

PROMOTING LEGAL INNOVATION IN JAPANESE STARTUP FINANCING

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I. INTRODUCTION

Over the past fifteen years, Silicon Valley has witnessed a variety of legal innovation designed to promote the funding of early-stage² startup businesses.³ Although newly developed seed funding⁴ instruments include repurposed forms of preferred stock and convertible notes, in many ways the most interesting and innovative tool in this category is convertible equity.⁵ In particular, in 2013, the startup accelerator Y Combinator released a new “simple agreement for future equity” (the “Safe”), which was designed to address the business and legal objectives of Y Combinator itself and the companies in which it invests.⁶ The Safe offers a simpler, faster, and generally more startup-friendly approach than other mainstream seed funding instruments,⁷ and it is increasingly used for startup fundraising outside of Y Combinator.⁸ To the extent that the Safe simplifies and speeds up the seed financing process for startups at a time when these companies typically face tight limitations on cash and time, it likely plays an important role in promoting a startup-friendly business environment.

In recent years, Japanese policymakers and businesspeople have devoted increasing attention to the development of a robust “startup ecosystem” in Japan, and the Japanese venture capital market, while still

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² As used in this Article, “early stage” refers generally to companies at an early stage of development. (It does not refer to companies at the Series A or Series B round of financing, as the term is sometimes used in the venture capital industry.)

³ John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 165-171 (2014).

⁴ “Seed” capital refers to the “initial capital raised by a [startup] company.” See, e.g., Geoff Ralston, *A Guide to Seed Fundraising*, Y COMBINATOR (Jan. 7, 2016), <https://blog.ycombinator.com/how-to-raise-a-seed-round>.

⁵ See generally Coyle & Green, *supra* note 3, at 165-171.

⁶ *Id.* at 166-170.

⁷ *Id.* at 169-170.

⁸ For example, the Securities and Exchange Commission has expressed concern about the use of Safes in crowdfunding transactions and the risk posed to investors. See *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, U.S. SECURITIES AND EXCHANGE COMMISSION (May 9, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

much smaller than the U.S. market, has grown to a record scale.⁹ Why this focus on startups? In addition to promoting technological innovation, new businesses are a major source of employment in Japan.¹⁰ Seed funding plays a critical role in the success of new technology ventures because it provides the capital necessary for startup founders to turn a mere idea into a viable product with some level of demonstrable market traction, which is typically required before venture capital funds will agree to make a large investment in a company.¹¹ Despite their importance, the legal instruments used in Japanese seed financings have not yet evolved in the manner of their Silicon Valley counterparts. Indeed, in Japan, common stock is still the typical security used for seed investments,¹² even though it suffers from considerable disadvantages as an early-stage investment instrument.¹³

Since Y Combinator announced the creation of the Safe, several Japanese lawyers have published analyses of the instrument itself or convertible equity in general, and many lawyers, founders, and investors in Japan are now aware of the Safe and its features.¹⁴ If convertible equity does offer meaningful advantages in Japan as compared to common stock and other fundraising instruments—a likely proposition discussed in more detail in Part II.D.iv—one would expect it to see it used in a sizeable

⁹ Kana Inagaki, *Japanese Venture Capital Investment Hits Record Levels*, FINANCIAL TIMES (March 1, 2018), <https://www.ft.com/content/927a9d14-1d21-11e8-aaca-4574d7dabfb6>. For an example of the focus on developing a startup ecosystem, see the Japanese government's Project for a Bridge of Innovation between Silicon Valley and Japan. "Japan Startup Selection" to be delegated to world's leading innovation ecosystem under "HIYAKU Next Enterprise" program, MINISTRY OF ECONOMY, TRADE AND INDUSTRY (Oct. 20, 2017), http://www.meti.go.jp/english/press/2017/1020_004.html.

¹⁰ For example, in 2014, companies established in 2005 or later accounted for approximately 20% of employment in Japan. MINISTRY OF ECONOMY, TRADE AND INDUSTRY, CHŪSHO KIGYŌ HAKUSHO [2018 WHITE PAPER ON SMALL AND MEDIUM ENTERPRISES IN JAPAN] 39 (2018), https://www.chusho.meti.go.jp/pamflet/hakusyo/H30/PDF/chusho/00Hakusyo_zentai.pdf.

¹¹ Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (Oct. 2008).

¹² Interview with Yohei Sawayama, Managing Partner of 500 Startups Japan, in Tokyo, Japan (Feb. 26, 2018) (on file with author). In fact, in 2016 over 29% of venture capital investments by yen amount were conducted using common stock, according to survey of Japanese VCs (¥24.974 billion of ¥85.463 billion in total, calculated from the responses of VCs who provided information on the investment instruments used). VENTURE ENTERPRISE CENTER, JAPAN, VEC YEARBOOK 2017 II-9 (2018) [hereinafter VEC YEARBOOK 2017].

¹³ See *infra* Part II.D.i.

¹⁴ See, e.g., Nobuki Takeuchi & Shuya Ogawa, *Shoki Raundo ni Okeru Shikin Chōtatsu no Jitsumu to Kadai* [Issues and Practice Relating to Initial Fundraising Rounds], 2087 SHŌJI HŌMU 37 (Dec. 15, 2015); see generally Anri Okamoto, *SAFE (Gaiyō)* [SAFE (A Summary)], JPXSV STARTUP LAWYER, <http://jp-sv-startuplawyer.blogspot.jp/2015/07/safe.html> (last visited Aug. 14, 2018); Junsuke Matsuo & Yoshimasa Umemoto, *Shōrai kabushiki shutoku ryakushiki keiyaku sukimu (SAFE) to kuraudo fandingu* [Crowdfunding and Contractual Arrangements for the Acquisition of Future Stock (SAFE)], 99 SHŌKEN KEIZAI KENKYŪ 1 (Sept. 2017), available at http://www.jsri.or.jp/publish/research/pdf/99/99_01.pdf.

number of early-stage financing transactions. And yet, convertible equity remains a rare choice for fundraising in Japan, with just a few exceptions.¹⁵

There are both legal and environmental factors present in the Japanese market that appear conducive to the widespread adoption of convertible equity, and under Japanese law convertible equity even offers certain benefits that are not present under U.S. law.¹⁶ In light of the technical advantages of convertible equity over other seed financing tools, the most compelling explanation for its disfavor in Japan is that certain environmental obstacles (*i.e.*, factors that are external to the legal instrument itself) are obstructing the spread of contractual innovation in this area.¹⁷ Accordingly, if these obstacles can be identified and mitigated, convertible equity might become an important part of the toolkit for Japanese startups to bridge the gap between inspiration and execution.

To build an understanding of the barriers to a broader use of convertible equity in Japan, this Article draws on legal scholarship, statistical information on the Japanese and American venture finance markets, practical guidance from key players in the startup communities in both Japan and the U.S., and interviews with over a dozen investors, founders, and lawyers in Silicon Valley and Tokyo.¹⁸ Synthesizing information from these sources, this Article presents an analysis of (i) the technical advantages of convertible equity (in the form of the Safe) as compared to other seed funding instruments, (ii) environmental and other factors that have led to increasingly widespread use of the Safe in Silicon Valley, and (iii) how these properties and other factors apply or fail to apply in Japan in light of the Japanese legal system, the alternative instruments currently used for seed financing in Japan, and certain characteristics of the Japanese venture finance market. This analysis is significant in part because it draws from a real convertible equity use case to conclude that the failure of convertible equity to proliferate in the Japanese market to date is the result of environmental or other external factors and not the properties of convertible equity within the Japanese legal system. Finally, this Article suggests some possible measures that influential participants in the Japanese

¹⁵ This is discussed in detail in Part II.D.iv.

¹⁶ This is discussed in detail in Parts II.C and II.D.

¹⁷ This is discussed in detail in Part II.E.

¹⁸ The interviewees were drawn from the author's personal and professional networks or introduced to the author by members of those networks, with a particular focus on persons with professional experience in both Silicon Valley and Tokyo. Accordingly, the interviewees may not be a representative sample of Silicon Valley- or Tokyo-based professionals, and their responses may not be representative of their respective broader professional groups. Because detailed quantitative information on the seed-stage market is scarce, the interviewees provided valuable qualitative responses based on their professional experience, in some cases drawn from firsthand involvement in dozens or hundreds of startup financing transactions. The interviewees were granted anonymity upon request to promote candor in their interviews; certain interviewees' professional titles have been modified slightly to better preserve their anonymity.

startup community could take to promote the wider availability of convertible equity as a tool for Japanese founders and investors.

II. COMPARATIVE ANALYSIS OF THE USE OF CONVERTIBLE EQUITY IN SILICON VALLEY AND JAPAN

At present, the driving force behind convertible equity's popularity as a seed funding instrument in Silicon Valley is undoubtedly the Safe, which is used far more frequently than any other convertible equity instrument in the market.¹⁹ In analyzing the Safe's predominance, the factors animating its popularity can be roughly split into two categories: (i) "internal" factors that relate to the technical characteristics of the Safe as a legal instrument and (ii) "external" factors that relate to environmental attributes of the Silicon Valley startup community and the efforts of certain parties to promote the Safe. Although there is some overlap between the categories, this internal-external distinction is particularly helpful because it highlights different advantages and challenges for convertible equity when transposed to the Japanese market. In addition, as this analysis will demonstrate, both categories appear to be important components of the Safe's success.

A. *Internal Factors: The Safe's Technical Characteristics as a Driver of Its Popularity*

i. Background

The Safe's technical merits are clearest in light of the historical context. Until roughly 2005, common stock was the instrument of choice for seed-stage investments in Silicon Valley.²⁰ Technological advances at that time made it possible for founders to develop a viable product for internet-based businesses with far less capital than had been necessary in

¹⁹ Although no comprehensive data set on the use of seed funding instruments exists, the Safe has received far more attention than any other instrument both in the news media and regulatory sphere. *See, e.g.*, Joe Green, *COMMENTARY: SEC rightly concerned about 'so-called SAFE' securities in crowdfunding*, REUTERS (June 2, 2017, 3:30 AM), <https://www.reuters.com/article/bc-finreg-crowdfunding-safe/commentary-sec-rightly-concerned-about-so-called-safe-securities-in-crowdfunding-idUSKBN18S63M>; Paul Martino, *Here's How the Smartest Startup Founders Raise Funds*, YAHOO! FINANCE (Mar. 3, 2017), <https://finance.yahoo.com/news/smartest-startup-founders-raise-funds-020019799.html> (mentioning the Safe but no other convertible equity instruments). In addition, the Silicon Valley-based lawyers and founders interviewed for this Article typically had direct experience with Safes but little or no such experience with other convertible equity seed funding instruments. Interview with Attorney 1, Partner at a California-based Law Firm (Mar. 2018); Interview with Founder 1, Chief Executive Officer of a California-based Startup (Mar. 2018); Interview with Startup Executive 1, Vice President of a California-based Startup (Mar. 2018) (all interviews are on file with the author).

