagination is expected to continue to grow. One piece of evidence of this phenomenon is that more and more Japanese university graduates seek to start their own business rather than join the government or large companies, in a sharp break with the traditional routes to power and prestige in Japan.

That said, the Japanese venture capital market remains smaller than one would expect. Japan is one of the four largest economies in the world, but its venture capital market is comparable to a mid-size venture capital market in the United States, as measured by the amount of investment in Japanese start-ups. According to the *CB Insights* 'State of Venture 2023 Report', Japan's venture capital market is on par with that of Seattle, Washington, DC and Denver, which is significantly smaller than those of New York (one-fifth the size) and Silicon Valley (one-sixteenth the size).

Even within Asia, where Japan's economy is the second largest, it is falling far behind China and India in terms of venture capital market size. In 2023, China and India attracted 8.3 times and 2.2 times more venture capital funding, respectively, than Japan ('State of Venture 2023 Report', *CB Insights*) (albeit a smaller differential than in 2022). Of the 10 largest venture capital financing rounds in Asia in the fourth quarter of 2023, four were in China, two in Saudi Arabia, one in each of India, Indonesia, Malaysia and the United Arab Emirates, and none was in Japan (State of Venture 2023 Report, *CB Insights*, 161). On the other hand, of the top 10 start-up investors in Asia by company count in the fourth quarter of 2023, five were from Japan, two were from China and Singapore, and one was from each of India and South Korea ('State of Venture 2023 Report', *CB Insights*, 164). In terms of percentage of GDP invested in start-ups, Japan ranks 19th among the 38 Organisation for Economic Co-operation and Development countries according to *Entrepreneurship at a Glance: 2018 Highlights*.

The relatively smaller size of the venture capital market in Japan leads to smaller valuations and financing rounds. For example, the average size of financing rounds globally in 2023 was US\$10 million for Series A, US\$19 million for Series B, US\$30 million for Series C, and US\$50 million for Series D and later (KPMG Venture Pulse Q4 2023, 9). By comparison, the [investment trend survey](#) by Venture Enterprise Center found that, in 2022, Japan's corresponding figures were approximately US\$730,000 for series seed and US\$700,000 for early-stage investments.

Another data point is the number of unicorns (private companies with a market cap exceeding US\$1 billion). At the end of 2023, there were 1,233 unicorns worldwide, with 71 reaching unicorn status in 2023. Japan currently has only seven unicorns, as compared with 653 in the US, 172 in China, 14 in South Korea and 71 in India (see the complete list of unicorn companies in the 'State of Venture 2023 Report', *CB Insights*).

Even so, venture capital financing is becoming increasingly important in Japan's financing market and the number of venture capital investors has been on the rise over the past few years, [increasing 23 per cent from 658 firms in 2019 to 810 firms in 2022](#). As the number of investors increases and Japan's start-up ecosystem matures, the Japanese venture capital market is expected to continue to grow and become more active. The entrance of government-backed funds into the venture capital market in recent years also shows a growing awareness and emphasis on supporting and developing Japan's venture capital market.

Japan is generally seen as a pro-investor market, as is evident from the various pro-investor rights described below. Japan can be grouped with other pro-investor markets such as China and India, whereas the United States and Israel are often viewed as pro-founders, and the UK and Germany falling in between the two camps.

**Law stated - 26 January 2024**

## Market conditions

### 2 | How would you describe the current market conditions for venture capital in your jurisdiction?

Despite its relatively small size and the global VC downturn, the Japanese venture capital market is growing and market participants remain bullish. The number of startups in Japan facing down rounds or flat rounds is growing, but at a slower clip than in the United States and in other major VC markets, in part because startups in Japan did not experience the dizzying valuations seen elsewhere in recent years.

Despite a global slowdown in the venture capital market in 2022 and 2023, the venture capital market in Japan has remained relatively stable (State of Venture 2023 Report, *CB Insights*, 178). Indeed, the Japan Startup Funding Report published by INITIAL found that venture capital investments in the country during the first half of 2022 exceeded half of the total investment amount for the full year of 2021, and the average investment per start-up also increased on a year-on-year basis.

Another sign of optimism is the fact that high-profile overseas venture capital funds are turning their attention to Japan. In 2021, SoftBank Vision Fund invested in Japanese start-ups for the first time. Despite its ties to Japan-based SoftBank, the Vision Fund had previously eschewed the Japanese market because few, if any, start-ups could accommodate the fund's minimum ticket size. In addition, overseas private equity funds and investment managers are increasing their investments in pre-IPO start-ups in Japan. The emergence of these new classes of investors is contributing to the enrichment and diversification of the country's venture capital market.

The Japanese venture capital market has also benefitted from buoyant corporate venture capital (CVC) activities. Japan has a huge number of companies with tremendous technological competence, but there exists the perception that they are no longer producing innovative products and the technologies of the future at the same clip as in the pre-2000s. Many companies have concluded that they can no longer rely solely on internal R&D to remain relevant on the global stage and that they must outsource innovation. These

companies have turned to CVC as a means of achieving this objective. The global venture capital market in 2023 exhibited continued sluggishness and Japan was somewhat impacted by this trend. However, both domestic and outbound CVC activity has grown significantly in the past few years. For example, of the top CVCs by company count in the fourth quarter of 2023, five were from Japan, two were from the United States, and one was from South Korea and China (State of Venture 2023 Report, *CB Insights*, 46).

Law stated - 26 January 2024

## PARTIES AND DEAL STRUCTURES

### Issuers – typical profile

- 3 | How would you describe the types of companies, and their different stages of development, that typically receive venture capital investment in your jurisdiction?

The profile of companies that receive venture capital financing is as one would expect: young companies that often focus on technology and fast growth. Companies receiving venture capital financing range from those that have just been formed and have nothing but a founder or two with an untested business plan to pre-IPO companies with valuations of hundreds of millions of US dollars. Start-ups in Japan generally do not reach the huge valuations one finds in major venture capital markets such as China, Europe, India and the United States. Few Japanese start-ups have valuations in excess of US\$100 million and the country boasts very few 'unicorns'.

Law stated - 26 January 2024

### Issuers – domicile and company structures

- 4 | Are there any preferred or required legal domicile or company structures for issuers in venture capital transactions?

Start-ups choose the traditional *kabushiki kaisha* (KK) corporate structure, which is similar to the C-corp structure in Delaware. The KK structure has been around for many decades. It is the most commonly used structure in Japan, is well known to investors and is the preferred structure for listings.

Japan also has the *gō dō kaisha* (GK) corporate structure, which is known as the Japanese equivalent of the Delaware LLC structure. While this structure can be advantageous from the tax perspective, it is not used for companies seeking venture capital funding, because implementing a preferred equity structure is complicated and it is not possible for GKs to list in Japan. For these and other reasons, venture capital investors do not invest in GK entities.

There are no particular regulations regarding domicile; it is possible for companies not incorporated under Japanese law to seek financing and operate in Japan. Some funds and governmental agencies, however, are under legal requirements to invest all or a portion

of their funds in Japanese companies. As a result, start-ups that seek funding from such investors must be incorporated in Japan.

Most start-ups in the country are established under Japanese law. Start-ups that seek to obtain financing in larger markets, such as the United States, sometimes incorporate as a Delaware corporation and operate and raise money in Japan as such, while others establish a parent company in Delaware for fundraising purposes and operate in Japan as a Japanese company.

There are no residency or citizenship requirements for directors or shareholders of Japanese companies, which makes it possible for foreigners to establish and operate companies in Japan. The number of start-ups established by foreigners is increasing.

**Law stated - 26 January 2024**

## Investors – typical profile

### 5 | How would you describe the types of investors that make venture capital investments, including by stage of company development, in your jurisdiction?