²⁰ Coyle & Green, *supra* note 3, at 136.

the past, creating new demand for a pre-Series A²¹ round of startup financing that would provide the startup with more capital than could be raised from friends and family.²² However, common stock offered angel investors²³ little protection for such investments, while preferred stock required excessively time-consuming and costly negotiations.²⁴ Furthermore, a startup that sells common stock to investors in a seed round subsequently faces limitations on its ability to issue stock options that imply a lower enterprise valuation for the startup, which in turn limits the startup's ability to use inexpensive options to recruit and incentivize employees.²⁵

Convertible notes, based on venture financing bridge notes but simplified and fine-tuned for seed funding, largely solved these problems.²⁶ A seed financing convertible note is in essence a corporate promissory note that converts into Series A preferred stock at the time of the startup's Series A financing, thus allowing the investor and founder to avoid the time and expense of negotiating preferred stock terms and valuing the company at the seed stage. By obviating the need for a valuation, convertible notes also permit the startup to avoid the increase in the appraised value of the company's common stock that typically accompanies a common stock-based investment, thereby allowing the startup to continue issuing inexpensive options for common stock. Furthermore, the Series A conversion allows the convertible note investors to enjoy the favorable terms offered to Series A investors rather than riding along with the common stock holders until the company's exit,²⁷ and a conversion discount

²¹ Series A financing generally refers to a startup's first full round of financing from venture capital funds (although some VC funds invest at earlier stages as well). It is so called because the investors in such rounds typically subscribe for "Series A preferred stock." Series A rounds involve a significant capital commitment on the part of investors. The median 2018 Series A financing round size was \$9.1 million as of mid-2018. Kate Clark, *Automation Anywhere raises huge Series A as deal sizes continue to inflate in 2018*, PITCHBOOK (July 2, 2018), <https://pitchbook.com/news/articles/automation-anywhere-raises-huge-series-a-as-deal-sizes-continue-to-inflate-in-2018> (last visited Mar. 1, 2019).

²² By raising additional funds before the Series A financing, a founder can reach important business milestones before Series A funding becomes necessary and accordingly negotiate a better valuation for the Series A round, resulting in less dilution for the founder. Coyle & Green, *supra* note 3, at 157-58.

²³ "Angel investors are wealthy individuals who personally finance the same high-risk, high-growth start-ups as venture capitalists but at an earlier stage." Ibrahim, *supra* note 11, at 1406. This Article uses the term "seed investment" to refer broadly to pre-Series A investments other than those raised from the founder's friends and family (some industry sources draw a distinction between "angel" and "seed" financings).

²⁴ Coyle & Green, *supra* note 3, at 159.

²⁵ Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 891-92 (2003).

²⁶ Coyle & Green, *supra* note 3, at 161.

²⁷ The exit is an event that provides liquidity to the company's investors, generally an acquisition or initial public offering.

and conversion cap²⁸ sweeten the deal for seed investors to compensate them for the increased risk of a pre-Series A investment and protect them against venture capital (“VC”) investors overvaluing the startup in the Series A round.²⁹

Despite the convertible note’s strengths, within a few years, the next phase of contractual innovation began to take shape. Between 2012 and 2014, various Silicon Valley lawyers were working separately on developing an improved seed funding instrument—evidence that convertible notes suffered from significant shortcomings apparent to legal specialists in the industry.³⁰ At the same time, Y Combinator was drafting and fine-tuning the Safe for use in its own portfolio companies.Carolynn Levy, a Y Combinator partner and attorney formerly at Wilson Sonsini Goodrich & Rosati, developed the Safe in collaboration with other partners at Y Combinator as well as various angel investors and VC firms.³¹

The Safe is a relatively simple contract and is similar to a convertible note in that a Safe investor acquires the right to receive a certain number of shares of equity issued in the startup’s next equity financing.³² Although there are many versions of the Safe available on the internet, Y Combinator makes the standard version of the document available for free on its website.³³ As with a convertible note, a Safe investor can negotiate a conversion discount and a valuation cap, providing compensation to seed investors for the extra risk they take on relative to Series A investors.³⁴ The principle differences between the Safe and convertible notes are that the Safe (1) does not bear interest, (2) does not have a maturity date or default

²⁸ These provisions provide convertible note investors with economic terms that are superior to the Series A investors when the convertible notes convert into Series A preferred stock. To provide a simplified example, a \$100,000 convertible note that converts at a 20% discount would convert into Series A preferred stock valued at \$120,000 based on the price paid by the Series A investors. (In practice, conversions are messier because multiple convertible instruments typically convert simultaneously, sometimes with different conversion mechanics, and convertible notes also accrue interest that converts together with the principal amount of the notes.)

²⁹ Coyle & Green, *supra* note 3 at 159-60.

³⁰ Among these efforts were Y Combinator’s SAFE, Yoichiro Taku’s “convertible security”, 500 Startup’s KISS, Cooley Godward Kronish’s Series AA, and Fenwick & West’s Series Seed. *See generally id* at 166-76. *See generally* Gregory Raiten, 500 Startups Announces ‘KISS’, 500 STARTUPS (July 3, 2014), <https://500.co/kiss/>.

³¹ Coyle & Green, *supra* note 3, at 168-169.

³² *SAFE Primer*, Y COMBINATOR, https://www.ycombinator.com/docs/SAFE_Primer.rtf (last visited Apr. 5, 2019).

³³ *See Startup Documents*, Y COMBINATOR, <https://www.ycombinator.com/documents/> (last visited Apr. 5, 2019). For more on certain other versions of the Safe, *see, e.g.*, Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-so-Safe Safe*, 102 VA. L. REV. ONLINE 168, 176 (2016) (noting that WeFunder has adopted its own form of Safe) and *SAFE: Simple Agreement for Future Equity (Seed-Stage Startup)*, THOMSON REUTERS, <https://us.practicalallaw.thomsonreuters.com/w-001-3072> (last visited Apr. 5, 2019) (Practical Law’s form of Safe).

³⁴ *See generally SAFE Primer*, *supra* note 32.

concept, (3) is a form of equity³⁵ rather than debt, and (4) is a shorter, simpler document.³⁶ Levy rejects the idea that the Safe is a radical departure from other seed funding instruments, describing it instead as “just a convertible note with the ‘event-of-default,’ interest, and maturity date provisions stripped out.”³⁷ By using a familiar framework for the Safe, Y Combinator hoped to increase the likelihood that members of the startup community in Silicon Valley would adopt the new instrument.³⁸

The simplified structure of the Safe offers several benefits. Because “the interest rate for a debt financing functions as the price of the deal,” the economic terms of a convertible note interest rate can be essentially replicated via adjustments to the Safe’s other price terms, namely the discount and valuation cap.³⁹ Accordingly, the removal of an interest rate provision does not necessarily disadvantage investors but does allow founders to avoid the “time sink” of interest rate negotiations.⁴⁰

Given that the maturity date of a convertible note is not a purely economic term, its absence from the Safe is a founder-friendly development. Typical seed notes may automatically convert into common stock at a pre-agreed (typically investor-favorable) valuation if the maturity date occurs prior to the company completing its next equity financing, but the investors may alternatively have the right to demand repayment of the note at maturity.⁴¹ If the company cannot repay the convertible note at maturity, the investor theoretically has the ability to bankrupt the startup.⁴² Some investors use this leverage to extract certain business or legal concessions from founders, such as “re-negotiat[ing] the terms of a note,” which, unsurprisingly, is vexing for founders.⁴³ The Safe’s lack of a maturity date provision means that a Safe-holder typically does not have

³⁵ The Safe does not fit perfectly within the category of equity, but at least from an accounting standpoint, it is more equity-like than debt-like. Zach Abramowitz, *Innovation More Than Another App: How Wilson Sonsini Lawyer Turned YC PartnerCarolynn Levy Is Revolutionizing Startup Investing*, ABOVE THE LAW (Jan. 20, 2015, 4:02 PM), <https://abovethelaw.com/2015/01/innovation-more-than-another-app-how-wilson-lawyer-turned-yc-partner-carolynn-levy-is-revolutionizing-startup-investing>. Alternatively, given that Safe holders are not owed fiduciary duties, from a legal standpoint it may be more accurate to characterize the Safe as a derivative. Green & Coyle, *supra* note 33, at 172.

³⁶ *Startup Documents*, *supra* note 33.

³⁷ Abramowitz, *supra* note 35.

³⁸ Coyle & Green, *supra* note 3, at 168.

³⁹ Spencer Williams, *Venture Capital Contract Design: An Empirical Analysis of the Connection Between Bargaining Power and Venture Financing Contract Terms*, 23 FORDHAM J. CORP. & FIN. L. 105, 137 (2017).

⁴⁰ Abramowitz, *supra* note 35.

⁴¹ See, e.g., *Series Seed Notes – Convertible Promissory Note*, GITHUB (June 21, 2017), <https://github.com/CooleyLLP/seriesseed/blob/master/notes/Series%20Seed%20Notes%20-%20Convertible%20Promissory%20Note.md> (explaining Cooley LLP’s form convertible promissory note for seed funding).

⁴² Coyle & Green, *supra* note 3, at 167.

⁴³ Abramowitz, *supra* note 35. This topic also came up twice in the interviews conducted for this Article. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

any right to demand repayment or conversion of the instrument unless a triggering event occurs, and when such an event does occur, the conversion is generally automatic.⁴⁴

As the Safe is a form of equity, Safe-holders do not enjoy the same repayment preference as convertible noteholders, which has been a point of concern for some seed investors.⁴⁵ Safe-holders are entitled to repayment of their investment amount in preference to the company's stockholders in the event that the company is dissolved, but this repayment obligation is typically subordinated to the Company's debt repayment obligations.⁴⁶ Levy explains this characteristic of the Safe as consistent with the philosophy that "startup investing is not about loaning money - it's about investing money."⁴⁷ The Safe's subordination to debt obligations is consistent with the business model of many experienced angel investors, who focus on generating returns through a few wildly successful investments rather than small exits and claw-backs of investment capital from unsuccessful portfolio companies.⁴⁸

ii. Advantages of the Safe's Technical Characteristics

Admittedly, some of the technical characteristics of the Safe are only advantageous from one party's perspective. For example, founders generally view the lack of a maturity date as a strength of the Safe, while some investors may view it as a drawback that negatively impacts their negotiation leverage should the company fail to raise its Series A financing within the anticipated timeframe.⁴⁹ Notably, however, certain characteristics of the Safe are beneficial for both founders and investors. After all, both parties typically share the medium-term goal of a successful Series A financing and the long-term goal of a successful exit for the startup.

⁴⁴ *Startup Documents*, *supra* note 33.

⁴⁵ Abramowitz, *supra* note 35.

⁴⁶ *See, e.g., SAFE*, Y COMBINATOR, https://www.ycombinator.com/docs/SAFE_Cap.rtf (last visited Aug. 14, 2018). However, some modified forms of the Safe place it *pari passu* with convertible debt. *See, e.g., SAFE: Simple Agreement for Future Equity (Seed-Stage Startup)*, *supra* note 33.

⁴⁷ Abramowitz, *supra* note 35.

⁴⁸ Green & Coyle, *supra* note 33 at 172-73 ("Savvy startup investors typically view the outcomes of seed investments in these companies as essentially binary: The companies will either succeed or go bust, leaving the investors with either a lucrative multiple return on their investment or a loss of most, if not all, of their principal. Often, in the downside scenario, the founders and investors try to salvage as much of their investments (and reputations) as possible through a sale or acqui-hire, but modest, middling returns are not what most investors are seeking in the feast-or-famine world of seed-stage startup investing[.]").

⁴⁹ Two lawyers with venture financing practice experience in Silicon Valley raised this point during interviews for this Article. Interview with Attorney 2, Former Partner at International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author); Interview with Attorney 3, Partner at International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author). *See also* Abramowitz, *supra* note 35.

Levy has characterized the appeal of convertible instruments as “speed, lack of friction and cost.”⁵⁰ In discussions of the Safe specifically, this sentiment was echoed by a Silicon Valley lawyer and a Silicon Valley-based startup founder interviewed for this Article.⁵¹ The lawyer, who frequently represents both VC funds and startups, described several ways in which these traits of the Safe can also benefit investors: (1) seed stage investors want a startup to use its limited funds on developing its business and not on fundraising transaction expenses; (2) using a convertible note’s maturity to force a company into bankruptcy is usually a waste of time and resources, because the company is not likely to have any significant assets that could be used to make the noteholder whole; (3) investors are aware that if they squeeze founders upon the maturity of convertible notes, they are likely to acquire a bad reputation and lose access to investments in the most promising startups; and (4) an investor who genuinely believes that she will need the negotiation leverage provided by a note reaching maturity to keep the founders in line may be better off not investing in that company and instead finding a startup with more trustworthy and competent management.⁵² The appeal of the Safe to founders is straightforward: It is a fast, inexpensive means of executing seed financing and is “highly company-favorable” as compared to a convertible note.⁵³ Basically, Safes preserve for founders the advantages of the convertible note over capital stock while also eliminating a few of the investor-favorable terms of convertible notes and the time required to negotiate those terms.⁵⁴ In light of these factors, a simple, low-cost instrument with a well-known standard form that does not require founders and investors to spend time negotiating an interest rate and maturity date may have broad appeal for certain types of early financing transactions.

iii. Disadvantages of the Safe’s Technical Characteristics

Importantly, despite its appeal to founders and some investors, the Safe is not well-suited to every context. Joseph Green and Professor John Coyle have written at length about the Safe’s structural reliance on the investee pursuing a typical startup fundraising plan in order for the Safe to achieve its intended outcomes.⁵⁵ For example, if founders take seed investment in the form of Safes and then proceed to further finance their business with bank loans rather than equity issuances, extract corporate wealth through high executive salaries and dividend distributions, and never exit through a sale or initial public offering, the Safe-holders are stuck holding essentially worthless paper with no legal right to extricate

⁵⁰ Abramowitz, *supra* note 35.

⁵¹ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

⁵² Interview with Attorney 1, *supra* note 19.

⁵³ Green & Coyle, *supra* note 33, at 173.

⁵⁴ These benefits are, namely, not needing to negotiate a valuation at the time of the investment, not owing fiduciary duties to investors until the investment converts into capital stock, and not having to negotiate the relatively complex terms of a preferred stock investment.

⁵⁵ See generally Green & Coyle, *supra* note 33, at 170.

themselves from their investment.⁵⁶ The risk of this type of exploitative founder behavior is low in Silicon Valley for reasons that are discussed in Part B, but it may be higher in other environments.⁵⁷

When asked about the potential drawbacks of Safe investments, two Silicon Valley-based professionals interviewed for this Article mentioned that occasionally founders misconceive the founder-friendly characteristics of the Safe as offering some intrinsic protection against excessive founder dilution when the company raises its Series A financing.⁵⁸ For example, a founder who raises \$2.5 million through Safes at a \$5 million valuation cap has essentially sold 50% of the company's equity, on top of the dilution that will result from the Series A financing, even if the Series A round is later raised at a \$20 million valuation.⁵⁹ Some founders erroneously assume that an instrument known to be founder-friendly must include an inherent protection against such dilution if they can achieve a sufficiently high valuation for the Series A round.⁶⁰ It is even possible for the dilutive effect of prior convertible fundraisings, especially those at a valuation that is much lower than the contemplated Series A round, to be so extreme that VC funds decline to invest in a startup.⁶¹

Notably, although there may be technical solutions to these disadvantages of the Safe that could be incorporated into the instrument, both of the above-mentioned issues (investors' inability to prevent exploitative founder behavior and founders' potential misconception of the instrument's terms) can also be mitigated through certain external measures described in Part i below. It is likely that any technical solutions would add to the complexity of the Safe, thereby eroding one of the Safe's chief strengths: simplicity.⁶² In any event, despite certain shortcomings, the Safe's technical strengths deserve serious consideration in that they have been sufficient, in concert with the extrinsic factors described in Part B below, to spur a large number of founders and investors in Silicon Valley to use the instrument in startup financings.

⁵⁶ *Id.* at 177-78.

⁵⁷ Green and Coyle focus on the crowdfunding context, which has also drawn the attention of the Securities and Exchange Commission. See *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, *supra* note 8.

⁵⁸ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. See also Pascal Levensohn & Andrew Krowne, *Why SAFE notes are not safe for entrepreneurs*, TECHCRUNCH (July 9, 2017), <https://techcrunch.com/2017/07/08/why-safe-notes-are-not-safe-for-entrepreneurs/>.

⁵⁹ In a typical Safe, the fully diluted capitalization of the company (used to calculate the number of shares into which the Safe should convert) is calculated including all stock options, warrants, the stock option pool but excluding all Safes and convertible notes and the new funds to be contributed by the equity financing investors. See *SAFE*, *supra* note 46.

⁶⁰ Levensohn & Krowne, *supra* note 58.

⁶¹ *Id.*

⁶² Green & Coyle, *supra* note 33, at 180 ("This desire for simplicity is attributable, at least in part, to the unique needs of this particular contracting community. These are deals for relatively small amounts of money and there is a strong desire to keep legal fees and friction low so as to execute the transaction quickly.").

B. External Factors: Environmental Attributes of Silicon Valley and Third-Party Activity as Drivers of the Safe's Popularity

i. The Availability of Effective Channels of Informal Control

Years before the development of the Safe, Professor Darian Ibrahim explored the motivations of angel investors in Silicon Valley who choose to invest in startups using simple, founder-friendly contracts.⁶³ This behavior is particularly striking because “extreme levels of uncertainty, information asymmetry, and agency costs in the form of potential entrepreneurial opportunism [...] plague angel investments.”⁶⁴ Ibrahim argued that, among other factors, certain aspects of the Silicon Valley ecosystem make simplified angel investment contracts economically rational despite apparent incentives for angels to use more detailed contracts that would mitigate legal risk in seed-stage startups.⁶⁵ Notwithstanding changes in seed funding practices over the past decade, the responses of the Silicon Valley lawyers interviewed for this Article are remarkably consistent with key aspects of Ibrahim’s analysis. Understanding the environmental factors that incentivize angel investors to use simplified investment contracts is a critical part of understanding the Safe’s popularity in Silicon Valley and how that may or may not be transferable to the Japanese market.

One factor in Ibrahim’s analysis that also surfaced in interviews conducted for this Article is the existence of “informal substitutes for the venture capitalist’s formal contract protections.”⁶⁶ These informal substitutes include (1) introductions from trusted parties, reducing the need for traditional due diligence; (2) angels investing in founders or industries they know well, reducing information asymmetry; and (3) angels investing in companies that are physically close to their homes and actively participating in the startup’s business, allowing them to both build trust and informally monitor the startup.⁶⁷ Another important factor is that angels’ investment contracts are typically unwound relatively quickly, which is also true of the Safe because it automatically converts into preferred stock at the time of the startup’s next equity financing.⁶⁸

Noting that costly contracting theory supposes that “contracts will be simpler when self-enforcement, in addition to court-enforcement, is available to an aggrieved party,” Ibrahim raises the possibility that the “reputation market among venture capitalists and entrepreneurs” may partially explain angels’ comfort with simplified contracts in light of “the

⁶³ Ibrahim, *supra* note 11, at 1406.

⁶⁴ *Id.* at 1420.

⁶⁵ *Id.* at 1405.

⁶⁶ *Id.* at 1431.

⁶⁷ *Id.* at 1431-33.

⁶⁸ Ibrahim, *supra* note 11, at 1434-35.

tight-knit nature of communities such as Silicon Valley.”⁶⁹ However, Ibrahim ultimately concludes that the impact of reputational sanctions is “unclear.”⁷⁰ In contrast, Professors Gregg Polsky and John Coyle have argued in more recent scholarship that “reputational concern, self-image, and a desire to avoid social sanctions” operate as restraints on exploitative entrepreneurial behavior in the acquihire context.⁷¹

Polsky and Coyle propose that investors have means of exerting pressure on opportunistic founders by (i) refusing to finance a founder’s future endeavors, (ii) appealing to a founder’s sense of moral obligation to those who have supported her business, and (iii) threatening to ostracize a founder.⁷² There is no reason that seed-stage investors would not be able to make use of these same means of influence, especially social sanctions, which are “perhaps most relevant in the context of smaller angel investors.”⁷³ In other recent scholarship, Professor Brad Bernthal similarly proposes that relationship networks in investment accelerators “make[] it possible to quickly mobilize group social sanctions where an individual’s deviations from norms become problematic.”⁷⁴ The general view of this more recent scholarship, then, is that robust relationship networks and threat of informal sanctions are significant factors in constraining opportunism in Silicon Valley.

Interestingly, the threat of reputational sanctions against *investors* may also work to the Safe’s advantage. As discussed in Part ii above, an investor’s aggressive use of a convertible note’s maturity date to extract concessions from a founder would violate behavioral norms among certain circles of Silicon Valley angels, including influential accelerators such as Y Combinator, and could damage an investor’s reputation.⁷⁵ There is evidence that reputation is truly important for investors: in the venture capital context, empirical research indicates that “high-reputation VCs are more likely to have their offers accepted than are low-reputation VCs” and that “high-reputation VCs pay between 10 and 14 percent *less* for shares than do low-reputation VCs.”⁷⁶ This means that, for angel investors who travel

⁶⁹ *Id.* at 1435.

⁷⁰ *Id.* at 1436.

⁷¹ Gregg D. Polsky & John F. Coyle, *Acqui-Hiring*, 63 DUKE L.J. 281, 311 (2013).

⁷² *Id.* at 314.

⁷³ *Id.* at 319. Ibrahim notes, however, that angel investors have an incentive to avoid public sanctions on wayward founders because the founder’s failure is tantamount to the angel’s investment failing as well. Ibrahim, *supra* note 11, at 1436.

⁷⁴ Brad Bernthal, *Investment Accelerators*, 21 STAN. J.L. BUS. & FIN. 139, 189 (2015).