The range of venture capital investors in Japan is quite broad and diverse. The following types of investors are active in the domestic Japanese venture capital market:

- large, traditional Japanese venture capital funds affiliated with banks and financial institutions (Mizuho Capital, Mitsubishi UFJ Capital, SMBC Venture Capital, SBI Investment, Daiwa Corporate Investment, Nissay Capital, Shinsei Corporate Investment);
- venture capital funds financed by public money and focused on supporting domestic technology and industry (DBJ Capital, Innovation Network Corporation of Japan, Regional Economy Vitalization Corporation of Japan, JIC Venture Growth Investments);
- established domestic venture capital funds without financial institution affiliation (JAFCO Group, Global Brain, Globis Capital Partners, JAIC Group);
- newer venture capital funds without financial institution affiliation (MPower Partners, Mistletoe, Beyond Next Ventures, ANRI, East Ventures, World Innovation Lab, Coral Capital (successor to 500 Startups Japan), Shizen Capital, Minerva Growth Partners, Genesia, Saisei Ventures);
- venture capital funds with ties to universities and research institutions (University of Tokyo Edge Capital, Miyako Capital, Osaka University Venture Capital);
- venture capital funds affiliated with overseas funds (DNX Ventures (related to Draper Nexus), Eight Roads, DCM);
- overseas investors (venture capital funds including SoftBank Vision Fund, Sequoia Capital, financial institutions such as Goldman Sachs, and corporate venture capital (CVC));
- overseas private equity funds (Bain Capital, Keyrock, Seiga Asset Management;
- corporate investors (as direct investors or through dedicated CVC arms);

- angel investors; and
- incubators (Samurai Incubate, Incubate Fund, Dream Incubator), several of which are affiliated with universities (for example, the University of Tokyo Entrepreneurs Plaza, SFC IV).

Law stated - 26 January 2024

## Investors – structures

- 6 | How are venture capital investors usually structured and does their structure affect their investment approach or terms?

The first round of outside investment is often in the form of common stock and convertible bonds with warrants. The J-KISS is being used with increasing frequency; it is modelled on the KISS developed by 500 Startups in the United States and was brought to the Japanese market in an attempt to introduce a convertible equity instrument similar to the simple agreement for future equity (SAFE). While simpler than a convertible bond with warrants, the J-KISS is much more complex than the SAFE used in the United States.

Law stated - 26 January 2024

## Seed financings

- 7 | What structures and types of investments are typically used for seed-stage investments in your jurisdiction?

Seed-stage investments are generally in the form of convertible bonds with warrants, J-KISS investments, preferred stock investments and, on occasion, common stock investments.

Law stated - 26 January 2024

## Early-stage and later investments

- 8 | What structures and types of investments are typically used for early-stage and later investments, following seed-stage investments, in your jurisdiction?

Preferred stock is most commonly used for early-stage and later investments.

Law stated - 26 January 2024

## PROCESS

### Term sheets

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## 9 | Do parties normally use term sheets? If so, what is normally covered in such term sheets?

Yes, term sheets are used in most venture capital financings and cover the key terms of financings, such as:

- dividend and liquidation preference;
- anti-dilution adjustments;
- reserved matters and veto rights;
- pre-emptive rights for new share issuances;
- rights of first refusal and co-sale or tag-along rights;
- drag-along rights;
- board and observer rights; and
- information rights.

Law stated - 26 January 2024

## Documentation

## 10 | What are the standard documents for a venture capital transaction, and who prepares them? Are there popular forms for such documentation in your jurisdiction?

The primary deal documents for convertible debt financings are the term sheet and the convertible bond with warrants or J-KISS. Convertible debt financings done with the J-KISS often dispense with the term sheet.

The primary deal documents for equity financings are:

- the term sheet;
- the investment or subscription agreement;
- the shareholders' agreement; and
- the articles of incorporation.

Side letters are also used where appropriate. The term sheet is almost always prepared by the investor and the other documents are generally prepared by the issuer.

The shareholders' agreement is sometimes divided into two agreements: a distribution agreement that deals with deemed liquidations (as opposed to 'true liquidations', which are addressed in the articles of incorporation), and a shareholders' agreement absent the deemed liquidation provision.

In many financings, all investors sign the same investment or subscription agreement, but it is not uncommon for different investors to sign slightly different investment agreements with bespoke provisions requested by the investors.

There is a publicly available form of J-KISS that is widely used, but there are no publicly available templates for the other standard documents; consequently, documents used in Japanese venture capital financings tend to be less uniform than, for example, in the United States, where financing documents are based on or follow the publicly available National Venture Capital Association forms.

English-language financing documents are sometimes used if companies have many foreign investors, but in most cases the documents are in Japanese, and foreign investors must rely on English translations for reference. Even if English-language documents are used, the controlling version of certain provisions in the investment agreement that must be registered (the rights and preferences of the preferred stock) will be in Japanese.

**Law stated - 26 January 2024**

## Key steps and timing

### 11 | What is the normal process and timing of venture capital investments in your jurisdiction?

The typical steps in an equity financing in Japan are as follows:

- the lead investor and the issuer may sign an NDA before they start discussions, in conjunction with the negotiation of the term sheet and before the start of the due diligence process, or they may not sign one at all and instead rely on the confidentiality provision typically found in the investment documents;
- the lead investor and the issuer agree on valuation and other major business terms;
- the lead investor proposes a term sheet;
- after the parties sign the term sheet, the lead investor sends a due diligence request list;
- while the lead investor and other investors conduct due diligence, the issuer prepares the investment documents, and the parties negotiate the deal terms and agreements;
- if the investment requires any foreign investors to make a Foreign Exchange and Foreign Trade Act (FEFTA) filing, foreign investors will prepare the filing with cooperation from the issuer, usually after the signing of the investment agreement; and
- if a FEFTA filing must be made, the parties will have to wait until receipt of approval from the regulators before the transaction can close. It usually takes a week or two to prepare the FEFTA filing, and two to four weeks after submission to receive approval from the regulators.

The entire process from proposal of the term sheet to closing (without a FEFTA filing) typically takes between two and three months, though we have seen cases where transactions have taken as little as a month or longer than a year.

**Law stated - 26 January 2024**

## Closing conditions

### 12 | What closing conditions are common in venture capital transactions?

Typical closing conditions include:

- accuracy of the issuer's representations and warranties;
- performance of the issuer's pre-closing covenants;
- execution of the shareholders' agreement and other ancillary documents;
- amendment to the articles of incorporation; and
- approval of the issuer's shareholders.

Additionally, investors may require that issues identified in due diligence be resolved before closing.

Legal opinions are not issued in Japan, and it is not customary to deliver closing certificates or copies of certified board and shareholder resolutions.

Law stated - 26 January 2024

## Multiple closings

### 13 | Are venture capital transactions ever divided into multiple closings? If so, how and why?

Yes, it is common to have multiple closings. The primary reason is to allow the issuer to raise funds from investors that require more time to close their investment.

Law stated - 26 January 2024

## DUE DILIGENCE

### Legal due diligence

### 14 | What legal due diligence is typically undertaken for venture capital transactions, and what specialists are typically involved?

The lead investor in a financing will typically conduct full legal due diligence and it is not uncommon for follow-on investors to conduct a more limited legal due diligence.

The most common areas of inquiry in legal due diligence are capitalisation, intellectual property, compliance and labour, but cautious investors will also examine other areas covered in due diligence for M&A transactions.

It is worth noting that unlike in the United States, it is not market practice in Japan for issuers to pay the legal fees of the lead investor in a round. As a result, the lead investor

is not deemed to perform due diligence for the benefit of all investors, and for this reason it is not uncommon to have several investors in a round conduct their own due diligence, independent of the other investors.

Law stated - 26 January 2024

### Critical due diligence areas

- 15** | What are normally critical areas of due diligence focus or red flags in venture capital transactions?

Japanese laws regarding employee inventions can lead to significant problems for the issuer if not properly observed; therefore, investors generally conduct detailed intellectual property due diligence. Labour laws in Japan are very onerous and complex, and many start-ups do not comply with them fully, so this is another area that is the subject of intense due diligence. The same can be said of privacy laws. Since there are extensive regulations covering all types of businesses, the legality of a start-up's business is also an area of critical importance during due diligence, especially in cases where the start-up's business reflects a novel industry.