⁷⁵ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. See also Abramowitz, *supra* note 35 (“[S]tartup investing is not about loaning money - it’s about investing money (really, RISKING money) for a potentially significant return. YC’s philosophy is that this early / seed-stage money is about helping the company get to the next level. It’s not important to claw it all back if the startup fails or if there is a weak acqui-hire.... But I fully appreciate that YC’s philosophy is different from the view of many other investors[.]”).

⁷⁶ ANDREW METRICK & AYAKO YASUDA, *VENTURE CAPITAL & THE FINANCE OF INNOVATION* 83, John Wiley & Sons (2d ed. 2010) (emphasis in original).

within these circles, a maturity date repayment right in a seed investment contract is not likely to be exercised and is therefore of limited value. Accordingly, many investors may decide (and, given the popularity of the Safe, appear to have decided in fact) that they are willing to forego this low-value provision in exchange for a faster, cheaper and smoother execution of their investment.⁷⁷

ii. Seed-Stage Investor Preferences

Ibrahim raises certain other possible contributing explanations for angel behavior that merit consideration in the context of a comparison with the Japanese market. First, subsequent venture capital investment is typically necessary for angel investors to receive a return on their investments, meaning that angels have an incentive to use simple or at least reasonable investment instruments that do not discourage VCs from making a Series A investment in the startup.⁷⁸ Second, seed investors overvaluing a startup is one of the most common issues that can hinder a Series A financing; convertible instruments reduce this risk by postponing the startup's valuation until the time of the Series A fundraising.⁷⁹ Third, angel investors may use simple, founder-friendly contracts to signal to entrepreneurs that they trust in the founder's judgment and will be easy to work with; this signaling may help angel investors get access to the best startup investment opportunities.⁸⁰

The typical business model of Silicon Valley seed stage investors is another important point in this comparative analysis, and one that arose repeatedly in interviews conducted for this Article.⁸¹ Angels' "most lucrative returns" result from companies that have consummated an initial public offering or been purchased at a high price, and these home-run deals

⁷⁷ See, e.g., Coyle & Green, *supra* note 3, at 180 ("These are deals for relatively small amounts of money and there is a strong desire to keep legal fees and friction low so as to execute the transaction quickly[.]").

⁷⁸ Ibrahim, *supra* note 11, at 1428. Startups' need for subsequent venture capital investment also allows larger angel investors to exert influence by carving up capital investment into staged financings. Zenichi Shishido, *Does Law Matter to Financial Capitalism?*, 37 *FORDHAM INT'L L.J.* 1087, 1118 (2014). However, smaller angel investors may not have the financial resources to participate in future funding rounds.

⁷⁹ Ibrahim, *supra* note 11, at 1430 ("Susan Preston, an experienced angel investor, also advises angels to keep the terms of their investment simple because '[n]othing can prevent follow-on funding faster than an overly complicated and burdensome first round, which a VC must try to unwind, often demanding a discounted value and other 'cram-down' requirements to offset onerous or overreaching first-round terms.'"). Nonetheless, there is still some risk that a valuation cap in a convertible instrument can be treated by seed investors and company insiders as a de facto valuation. See, e.g., Mark Suster, *Bad Notes on Venture Capital, BOTH SIDES OF THE TABLE* (Sept. 17, 2014), <https://bothsidesofthetable.com/bad-notes-on-venture-capital-5967b9e7ec74>.

⁸⁰ Ibrahim, *supra* note 11, at 1442.

⁸¹ Interview with Investor 1, Partner at a Venture Capital Investment Firm in Tokyo, Japan (Feb. 2018) (on file with author); Interview with Attorney 4, Partner at an International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author); Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

“compensate angels for the far larger number of start-ups that fail.”⁸² Similarly, investment accelerators, such as Y Combinator, are in the “hits business,”⁸³ where “one successful investment can make up for a whole bunch of investments with a zero return.”⁸⁴ This is also consistent with the behavior of VCs, which typically “ignore... lesser payoffs and focus attention on the places where the payoffs are significant.”⁸⁵ In the aggregate, this collective focus on big hits rather than small or medium-sized returns means that investors in Silicon Valley are typically not focused on recouping their invested capital from failed startups. In light of this, it is perhaps not surprising that many angel investors are willing to accept the Safe’s sacrifice of certain investor protections in favor of increased speed and reduced costs.

The popularity of the Safe also likely reflects that promising founders currently command substantial negotiation leverage in Silicon Valley.⁸⁶ If the terms of the Safe were grossly inconsistent with the balance of founders’ and investors’ relative leverage, it is extremely unlikely that these parties would agree to use the instrument for such a large number of transactions.⁸⁷ Indeed, the Safe’s founder-friendly terms appear to reflect in part a Silicon Valley fundraising environment where for the best startups there is something approaching “access to unlimited capital” and investors are loath to upset the most promising founders.⁸⁸ To this end, the Safe provides angel investors a tool that they can use to signal their trust in founders and willingness to let founders maintain control of the startup, thereby increasing the angels’ chance of getting access to the most desirable deals.⁸⁹ This may be a particularly useful signaling mechanism for angels because many Silicon Valley angels invest in part for non-financial reasons, such as an intense interest in a startup’s technology or an emotional attachment to the startup.⁹⁰

⁸² Ibrahim, *supra* note 11, at 1428.

⁸³ Bernthal, *supra* note 74, at 185.

⁸⁴ Abramowitz, *supra* note 35.

⁸⁵ METRICK & YASUDA, *supra* note 76, at 179.

⁸⁶ See, e.g., Steve Blank, *When Founders Go Too Far*, HARVARD BUSINESS REVIEW (Nov.-Dec. 2017), <https://hbr.org/2017/11/when-founders-go-too-far> (“Whereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing too few quality start-ups[.]”).

⁸⁷ Williams, *supra* note 39, at 159 (“[V]enture financing supply has a statistically significant relationship with price and non-price terms in both equity and debt financings.”). As noted in Part II.A.i, Y Combinator structured the Safe while considering input from both founders and investors and trying to strike a fair balance in the context of the Silicon Valley ecosystem. Coyle & Green, *supra* note 3, at 170.

⁸⁸ Sheelah Kolhatkar, *At Uber, A New C.E.O. Shifts Gears*, THE NEW YORKER (Apr. 9, 2018), <https://www.newyorker.com/magazine/2018/04/09/at-uber-a-new-ceo-shifts-gears>.

⁸⁹ Ibrahim, *supra* note 11, at 1442.

⁹⁰ Ibrahim, *supra* note 11, at 1438-39. Relinquishing control would typically be less costly for an angel investor with non-financial motivations than for a financially-oriented investor, who will generally seek formal channels of influence over startup decision-making to maximize its investment.

iii. The Impact of Y Combinator

The factors described in Parts II.B.i and II.B.ii above explain why a simple, fast, and low-cost seed funding contract might gain popularity in Silicon Valley, but do not explain why the Safe, rather than an alternative such as Yoichiro Taku's convertible security, has become the market's convertible equity instrument of choice.⁹¹ To understand the Safe's predominance, it is necessary to consider Y Combinator's role in Silicon Valley and the actions it has taken to promote the Safe. Because Y Combinator functions as a "kingmaker, research center, and massive instigator of change" in the startup community, investors will typically give serious consideration to investing in Y Combinator-graduated startups.⁹² Furthermore, Y Combinator invests in over 200 startups per year, meaning that active angels and VCs are likely to encounter Y Combinator's portfolio companies with some frequency.⁹³ As Y Combinator invests in startups using the Safe,⁹⁴ both founders and investors have strong incentives to gain an understanding of the instrument: Founders are eager to enter the program and benefit from mentorship and investor connections, and investors are eager to find the next Airbnb or Dropbox (both Y Combinator graduates).⁹⁵

In addition to deploying the Safe in real-world investments at a rapid pace, Y Combinator uses its website as a platform to increase public knowledge of the Safe.⁹⁶ The combination of hundreds of real-world use cases among top-class startups and public promotion by Silicon Valley's leading startup accelerator has surely contributed to the Safe's popularity, at minimum by reducing the number of founders and investors who are unfamiliar with the mechanics and terms of the Safe.⁹⁷ And the efforts by Y

⁹¹ This "convertible security" is a convertible equity instrument with Safe-like terms that Taku, a partner at Wilson Sonsini Goodrich & Rosati, introduced the year before Y Combinator created the Safe. Coyle & Green, *supra* note 3, at 167.

⁹² Sandra Upson, *At Y Combinator's Demo Day, The Age of Overpromises Is Over*, WIRED (Mar. 20, 2018, 2:30 PM), <https://www.wired.com/story/y-combinator-demo-day-uber-for-x>. At Y Combinator's Demo Day, startups that are graduating the program have the opportunity to pitch to "500 of Silicon Valley's top investors." Aditi Roy, *For Many Tech Investors in Silicon Valley, This is the Most Important Event of the Year*, CNBC (Mar. 21, 2017, 8:41 PM), <https://www.cnbc.com/2017/03/21/y-combinator-demo-day-what-is.html>; see also Nathaniel Rich, *Silicon Valley's Start-Up Machine*, N.Y. TIMES (May 2, 2013), <https://www.nytimes.com/2013/05/05/magazine/y-combinator-silicon-valleys-start-up-machine.html>.

⁹³ The 2017 winter batch alone included 120 companies. See Roy, *supra* note 92.

⁹⁴ Paul Graham, *Announcing the Safe, a Replacement for Convertible Notes*, Y COMBINATOR (Dec. 6, 2013), <https://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes>.

⁹⁵ Y Combinator's acceptance rate for its winter 2017 batch was less than 2% (7,000 applications for 120 or fewer spots). Roy, *supra* note 92.

⁹⁶ For example, Y Combinator has promoted the Safe on its website, published a Safe primer on its website, and explained in its blog how the Safe can be used by startups for seed funding. See Graham, *supra* note 94; *SAFE Primer*, *supra* note 32; Ralston, *supra* note 4.

⁹⁷ Statements by Levy in a 2015 interview suggest lack of understanding of the Safe's terms was at least a partial impediment to its use by certain lawyers and investors who were unfamiliar with the instrument. Abramowitz, *supra* note 35.

Combinator to draft the terms of the Safe in a manner that would be palatable to both founders and investors has likely reduced the number of parties who, being familiar with the terms of the Safe, reject it based on the substance of the instrument.

The various forms⁹⁸ of the Safe that Y Combinator makes available also serve as standard documents for Safe investments in Silicon Valley. Some parties modify the Safe, but the standard form is commonly used as a starting point and modifications are generally limited.⁹⁹ In contrast, there is no single market-standard form of convertible note.¹⁰⁰ The result is that Safes are less likely to include highly unusual terms, drafting errors, or other irregularities that may require additional time and expense to resolve or that may discourage subsequent venture capital firms from investing in the startup.¹⁰¹ Clerky (a Y Combinator graduate itself) is a tool that further streamlines this process by automatically generating execution-ready Safe documents based on Y Combinator's form, collecting signatures, and producing fully executed contracts at closing.¹⁰²

Y Combinator's physical presence in Silicon Valley and its requirement that participating founders relocate to Y Combinator's offices for the duration of its three-month accelerator program¹⁰³ may facilitate the development of trust networks and bolster the efficacy of reputational sanctions. Specifically, the "social integration of an [investment accelerator] system" helps "build networks that utilize prior connections and overlay pre-existing norms already present in the startup community" and "lowers the cost to mobilize group social sanctions where an individual deviates from behavioral norms."¹⁰⁴ As discussed in Part i above, the threat of reputational sanctions appears to be a key supplement to the limited legal rights investors acquire via a Safe.

Y Combinator and other highly reputable accelerators may also increase investor comfort with the Safe by conducting screening activities that would not be possible for individual angel investors.¹⁰⁵ Y Combinator's

⁹⁸ The forms offered are (1) cap, no discount; (2) discount, no cap; (3) cap and discount; and (4) most-favored nation clause, no cap, and no discount. *Startup Documents*, *supra* note 33.

⁹⁹ Interview with Attorney 1, *supra* note 19.

¹⁰⁰ *Id.* This is also clear from the fact that various well-known startup- and venture-focused law firms offer different forms of convertible note on their respective websites. *See, e.g., Series Seed Notes – Convertible Promissory Note*, *supra* note 41; Kristine M. Di Bacco et al., *Convertible Note (Seed-Stage Start-Up)*, LEXISNEXIS, <https://www.fenwick.com/FenwickDocuments/Convertible-Note-Seed-Stage-Startup.pdf> (last visited Aug. 14, 2018).

¹⁰¹ Interview with Attorney 1, *supra* note 19.

¹⁰² *See generally*, CLERKY, <https://www.clerky.com> (last visited Aug. 14, 2018).

¹⁰³ *Frequently Asked Questions*, Y COMBINATOR (June 2016), <https://www.ycombinator.com/faq/#q24>.

¹⁰⁴ Bernthal, *supra* note 74, at 145.

¹⁰⁵ Y Combinator alone reviews thousands of startup applications for each semiannual intake. Roy, *supra* note 92.

selection process and intensive three-month program may act as a substitute for the trusted referrals that angels use to screen out low-quality deals and also reduce the need for due diligence.¹⁰⁶ Although successful completion of a prestigious accelerator program is no guarantee that a founder has a sound business idea and will behave ethically, the risks of a flatly unworkable business model or exploitative founder behavior are surely lower for graduates of a highly selective program as compared to the entire universe of startups. Within this pre-screened group, investors may be more willing to bear the risk of reduced contractual protections for the most attractive investment opportunities.¹⁰⁷

Finally, Y Combinator and other major investment accelerators may perform a critical role within the Silicon Valley startup community by “aggressively us[ing] communications platforms – especially blogs, books, and an industry group association – to congeal startup community norms.”¹⁰⁸ Y Combinator’s blog touches on a wide range of topics, including fundraising.¹⁰⁹ Paul Graham, the co-founder and “paterfamilias” of Y Combinator,¹¹⁰ was a prolific blogger for many years, writing on topics related to startup founders and investors.¹¹¹ The norms that Y Combinator and others promote through these communication platforms may thus make streamlined contracts easier to use by bolstering the informal rules that act as a backstop when contractual protections are inadequate to discourage opportunistic behavior.

iv. Summary

In short, the Safe offers a low-cost, simplified set of terms that generally reduces the negotiation burden on both parties compared to the mainstream alternatives,¹¹² eliminates a convertible note provision (the maturity date) that has been known to vex founders, allows the postponement of the company’s valuation, is subordinated to the company’s debt obligations, and converts into the company’s Series A preferred stock when the company raises its Series A funding. One important drawback of

¹⁰⁶ Ibrahim, *supra* note 11, at 1432.

¹⁰⁷ However, it is important to note that successful completion of even a program like Y Combinator is no guarantee of investment. For example, about 20% of Y Combinator’s 2011 summer batch either did not or could not raise capital from investors following completion of the program. RANDALL STROSS, *THE LAUNCH PAD* 233 (2012).

¹⁰⁸ Bernthal, *supra* note 74, at 182.

¹⁰⁹ See, e.g., Ralston *supra* note 4, and Aaron Harris, *Process and Leverage in Fundraising*, Y COMBINATOR (May 7, 2018), <https://blog.ycombinator.com/process-and-leverage-in-fundraising>.

¹¹⁰ See Steven Levy, *Y Combinator Has Gone Supernova*, WIRED (June 28, 2017, 6:55 AM), <https://www.wired.com/story/y-combinator-has-gone-supernova>.

¹¹¹ See *Essays*, PAUL GRAHAM, <http://www.paulgraham.com/articles.html> (last visited Aug. 14, 2018).

¹¹² Although common stock requires the negotiation of only an issuance price, fixing the issuance price requires agreeing on a valuation for the company. A common stock investor may also seek to execute a shareholders’ agreement, which will increase the complexity of the investment.

the Safe is an increased risk that founders may use the funds imprudently or elect to postpone future equity fundraising because the Safe provides investors little legal recourse in such cases. However, mechanisms for informal sanctions, including robust informal relationship networks (which are bolstered by investment accelerator communities) provide an additional check on founder behavior. Furthermore, angel investors may be willing to use the Safe because their primary focus is on achieving a small number of hugely successful investments and because a willingness to use the founder-friendly Safe may act as a positive signal to in-demand founders deciding to apportion a seed round among a limited number of investors. Finally, Y Combinator's use of the Safe for its own investments and continued advocacy for the instrument has likely helped increase both widespread understanding of the Safe and willingness of other parties to use it in their own investments.

C. *Overview of the Japanese Startup Landscape*

In examining how the factors contributing to the widespread availability of convertible equity as a tool for seed fundraising in Silicon Valley might apply in the Japanese context, it is necessary to consider certain key aspects of the legal, business and financial environment for startups in Japan. Interestingly, many characteristics of the Japanese startup environment appear conducive to the widespread use of a lightweight convertible equity instrument. Nonetheless, such a trend has not yet materialized. Part E below discusses possible explanations for this somewhat counterintuitive outcome.

An extreme difference in scale is the most salient contrast between the Japanese and American¹¹³ venture financing markets. The Japanese market is very small relative to the American market in terms of both total amount invested and average deal size. In 2016, American VC investment totaled about \$69 billion (across 8,136 deals), compared to approximately \$1.4 billion (across 1,387 deals) of VC investment in Japan.¹¹⁴ Within this small market, the breakdown of startup funding sources is notably different from that of the American market. According to a 2017 survey, the most

¹¹³ At times, this Article refers to the “Silicon Valley” market and the “American” or “U.S.” market in a manner that implies interchangeability. Although the Silicon Valley market is just one of several markets that make up the whole U.S. venture financing market, it is by far the single largest venture financing market in the United States. VENTURE ENTERPRISE CENTER, JAPAN, BENCHĀ HAKUSHO 2017 [VENTURE WHITE PAPER 2017] I-62 (2017). The author takes sole responsibility for the accuracy of all citations to Japanese-language sources throughout this Article, including this note 113 and notes 118, 126, 130, 133, 140, 144, 145, 149, 150, 166, 187, and 204. This Article relies on overall U.S. market data because the available data for the Silicon Valley market is far less detailed.

¹¹⁴ VEC YEARBOOK 2017, *supra* note 12, at II-41. Throughout this Article, references to a particular year with respect to statistical Japanese market data refer to the typical Japanese fiscal year, which runs from April 1 to March 31 (e.g., Japanese market data for “2016” covers the period beginning on April 1, 2016 and ending on March 31, 2017).

frequent sources of startup funds in Japan were banks and credit unions, which were used even more commonly than founder self-funding.¹¹⁵ Angel funding is limited; angel investors supplied only 6.5% of the total money raised by startups since their inception, and 6.3% of the total money raised by startups in the year prior to the 2017 survey.¹¹⁶ Nonetheless, angel financing appears to be an important step in startups securing VC funding, as during the same period 36.0% of companies that secured venture capital investments had raised funds from angel investors, while only 25.0% of companies that failed to secure venture capital investment had raised from angels.¹¹⁷

Investments in Japanese VC funds in 2016 were sourced (by amount of capital) approximately 23% to corporates and 26% to banks, trusts, and credit unions, which are particularly risk averse.¹¹⁸ Often, these limited partners (“LPs”) are “not genuinely equity-oriented” because they commonly have an ownership or other business relationship with their chosen VC fund, which creates a high barrier to the LP redirecting future investments to other funds that offer superior performance.¹¹⁹ As a result, poorly performing funds “can and do survive” in Japan.¹²⁰ Furthermore, in comparison to the U.S., the proportion of VCs in Japan that are “owned by banks, insurance companies (financial firms) and corporates is relatively large.”¹²¹

These differences in VC fund structure and incentives do not appear to foster strong performance. As of 2017, “[w]hen aggregated by launch year, all 427 Japanese venture capital funds surveyed by [Japan’s Venture Enterprise Center] had inferior performance to their U.S. peers, with the exception of the funds launched in the 1982-to-1984 period and funds launched in 1999.”¹²² In addition, the startups in which U.S. VCs

¹¹⁵ Specifically, among all startup financings in the year prior to the survey, more rounds involved fundraising from banks and credit unions than from founders. VEC YEARBOOK 2017, *supra* note 12, at I-69.

¹¹⁶ VEC YEARBOOK 2017, *supra* note 12, at I-68-69. According to the Pitchbook-NVCA Venture Monitor, angel and seed financing rounds amounted to \$7.5 billion in 2018, compared to a total \$130.9 billion in VC investment, meaning angel and seed funding comprises about 5.7% of the total. John Gabbert et al., *4Q 2018 Venture Monitor*, PITCHBOOK 4, 8, https://files.pitchbook.com/website/files/pdf/4Q_2018_PitchBook_NVCA_Venture_Monitor.pdf (last visited Mar. 1, 2019).

¹¹⁷ VEC YEARBOOK 2017, *supra* note 12, at I-67. However, other factors (such as the startups that attract angel investment simply being more promising than those that do not) could also explain this correlation.

¹¹⁸ *Id.* at II-21. TETSUYA ISOZAKI, KIGYŌ NO FAINANSU ZŌHŌKASEIBAN [STARTUP FINANCE, EXPANDED AND REVISED EDITION] 255 (2015) [hereinafter ISOZAKI, STARTUP FINANCE, EXPANDED AND REVISED EDITION].

¹¹⁹ See Shishido, *supra* note 78, at 1119-20.

¹²⁰ *Id.* at 1120.

¹²¹ Wako Watanabe, Early Results of the VC Project 2 (Aug. 17, 2018) (unpublished early report of research for the Economic and Social Research Institute, Cabinet Office, Japan) (on file with author).