Law stated - 26 January 2024

### Other due diligence

- 16** | What other types of due diligence are commonly undertaken in venture capital transactions?

In addition to legal due diligence, investors often undertake financial due diligence and will sometimes undertake business due diligence, but usually only in larger rounds.

Law stated - 26 January 2024

## ECONOMIC TERMS

### Valuation and pricing

- 17** | How is the company valuation and investors' purchase price usually determined in venture capital transactions?

Valuing start-ups, especially pre-revenue start-ups, is inherently difficult. As a result, rather than relying on written valuations based on discounted cash flow, EBITDA multiples and other standard metrics, valuations are often arrived at through negotiations between the issuer and the lead investor based on a variety of factors, including valuations of comparable companies and the post-investment percentage ownership sought by the founders and investors. Third-party valuation firms are typically not used in venture capital financings.

Law stated - 26 January 2024

## Option pool

- 18** | What do investors typically require for option pools or equity incentive arrangements in connection with venture capital transactions?

It is common to set aside about 10 per cent to 15 per cent of a company's outstanding shares for stock options.

Japan has tax-qualified stock options (taxation is deferred until disposition and the capital gains rate applies) and non-tax qualified stock options (exercise is a taxable event at income tax rate). Tax-qualified stock options are onerous to implement and are not well suited for startups seeking M&A exits, as opposed to IPO exits, and for these reasons, many early-stage start-ups instead opt for non-qualified stock options. In addition, the rules governing stock option grants make it difficult to establish stock option pools.

Cognisant of the practical difficulties faced by start-ups in making effective use of stock options and wishing to address the deficiencies that limited their use, in 2023 the Japanese tax authority published revised guidelines clarifying certain points with respect to the tax treatment of tax-qualified stock options and the Japanese government announced its intention to amend the rules governing stock options. If these amendments are implemented in the future, it will be much easier for start-ups to create stock option pools and grant tax-qualified stock options.

Law stated - 26 January 2024

## Dividends, distributions and redemptions

- 19** | What are the normal provisions governing dividends, distributions, redemptions or other profit distributions in venture capital transactions? Are there any legal limits thereon in your jurisdiction?

Dividends are typically non-accruing and on an if-and-as-declared basis. Preferred holders receive accruing dividends in a minority of cases.

Holders of preferred shares have priority over holders of common shares with respect to liquidations and company sales (deemed liquidations). Later classes of preferred shares often have priority over earlier classes, but *pari passu* liquidation preference among classes of preferred shares is not uncommon. Liquidation preferences for holders of preferred shares are usually uncapped and participating; after receiving their preferred liquidation preference, holders of preferred shares receive their pro rata share of liquidation proceeds available to holders of common shares as if they had converted to common .

Redemption rights are not standard, but they are sometimes seen where the issuer does not have an exit event within a specified number of years after a financing or where the issuer has breached certain covenants that entitle holders of preferred shares to have their shares redeemed.

Under Japanese law, the distribution of dividends from surplus and repurchase of shares by the issuer through the exercise of redemption rights may only be made within the distributable amount, which is calculated by subtracting the book value of the issuer's treasury stock from the surplus present at the time of distribution. Furthermore, a distribution of surplus is not allowed if the issuer's net assets are less than ¥3 million.

**Law stated - 26 January 2024**

## **Company sales and liquidations**

- 20** | How are venture capital investments treated in portfolio company sales or liquidations?

Preferred shares in Japanese companies typically benefit from liquidation preference, often of the participating and uncapped variety. Liquidation preferences apply both to actual liquidations and deemed liquidations such as M&A exits. Holders of preferred shares will benefit from these liquidation preferences in portfolio company sales and liquidations.

**Law stated - 26 January 2024**

## **Anti-dilution protection**

- 21** | What anti-dilution protections are typically built into the terms of venture capital securities?

Preferred shares typically benefit from broad-based weighted average anti-dilution protections. Full-ratchet anti-dilution protections are seen on very rare occasions.