¹²² VENTURE ENTERPRISE CENTER, JAPAN, VEC YEARBOOK 2016 I-42 (2017) [hereinafter VEC YEARBOOK 2016].

invest outperform their Japanese counterparts over time in terms of both job-creation and operating revenue.¹²³

Japanese VC firms that are directly affiliated with banks, securities companies, and large corporates have a reputation for being traditional-minded and rigid in their structure, with little investment discretion allocated to the employees responsible for sourcing and managing deal flow.¹²⁴ These employees also typically do not enjoy an equity or profit-sharing incentive.¹²⁵ Investment decisions are generally slow, taking anywhere from one month to as long as one year from the date of first contact with the founder.¹²⁶ Corporate VC investors (“CVCs”) are also a popular source of startup funding, with a majority of startups anticipating investment from a corporate investor.¹²⁷ An increasingly large number of CVCs have funded investment accelerators or launched their own accelerators.¹²⁸ One company that specializes in helping CVCs set up accelerators, Creww Inc., stated in 2016 that it had already implemented or was scheduled to implement over 230 accelerator programs.¹²⁹

The Japanese seed financing market is similar to the pre-2005 Silicon Valley market in one important respect: common stock is still the seed funding instrument of choice.¹³⁰ Although in Silicon Valley seed-stage investing is more typically the purview of angel investors and “micro-VCs,”¹³¹ in Japan it is common for VCs to invest in seed-stage companies.¹³² This is likely in part due to the fact that there are far fewer angel investors in Japan than in America.¹³³ Despite the relatively small size of the market, competition for access to the most promising seed-stage deals in Japan is fierce and has been increasing in recent years.¹³⁴

Classified stock has gradually increased in popularity to overtake common stock as the instrument of choice for Japanese VC investments on

¹²³ Watanabe, *supra* note 121, at 9.

¹²⁴ ISOZAKI, *STARTUP FINANCE, EXPANDED AND REVISED EDITION*, *supra* note 118, at 275-76.

¹²⁵ Shishido, *supra* note 78, at 1119.

¹²⁶ HIDEYUKI SHIMAUCHI, *BENCHĀ KYAPITARU KARA NO SHIKINCHŌTATSU [FUNDRAISING FROM VENTURE CAPITAL]* 120 (3rd ed. 2012).

¹²⁷ VEC YEARBOOK 2017, *supra* note 12, at I-70.

¹²⁸ *Id.* at I-33.

¹²⁹ VEC YEARBOOK 2016, *supra* note 122, at I-52.

¹³⁰ Yukihiro Machida, *Shinkabuyoyakukentsukishasai no katsuyō nitsuite no ikkōsatsu (jō) [Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part I of 2)]*, 2139 SHŌJI HŌMU 20, 21-22 (July 15, 2017).

¹³¹ These are VCs that focus on seed-stage investments and generally manage relatively small funds. See Samir Kaji, *Where is the Micro-VC Market Going*, CB INSIGHTS (Sept. 4, 2014), <https://www.cbinsights.com/research/revisiting-micro-vc-market>.

¹³² In 2016, 19.2% of total VC investments by number and 21.0% of the total amount invested went to seed-stage companies. VEC YEARBOOK 2017, *supra* note 12, at II-15.

¹³³ TETSUYA ISOZAKI, *KIGYŌ NO EKUITI FAINANSU---KEIZAI KAKUMEI NO TAME NO KABUSHIKI TO KEIYAKU [STARTUP EQUITY FINANCE—STOCK AND CONTRACTS FOR AN ECONOMIC REVOLUTION]* 69 (2014) [hereinafter ISOZAKI, *STARTUP EQUITY FINANCE*].

¹³⁴ VEC YEARBOOK 2017, *supra* note 12, at I-14.

the whole,¹³⁵ bringing the Japanese market practice closer in line with the American practice, which relies heavily on preferred stock.¹³⁶ However, Japanese VC investment contracts often include a “buyback” mechanism, something that is rarely, if ever, seen in the United States.¹³⁷ Under this provision, the founders are typically obligated to repurchase the VC’s investment at cost upon demand.¹³⁸ This arrangement is extremely unfavorable to founders, and—even worse, from the founder’s perspective—VCs actually use the provision with some frequency. In 2016, approximately 27.5% of VCs’ exits were achieved through buybacks by company management.¹³⁹ To analyze how these factors are conducive or obstructive to the use of convertible equity in Japan, it is also necessary to understand the key technical characteristics of the investment instruments currently used in Japanese seed financing transactions.

D. Overview of Seed Financing Instruments in Japan

i. Common Stock

Despite its prevalence in Japan, seed financing via common stock suffers from many of the same drawbacks as it does in the United States, and in some respects common stock is an even more cumbersome tool in Japan. From the founder’s perspective, common stock is likely to result in more dilution than a convertible instrument, because market practice in Japan is to provide relatively low startup valuations in the seed round.¹⁴⁰ A 2017 Japanese book on startup finance, for example, advises founders to target a seed round valuation of at least ¥50 million (about \$500,000),¹⁴¹ while the average seed-stage valuation in the US is more than ten times that amount.¹⁴² As in the United States, it is often difficult for Japanese founders to make a case to investors about any kind of objective value of their companies, because seed stage companies typically have almost no revenue and face highly uncertain long-term prospects.¹⁴³ With such extreme downward pressure on seed round pricing, postponing a company’s

¹³⁵ VEC YEARBOOK 2016, *supra* note 122, at I-30.

¹³⁶ Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1164-65 (2013).

¹³⁷ See Shishido, *supra* note 78, at 1121.

¹³⁸ See *id.*

¹³⁹ VEC YEARBOOK 2017, *supra* note 12, at I-19. A Tokyo-based lawyer interviewed for this Article speculated that many of these exits may be at enormous discounts from the VC’s equity purchase price. Interview with Attorney 2, *supra* note 49.

¹⁴⁰ *Konbātiburu • ekuiti ga nihon no sutātoappu wo kaeru* [Convertible Equity Will Change Japan’s Startups], BUSINESS LAWYERS (Sept. 21, 2017, 10:50 AM), <https://business.bengo4.com/category16/article236> [hereinafter Convertible Equity Will Change Japan’s Startups].

¹⁴¹ ISOZAKI, STARTUP EQUITY FINANCE, *supra* note 133, at 71.

¹⁴² Kate Clark, *Late-stage valuations have increased nearly 20% in 2018*, PITCHBOOK (May 8, 2018), <https://pitchbook.com/news/articles/late-stage-valuations-have-increased-nearly-20-in-2018>.

¹⁴³ Machida, *supra* note 130, at 20.

valuation until the Series A financing can be very important for founders seeking to minimize the dilution of their ownership share.

Additionally, the tax complications of common stock fundraising in the United States have analogues in Japan. Under Japanese law, for startup managers and employees to receive certain favorable tax treatment of their stock options, the exercise price of the option must be equal to the value of the stock at the time of the grant.¹⁴⁴ In effect, the sale of common stock to investors can act as a ratchet for the exercise price on any future option grants to employees.¹⁴⁵ The impact of this on a startup can be significant, because stock options with a low exercise price are a key method of recruiting and incentivizing employees, especially in a company's early stages.¹⁴⁶ Given that many seed-stage founders in Japan identify human resources as their single largest concern, the availability of cheap stock options as a means of attracting top talent would seem to be particularly important.¹⁴⁷ Japan also suffers from a comparative lack of professional managers, making recruiting a strong management team very difficult for Japanese founders.¹⁴⁸ In these respects, common stock-based seed financing is particularly disadvantageous for startups in Japan.

There is also another tax issue at play. Subscriptions for a corporation's capital stock are subject to a 0.7% registration tax to the extent the capital contributed is used to increase the registered corporate capital of the corporation,¹⁴⁹ and under Japanese law at least 50% of capital via an equity issuance must be allocated to an increase in registered corporate capital.¹⁵⁰ Even assuming that the tax is minimized to the extent possible, 0.35% of any common stock seed investment is effectively extinguished as soon as the investment is made as a result of this tax liability. At the seed stage where every dollar (or yen) counts, even this small percentage can be significant.

With low valuations as a market norm, a founder is likely to sell a significant share of her company at the seed stage, and through subsequent financing rounds, it is certainly possible that majority control of the

¹⁴⁴ Sozei Tokubetsusochihō [Act on Special Measures Concerning Taxation], Law No. 26 of 1957, art. 29, para. 2(3) (Japan) (available at http://elaws.e-gov.go.jp/search/elawsSearch/elaws_search/lsg0500/detail?lawId=332AC0000000026&openerCode=1#881).

¹⁴⁵ KATSUYA GOTO ET AL., BENCHĀ JITSUMU A TO Z [VENTURE PRACTICE A TO Z] 312-13 (2016).

¹⁴⁶ See, e.g., Scott Kupor, *Recommendations for Startup Employee Option Plans*, ANDREESSEN HOROWITZ (July 26, 2016), <https://a16z.com/2016/07/26/options-plan>.

¹⁴⁷ In a 2017 survey, 28% of all founders, and 20% of seed stage founders, identified human resources as their top concern. VEC YEARBOOK 2017, *supra* note 12, at I-71.

¹⁴⁸ ISOZAKI, STARTUP FINANCE, EXPANDED AND REVISED EDITION, *supra* note 118, at 255-56.

¹⁴⁹ Tōroku Menkyo Zeihō [Registration and License Tax Act], Law No. 35 of 1967, annex table 1, item 24(1)(4) (Japan).

¹⁵⁰ Kaishahō [Companies Act], Law No. 86 of 2005, art. 445, para. 2, translated in (Japanese Law Translation [JLT DS]), <http://www.japaneselawtranslation.go.jp> (Japan).

company could slip out of the founder's grasp.¹⁵¹ When selling a significant stake of common stock, founders in Japan relinquish more control than their American counterparts. Unlike Delaware corporations, which have two primary governing documents (the charter and the bylaws), Japanese corporations (*kabushiki kaisha*) are governed solely by their corporate charter.¹⁵² Shareholders have the ability to amend the corporate charter unilaterally by special resolution, without the resolution of the board of directors that would be required under Delaware law.¹⁵³ As insightfully noted by Professor Gen Goto, this means that in theory shareholders can unilaterally amend a company's charter to give themselves voting rights over a corporation's ordinary business matters without the consent of the company's board.¹⁵⁴

It gets worse (for founders). Japanese law requires that a company's shareholders fix the maximum aggregate compensation for the company's directors.¹⁵⁵ Although the shareholders vote to simply establish the size of the total pool of funds for annual director compensation,¹⁵⁶ in a startup with one, two, or three directors, the intended compensation for each director is likely to be obvious, and the majority shareholders effectively have a veto right over any irksome founder compensation arrangement.

On top of low seed-stage valuations and twofold tax complications, common stock seed investments may also involve substantial contractual complexity in the Japanese market. In Japan, VCs' common stock investments are often accompanied by detailed side contracts, and because these contracts are non-public and no accepted standard forms exist, there is confusion among Japanese founders regarding which terms can be negotiated and to what extent.¹⁵⁷ Additionally, because the overwhelming majority of Japanese founders are first- or second-time founders, they are very likely to lack experience and know-how in negotiating seed-stage investment contracts.¹⁵⁸ Accordingly, common stock seed investments in Japan can be exceedingly unfavorable for founders, diluting their equity stakes, ratcheting up the exercise price at which they can grant stock options

¹⁵¹ Investors contributed an average of ¥95.9 million per seed stage deal in 2016 and ¥58.9 million in 2015. VEC YEARBOOK 2017, *supra* note 12, at I-13. A founder receiving an average amount of investment would lose control of her company in a just a single funding round at a low-but-conceivable seed stage valuation of ¥50 million.