**Law stated - 26 January 2024**

## **Future investments**

- 22** | What pre-emptive or pro rata investment rights do venture capital investors usually receive?

It is standard for holders of preferred stock to receive pro rata rights to participate in future share issuances.

**Law stated - 26 January 2024**

## **Insider sales**

- 23** | What rights do venture capital investors normally have over insider sales of securities of portfolio companies?

It is common for founders (and other key holders of common stock) and holders of preferred stock to benefit from and be bound by rights of first refusal and co-sale or tag-along rights, which means that all holders of preferred stock must comply with right of first refusal and co-sale or tag-along right procedures if they wish to sell shares. This differs from the US approach whereby only founders are bound by these procedures and preferred holders benefit from but are not bound by them.

Law stated - 26 January 2024

## CONTROL RIGHTS

### Voting rights

- 24** | What voting rights, including veto or consent rights, do venture capital investors normally have as shareholders of their portfolio companies? Do they typically have special voting or consent rights as shareholders?

Under Japanese law, if the issuer takes actions that will adversely affect the rights of a class of preferred shares (eg, the creation of a new class of shares), such actions are not effective unless the consent of the holders of a majority of the affected shares is obtained. Apart from statutory consent rights, holders of preferred shares typically have contractual consent rights with respect to other material matters. These consent rights are generally in favour of all classes of preferred shares, as opposed to specific classes of preferred shares, which means that consent of a specified percentage of holders of all classes of preferred shares, voting together, must be obtained to approve reserved matters.

Law stated - 26 January 2024

### Board rights

- 25** | What rights to representation on the board of directors or at meetings of the board of directors of portfolio companies do venture capital investors typically receive?

It is common for each class of preferred shares to obtain one seat on the issuer's board. Whether a class receives a board seat depends in part on the post-closing shareholding percentage of the class. Where a class has a large percentage of all outstanding shares, the class may receive two board seats or more, and where the percentage is low, the class may receive no board seats.

If a class of preferred shares receives a board seat, the lead investor in the class generally has the right to designate the class director.

Large investors that are not eligible for a board seat sometimes receive observer rights.

Law stated - 26 January 2024

### Board protections

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## 26 | What fiduciary duties and liability protections normally apply to investor directors in your jurisdiction? Do directors typically have special voting or consent rights?

Directors of Japanese companies are subject to fiduciary duties similar to those that apply to directors in the United States. Under Japanese law, an issuer may enter into a limited liability agreement with its non-executive directors, which would cap the directors' liability at no less than twice their total annual compensation, on condition that the directors fulfil their duties without gross negligence. It is common for issuers to execute a limited liability agreement with investor-appointed directors.

The limited liability agreement covers only liability arising from damages caused by the directors' negligence in performing duties owed by the directors to the issuer; thus, the limited liability agreement does not cover liability of directors with respect to claims for damages from third parties.

Indemnification coverage intended to protect directors from personal losses in the event they are sued because of their position would generally be covered by director and officer insurance. Under Japanese law, the issuer may also execute indemnification agreements with directors, but director and officer insurance and indemnification agreements are not as commonly used as limited liability agreements in Japan.

Law stated - 26 January 2024

### Financial reports

## 27 | What rights to financial reporting or company access do venture capital investors normally receive?

Holders of preferred stock typically receive annual, quarterly and sometimes monthly financial statements, balance sheets, budgets, business plans and similar financial information. Information rights are generally available to all holders of preferred shares, but are sometimes limited to 'major' holders of preferred shares.

Law stated - 26 January 2024

## PUBLIC OFFERINGS AND LISTINGS

### Securities law requirements

## 28 | What are the securities law requirements in your jurisdiction for venture capital investors to sell their securities in the public markets?

There are no statutory restrictions on the resale of unlisted securities in Japan, but share transfers in privately held companies require approval of shareholders (if a company does not have a board of directors) or the board of directors (if a company has a board of directors).

Rights of first refusal and co-sale provisions are common in Japanese start-ups. In most cases, rights of first refusal and co-sale bind all major shareholders, including all preferred shareholders.