¹⁵² Gen Goto, *Legally "Strong" Shareholders of Japan*, 3 MICH. PRIVATE EQUITY & VENTURE CAP. L. 125, 129-30 (2014).

¹⁵³ *Id.* at 129-30 (citing Companies Act, *supra* note 150, art. 466; DEL. CODE ANN. tit. 8, § 242(b)(1) (2011)).

¹⁵⁴ *Id.* at 130 (citing Companies Act, *supra* note 150, art. 295).

¹⁵⁵ *Id.* at 131 (citing Companies Act, *supra* note 150 art. 361, para. 1).

¹⁵⁶ *Id.*

¹⁵⁷ Takeuchi & Ogawa, *supra* note 14, at 44.

¹⁵⁸ According to a 2017 survey, for example, 71% of founders were first-time founders and 21% of founders were second-time founders. VEC YEARBOOK 2017, *supra* note 12, at I-73.

employees, weakening their control of the business, and offering limited (if any) benefits in terms of speed and legal cost.

Nonetheless, some of these weaknesses of common stock from the founder's perspective may represent positive features from the investor's perspective. The stock option exercise price ratchet and increased delay and expense of complicated financing contracts are not likely to help either party, but the founder's dilution means that the investor holds a greater share of the company's equity, the founder's loss of control is a result of the investor's gain of some shareholder protections, and the opacity of the side contracts provides an aggressive investor an opportunity to negotiate more favorable terms (though at increased expense).

Even from the founder's perspective, there are circumstances where common stock does offer some advantages. One Japanese founder interviewed for this Article noted that he had chosen to raise seed funding using common stock because requesting a straight common stock raise with no special terms allowed him to minimize the risk that investors would ask for an onerous founder-buyback provision.¹⁵⁹ If a founder succeeds in securing investors' agreement to these terms, the founder will also be able to avoid the contractual complexity that arises from detailed side agreements, thus reducing legal costs, and may be able to increase his chance of obtaining subsequent financing by agreeing to use an instrument familiar to Japanese VCs.¹⁶⁰

There is also one respect in which raising capital through the sale of common stock benefits both founders and investors: the lack of a corporate registration (*toki*) requirement.¹⁶¹ Under Japanese law, seed financing through convertible notes and convertible equity is effected using of a type of warrant (*shinkabuyoyakuken*, sometimes also referred to as a "stock option" or "stock acquisition right") that, once issued, the company must register with the Legal Affairs Bureau.¹⁶² Classified stock is subject to a similar registration requirement.¹⁶³ The terms of side contracts can be excluded from the corporate registration, but the terms that must be registered include the exercise price and enough information to allow a third

¹⁵⁹ Interview with Founder 2, Chief Executive Officer of Japan-Incorporated Startup with Overseas Headquarters in Tokyo, Japan (May 18, 2018) (on file with author).

¹⁶⁰ Venture capital firm employees not understanding an instrument, or having difficulty explaining the instrument to their superiors, can delay or sink an investment deal. *See, e.g.*, Convertible Equity Will Change Japan's Startups, *supra* note 140; Machida, *supra* note 130, at 23 (explaining that this may be a current hindrance to the use of convertible equity in the Japanese market). *See* discussion *infra* Part II.E.ii.c.

¹⁶¹ Machida, *supra* note 130, at 22.

¹⁶² *Id.* at 22-23.

¹⁶³ *Id.* at 22-23.

party to calculate the valuation.¹⁶⁴ Because the information registered with the Legal Affairs Bureau is available to the public, the material terms of these seed financings are essentially public information once the registration is complete.¹⁶⁵ In fact, Yohei Sawayama, a Managing Partner of 500 Startups Japan (recently rebranded as Coral Capital), has created a large database of deal information based on this public disclosure, including amount invested, investment instrument, and pre- and post-money valuation.¹⁶⁶ Some Japanese investors cite the ability to avoid this public disclosure as one of the appealing aspects of investing via common stock.¹⁶⁷

ii. Classified or Preferred Stock

Classified stock carries many of the same disadvantages in seed-stage financings in Japan as it does in the United States. First, as in the United States, creating and issuing a new class of stock in Japan requires negotiating a valuation and amending the corporate charter, which increases transaction costs.¹⁶⁸ In addition, registered corporate capital contributed in exchange for classified stock is also subject to the 0.7% registration tax that applies to capital contributions for common stock.¹⁶⁹ Although the terms of classified stock can be structured so that it functions similarly to convertible equity, these disadvantages still make the instrument less appealing than a convertible equity instrument under typical circumstances.¹⁷⁰

Classified stock does offer one important advantage over common stock in that, unlike common stock, an issuance of classified stock does not immediately set a floor for the exercise price of future tax-favorable issuances of options to purchase common stock.¹⁷¹ However, the terms of classified stock issuances are subject to the corporate registration (*toki*) requirement, meaning that key valuation terms will become public information after the transaction is closed.¹⁷² In some cases, there is also a corporate law requirement for separate shareholder meetings of classified

¹⁶⁴ See Companies Act, *supra* note 150, art. 911, para. 3(12), art. 915, para. 1 (setting forth the items that must be registered upon the issuance of *shinkabuyoyakukken*); art. 108, para. 2; art. 915, para. 1 (requiring amendments to the articles of incorporation in the case of creation of new series of classified stock and requiring an update of the corporate registration in the case of such amendment).

¹⁶⁵ Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁶⁶ See generally Yohei Sawayama, *Chōsa repōto: 186-sha no tōkibo kara wakatta sutātoappu no shikinchōtatsu no "sōba"* [Survey Report: The Fundraising "Market" for Startups as Determined from 186 Companies' Corporate Registrations], CORAL CAP., INC. (June 19, 2017), <https://coralcap.co/2017/06/deal-terms/>. The author has also reviewed the spreadsheet.

¹⁶⁷ Takeuchi & Ogawa, *supra* note 14, at 43. In Delaware, there is no such disclosure requirement.

¹⁶⁸ Companies Act, *supra* note 150, art. 108(2); Machida, *supra* note 130, at 22.

¹⁶⁹ Convertible Equity Will Change Japan's Startups, *supra* note 140. See also Registration and License Tax Act, *supra* note 149, annex table 1, item 24(1)(4).

¹⁷⁰ See Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁷¹ GOTO ET AL., *supra* note 145, at 312-13.

¹⁷² Machida, *supra* note 130, at 22.

stock holders, which creates an administrative burden for both startups and investors.¹⁷³

iii. Convertible Notes

Although convertible notes are an increasingly popular method of seed financing in Japan, they are not yet mainstream.¹⁷⁴ In Japan, seed financing notes are generally structured as corporate promissory notes paired with stock warrants, and they allow founders and investors to avoid some of the most troublesome aspects of fundraising through capital stock.¹⁷⁵ Because the price at which the note's principal and interest converts into capital stock can be based on the stock's future issuance price to Series A investors, a valuation is not necessary at the time the convertible note is issued.¹⁷⁶ Additionally, a cap and a discount can be employed to compensate seed-stage investors for the additional risk of their early-stage investments.¹⁷⁷ According to a Tokyo-based lawyer interviewed for this Article, Japanese convertible seed notes tend to bear interest at a low rate of 2% to 3%.¹⁷⁸ Convertible notes also allow seed investors to benefit from the favorable terms negotiated by the Series A investors, as the convertible note will convert into Series A preferred stock. This is increasingly relevant in Japan given that classified stock is becoming the standard instrument for venture financings.¹⁷⁹

Despite these strengths, convertible notes in Japan suffer from significant shortcomings. One disadvantage that may surprise American investors is simply the nature of convertible notes as indebtedness. Traditional-minded Japanese companies are often reluctant to do business with a startup that has an apparently excessive level of debt on its balance sheet, even if the debt is entirely the result of convertible note seed financings.¹⁸⁰ Furthermore, there is a significant possibility that angel investors in Japan, where startup financing norms are not yet broadly standardized, will demand the repayment of a convertible note if the maturity date is reached before the company raises equity financing.¹⁸¹

The issuance of a convertible note in Japan also requires compliance with numerous contractual formalities to avoid onerous obligations under the Companies Act of Japan, such as the appointment of a company bond administrator.¹⁸² Furthermore, the stock warrant portion of

¹⁷³ *Id.*; see also Companies Act, *supra* note 150, art. 324.

¹⁷⁴ Takeuchi & Ogawa, *supra* note 14, at 42.

¹⁷⁵ Machida, *supra* note 130, at 23; Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁷⁶ Machida, *supra* note 130, at 23.

¹⁷⁷ *Id.*

¹⁷⁸ Interview with Attorney 2, *supra* note 49.

¹⁷⁹ See discussion *supra* Part II.C; see *supra* text accompanying note 135.

¹⁸⁰ Convertible Equity Will Change Japan's Startups, *supra* note 140; Machida, *supra* note 130, at 23.

¹⁸¹ Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁸² Companies Act, *supra* note 150, art. 702; Takeuchi & Ogawa, *supra* note 14, at 42.

the note must be registered through the *toki* process described in Part II.D.i above.¹⁸³ As with classified stock, this registration essentially makes the terms of the financing publicly available information. Revisions to the terms of a warrant that are disadvantageous to warrant-holders require the consent of all warrant-holders,¹⁸⁴ so it is not possible to contractually set a lower consent threshold (for example, a majority of all warrant-holders) for the startup's convenience, a mechanic that is employed in Silicon Valley with some frequency.¹⁸⁵ Finally, although convertible notes used in Silicon Valley seed financing transactions are typically stripped down and lacking nearly all of the investor protections of a typical Series A investment,¹⁸⁶ there does not appear to be consensus among Japanese lawyers and investors that seed financing documents should employ this level of simplicity.¹⁸⁷ There are also a number of contractual terms for convertible notes that are required to be fixed by statute, including many that are not included in a typical Silicon Valley-style convertible note.¹⁸⁸ Although these terms are not likely to be the focus of negotiation,¹⁸⁹ they certainly increase the complexity of the required legal documentation and thus increase the time necessary for document preparation and review for a note-based seed investment.

iv. Convertible Equity

There is still some debate around the preferred form of convertible equity in Japan, with lawyers suggesting that each of convertible notes, classified stock, common stock, and stock warrants could be structured in some way to achieve at least an imitation of a Silicon Valley-style convertible equity instrument.¹⁹⁰ Masakazu Masujima, a partner at the Tokyo-headquartered law firm of Mori Hamada & Matsumoto, is the lawyer most prominently involved in the development of convertible equity

¹⁸³ Machida, *supra* note 130, at 23.