Japan does not have an active secondary-share transfer market.

For the above reasons, although there are no statutory restrictions on the sale of shares of private companies in Japan, sales of shares by investors are rare. When investors wish to sell shares, they usually do so as part of a financing; for example, holders of Class A preferred shares may sell part of their shares to investors in the issuer's Class B preferred financing.

Law stated - 26 January 2024

## Registration and listing rights

**29** | What registration rights, listing rights or other rights do venture capital investors normally receive?

In Japan, when a company is listed, it must register all outstanding shares as part of the listing. As a result, investors do not need 'piggy-back' rights (rights to have their shares included in any listing of the company). US-style demand registration rights are not seen in the Japanese venture capital market except for start-ups that are contemplating a listing in the United States.

It is not uncommon for founders and the issuer to agree to exercise reasonable commercial endeavours to complete a listing within a specified number of years (often around six to eight years from the first outside investment round). If the founders or the issuer fail to exercise such efforts, they must repurchase the investors' shares. These provisions are very rarely enforced.

Law stated - 26 January 2024

## Other resale rights

**30** | What other resale rights in the public markets do venture capital investors usually receive?

None.

Law stated - 26 January 2024

## COMPANY SALES (M&A)

### Standard sale structures

**31** | What are the standard structures or methods for venture capital portfolio companies to be sold in your jurisdiction?

The gold standard for Japanese start-ups is an IPO, the perception being that a company that does an M&A exit has failed. As a result, many founders aspire to a listing, though M&A exits are increasing on account of pressure from investors who want to see a fast return on their investment to boost their IRR, the influence of many successful M&A exits by startups in other parts of the world, and a slower IPO market in Japan.

M&A exits in Japan are almost always in the form of stock purchases, even if there are many shareholders. In the United States and certain other jurisdictions, it is common to structure M&A exits with many selling shareholders as mergers to avoid the need to obtain the signatures of all shareholders (and instead obtain the approval of a majority of the target's shareholders). In Japan, however, reverse triangular mergers do not exist, and consequently, the majority of start-up buyouts are structured as share purchases. The threshold for a squeeze-out that does not require a shareholders' resolution is 90 per cent; therefore, purchasers in M&A exits will often insist on buying at least 90 per cent of all shares as a condition to closing.

If it is not possible to attain the 90 per cent threshold, shareholders with two-thirds of voting rights may implement a reverse stock split as a means of ejecting shareholders who are opposed to an M&A exit. Therefore, if investors are unable to secure ownership of 90 per cent or more of all shares, a reverse stock split can serve as an alternative strategy, as long as at least two-thirds of the voting rights are secured.

In general, investors not involved in management of the issuer seek to limit their liability upon company sales by having founders as the exclusive source of company representations and warranties, and by limiting their liability through a low-liability cap.

**Law stated - 26 January 2024**

## Role of investors

- 32** | What is the role of venture capital investors in a portfolio company sale? Do they have rights to force or block a company sale?

If investors control the board at the time of a company sale, their consent will be required to pursue the company sale. In addition, investors will typically have contractual rights to approve company sales. As a result, in most cases, company sales will require the approval of investors.

Investors will also typically have drag-along rights by which they may initiate company sales. They tend to play an active role in company sales, participating in the review of agreements and negotiations.

**Law stated - 26 January 2024**

## Post-closing protections

- 33** | What post-closing matters or protections do venture capital investors typically obtain, for example to address ongoing company sale indemnities or director tail liabilities?

Venture capital investors receive a host of post-closing protections, including the following:

- liquidation and dividend preferences;
- adjustment to conversion price in the event of dilutive share issuances ('down rounds');
- pre-emptive rights to subscribe to their pro rata share of future share issuances;
- veto rights on important corporate matters;
- information and inspection rights;
- redemption or share repurchase rights on the occurrence of limited events, such as breach of important covenants;
- rights of first refusal and co-sale rights with respect to sales by founders and other investors;
- drag-along rights to initiate company sales (often subject to the approval of the board and holders of common shares); and
- right to designate directors or board observers.

The issuer will typically enter into agreements with each director limiting their liability to the extent permitted under Japanese law. Director and officer insurance is not very common in early-stage Japanese start-ups, but it is becoming more common in later-stage start-ups.

Law stated - 26 January 2024

## LEGAL AND REGULATORY CONSIDERATIONS

### Disputes

- 34** | What types of disputes typically arise in venture capital transactions and how are disputes commonly handled? What provisions normally govern disputes, including choice of governing law, choice of forum and alternative dispute resolution mechanisms?

Disputes are most likely to arise from a breach of warranties or covenants.

Formal legal claims arising from disputes in venture capital financings are rarely brought in Japan, because in most cases, the potential financial recovery will not justify the cost of bringing a claim. In addition, because investors are shareholders of the issuer, bringing suit against an issuer is not always in the investors' interest. Even if it is possible to bring suit against a founder or management team, this is rarely done as there are obvious downsides to suing the persons on whose performance a company's success depends.

When disputes arise, they are typically resolved amicably through negotiations and the resolution depends on the particular facts leading to the dispute. For example, if an issuer breaches a post-closing covenant, the issuer may undertake to adopt remedial measures to prevent the reoccurrence of the breach in a side letter. If a breach of a representation and warranty that diminishes the issuer's value is discovered after closing, investors may

receive warrants as compensation. Such arrangements, however, are the exception rather than the rule, and most disputes end up being swept under the rug.

**Law stated - 26 January 2024**

## Regulatory consents and filings

**35** | What regulatory consents, notifications and filings are required for all investors in venture capital transactions in your jurisdiction? Are there ownership restrictions?

There are no regulatory consents, notifications or filings that are required for all investors in venture capital transactions.

Foreign investors in start-ups in certain industries must comply with the Foreign Exchange and Foreign Trade Act (FEFTA).

Venture capital investments are subject to the Antimonopoly Act (AMA), but they almost never trigger the AMA because, as a general rule, the AMA applies only to control transactions, and venture capital investments almost always entail acquisitions of minority stakes.

Other than restrictions found in the FEFTA, there are no particular ownership restrictions with respect to start-ups in Japan.

**Law stated - 26 January 2024**

## Foreign investment

**36** | What foreign investment restrictions and other domestic regulatory issues arise for venture capital investors based outside your jurisdiction?

The FEFTA imposes restrictions on investments made by foreign investors in Japanese companies active in specified industries (notably, the software, information and communications technology industries). Foreign investments, even minority investments, in these specified businesses require advance notification to, and approval from, the Japanese government before the investment can close. The statutory review period is 30 days from the acceptance of the notification. Depending on the circumstances, this period can be shortened to two weeks, and sometimes even less than a week, but it can also be extended to several months.

Furthermore, if foreign investors desire to appoint a related person as a director of an issuer that operates in specified industries, in addition to the advance notification required for the investment itself, prior notification pertaining to the proposal for the election of directors is also required.

Finally, even if the issuer is not operating in these specified industries, foreign investors in Japanese companies, together with their related parties, must make post-closing informational filings with the Bank of Japan if their ownership or voting rights exceed 10 per cent.

Law stated - 26 January 2024

## UPDATE AND TRENDS

### Key developments

- 37** | What are the most noteworthy current trends and recent developments in venture capital transactions in your jurisdiction? What developments are expected in the coming year?

The Japanese government is keen to invigorate Japan's VC ecosystem. Local governments all over the country are creating incentives for startups and several years ago the Japanese government established a tax incentive for individuals to invest in early-stage startups. The government is also considering a visa programme to attract overseas VCs to the country.

As noted above, the Japanese government has announced major regulatory reforms to facilitate the use of stock options. And in May 2023, the National Tax Agency issued a clarification that gives startups more flexibility in determining fair market value for purposes of setting the exercise price of tax-qualified stock options, which will further enhance the appeal of tax-qualified stock options.

Also worth noting is the fact that more and more Japanese start-ups are incorporating in, or making inversions to, the United States, Singapore and other international financial hubs to tap into larger foreign venture capital markets.

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