¹⁸⁴ Takeuchi & Ogawa, *supra* note 14, at 42.

¹⁸⁵ See, e.g., *Series Seed Notes – Convertible Promissory Note*, *supra* note 41.

¹⁸⁶ Coyle & Green, *supra* note 3, at 160.

¹⁸⁷ Yukihiro Machida, *Shinkabuyoyakukentsukishasai no katsuyō nitsuite no ikkōsatsu (ge)* [Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part 2 of 2)], 2140 SHŌJI HŌMU 40, 44-45 (July 25, 2017) (suggesting that seed stage investors should seek contractual representations and warranties as to the (i) accuracy of the startup's financial statements, (ii) the startup's proper ownership of intellectual property, and (iii) lack of litigation facing the startup, among other matters, as well as a board observer seat, pro rata rights, notice rights for certain important events, and tag along rights for equity sales by the company's managers).

¹⁸⁸ Machida, *supra* note 130, at 23; cf. *Series Seed Notes – Convertible Promissory Note*, *supra* note 41.

¹⁸⁹ The terms that are not included in a U.S.-style convertible note but are required by statute would not generally affect the key legal rights of the parties or the economics of the transaction.

¹⁹⁰ Takeuchi & Ogawa, *supra* note 14, at 42-43; *Convertible Equity Will Change Japan's Startups*, *supra* note 140.

in Japan.¹⁹¹ Initially inspired by the Silicon Valley-based Founder Institute's 2012 introduction of a convertible equity instrument for seed funding,¹⁹² Masujima set out to create a similar instrument in Japan.¹⁹³ His first attempt was a perpetual, subordinated, zero-coupon convertible note that offered two of the key benefits of the Founder Institute's instrument by eliminating the need for a startup to repay the note and eliminating the need to negotiate and document an interest rate.¹⁹⁴ The structure was received well by a large startup incubator,¹⁹⁵ but there was one problem: traditional-minded potential business partners viewed the subordinated convertible note debt as a risky liability on the startup's balance sheet, even though the note never needed to be repaid and bore no interest.¹⁹⁶

Ultimately concluding that a debt instrument was impractical in the Japanese market, Masujima designed a series of classified stock with the characteristics of convertible equity.¹⁹⁷ This, unfortunately, suffered from the disadvantages discussed in Part II.D.ii above, including requiring an amendment to the startup's charter and giving rise to a 0.7% registration tax on the amount of the investment that was allocated to increase the company's registered corporate capital.¹⁹⁸ These disadvantages were vexing enough to send Masujima looking for yet another investment structure.¹⁹⁹

Although Masujima had worked with stock warrants (*shinkabuyoyakuken*) on some fundraising transactions for public companies, prior to his adoption of the warrant for seed funding, warrants alone had apparently never been used for startup fundraising in Japan.²⁰⁰ A warrant offered the advantages of a convertible note, including the ability to postpone the negotiation of a valuation and to offer a valuation cap and conversion discount to investors.²⁰¹ In addition, using a warrant instead of a convertible note obviated the need to negotiate an interest rate, did not add debt to the startup's balance sheet, and eliminated the risk of an angel investor demanding repayment of the note at maturity.²⁰²

¹⁹¹ See, e.g., Convertible Equity Will Change Japan's Startups, *supra* note 140.

Masujima is an advisor to the Japan Venture Capital Association and created the Japanese version of 500 Startups' convertible equity Keep It Simple Security. *Id.*; *About JVCA, JAPAN VENTURE CAP. ASS'N*, <https://jvca.jp/about/directors> (last visited Apr. 21, 2019).

¹⁹² Adeo Ressi, *Startups Can't Borrow Their Way to Success*, FOUNDER INSTITUTE (Aug. 31, 2012) <https://fi.co/insight/startups-can-t-borrow-their-way-to-success-by-adeo-ressi>.

¹⁹³ See Interview with Masakazu Masujima, Partner at Mori Hamada & Matsumoto in Tokyo, Japan (Mar. 12, 2018) (on file with author).

¹⁹⁴ *Id.*; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁵ Interview with Masakazu Masujima, *supra* note 193.

¹⁹⁶ *Id.*; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁷ Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ Interview with Masakazu Masujima, *supra* note 193; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁰¹ Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁰² See Interview with Masakazu Masujima, *supra* note 193; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

In light of these factors, Masujima settled on the warrant as his instrument of choice when he was tasked with developing a convertible equity instrument for 500 Startups Japan.²⁰³ In creating the Japanese instrument, 500 Startups Japan sought as much as possible to preserve the substance of its U.S. law Keep It Simple Security (KISS), with necessary adjustments only to accommodate the Japanese legal system.²⁰⁴ Because Japanese corporate law requires that warrants undergo corporate registration (*toki*) procedures, Masujima had to educate the staff of the Japanese Legal Affairs Bureau²⁰⁵ on the mechanics of this new instrument to minimize the possibility that the Legal Affairs Bureau would reject future filings from 500 Startups' investees.²⁰⁶

E. Comparative Analysis of Convertible Equity in Japan

The advantages of convertible equity in comparison to common stock, preferred stock and convertible notes highlighted above are not the only strengths of the instrument. In addition, the corporate registration fee for a warrant is only ¥90,000 (less than \$900), in contrast to the 0.7% tax that would be levied on a capital increase through the sale of capital stock, and no amendment to the company's Articles of Incorporation is necessary in connection with a warrant issuance.²⁰⁷ Furthermore, the ability to include valuation cap and discount terms appears to be an important benefit for investors; according to Masujima, Japanese seed investors who use a convertible instrument typically convert at the valuation cap and as a result receive a discount in the range of 40% to 50% of the Series A price in the conversion.²⁰⁸ In light of the benefits that convertible equity offers as compared to common stock, preferred stock, and convertible notes, its limited use to date in the Japanese market merits serious analysis.

As a starting point for this inquiry, it is instructive to revisit the factors that appear to have contributed to the Safe's success. Among these, Part A identifies the following technical characteristics of the Safe: (1) low cost, (2) simplicity, (3) speed, and (4) preservation of the terms (discount and valuation cap) that are most important to many influential angel investors. Part B further identifies the following external factors as likely

²⁰³ Interview with Masakazu Masujima, *supra* note 193.

²⁰⁴ Interview with Yohei Sawayama, *supra* note 12. The KISS comes in a debt version and an equity version, but 500 Startups decided to create a Japanese version of the equity version only. See Raiten, *supra* note 30; Yohei Sawayama, *J-KISS: Dare mo ga jiyū ni tsukaeru, shīdo shikinchōtatsu no tame no tōshikeiyakusho* [The J-KISS: An Investment Contract Anyone Can Use Freely for Seed Fundraising], CORAL CAP., INC. (Apr. 28, 2016), <https://coralcap.co/2016/04/j-kiss/> [hereinafter The J-KISS].

²⁰⁵ These are local offices that handle administrative matters for Japan's Ministry of Justice. *Civil Affairs Bureaus*, MINISTRY OF JUSTICE, <http://www.moj.go.jp/MINJI/index.html> (last visited Apr. 21, 2018).

²⁰⁶ Machida, *supra* note 130, at 23; Interview with Masakazu Masujima, *supra* note 193.

²⁰⁷ Registration and License Tax Act, *supra* note 149, annex table 1, item 24(1)(10).

²⁰⁸ Convertible Equity Will Change Japan's Startups, *supra* note 140.

supporting the Safe's proliferation in Silicon Valley: (1) the availability of informal protective mechanisms and informal sanctions to curtail bad behavior even when the vulnerable party lacks contractual recourse, (2) the preferences of seed-stage investors, and (3) Y Combinator's role in building widespread awareness of the Safe and promoting the Safe among its own portfolio companies as well as Silicon Valley startups at large. These factors can be analyzed in turn from a comparative perspective to examine to what extent the Japanese market may be conducive to the use of convertible equity instruments in seed financing transactions.

i. Comparative Analysis of the Technical Characteristics of Convertible Equity in Silicon Valley and Japan

Like the Safe in Silicon Valley, convertible equity in Japan offers greater simplicity than all seed financing alternatives except common stock.²⁰⁹ And because common stock is frequently paired with detailed supplementary contracts, convertible equity may be an even simpler tool than common stock in many cases.²¹⁰ This simplicity allows relatively high-speed negotiation and completion of financing transactions, because fewer terms need to be agreed between founders and investors before the deal can be closed.²¹¹

From a cost perspective, the relative merit of convertible equity depends in part on the amount of funds raised. Assuming that a founder raising money through capital stock minimizes the corporate capital registration tax by allocating only 50% of funds raised to registered corporate capital, the registration tax for a capital stock financing would exceed the ¥90,000 convertible equity registration tax when the amount of funds raised exceed ¥25.7 million (about \$233,500 at exchange rates as of May 17, 2019).²¹² The average seed financing in Japan exceeds this threshold.²¹³ Importantly, any contracts negotiated together with a common stock issuance would typically generate additional legal fees on top of the corporate capital registration tax. In addition, attorneys' fees for the review of convertible notes or preferred stock are generally more expensive than

²⁰⁹ See Machida, *supra* note 130, at 22-23.

²¹⁰ See *supra* text accompanying note 157.

²¹¹ See *infra* note 267. Convertible equity instruments are, however, subject to corporate registration. See *supra* text accompanying note 206.

²¹² Under these circumstances, the effective registration tax on capital stock would be 0.35% (50% of 0.7%). This effective 0.35% registration tax would exceed the ¥90,000 registration fee on a convertible equity issuance when the amount raised is greater than ¥25.7 million.

²¹³ See VEC YEARBOOK 2017, *supra* note 12, at I-13.

for convertible equity.²¹⁴ On the whole, convertible equity is at least highly competitive from a cost standpoint, if not always the cheapest seed financing instrument.²¹⁵ Furthermore, the relatively small amount of funds raised in a typical Japanese seed round should increase the importance of cost-competitiveness, as the transaction costs comprise a greater portion of the money being raised.²¹⁶

The ability to postpone a company's valuation until the Series A round offers similar benefits to both Japanese and American founders by reducing founder dilution and preserving a low exercise price for employee stock options.²¹⁷ Recall, furthermore, that these factors may have particular importance for Japanese founders.²¹⁸ Additionally, given that angel investors' aggressive use of convertible note maturity dates has been a problem for founders in Japan just as in Silicon Valley, Japanese convertible equity offers another significant benefit to founders by removing this provision (though at the cost of investors losing a source of leverage over founders).²¹⁹ From the investors' perspective, receiving the rights and benefits of the Series A preferred stock after the convertible equity converts into preferred stock is a significant advantage.²²⁰ The registration requirement for warrants means that—unlike in the United States—the key terms of convertible equity investments will become public information, but in light of the fact that most Series A and later stage venture financings are already subject to this requirement in Japan, this is a practice to which the seed financing market should adjust if sufficiently incentivized by convertible equity's other benefits.²²¹ In sum, despite

²¹⁴ Given that convertible notes include a stock warrant subject to the ¥90,000 registration fee and also incorporate additional terms beyond those in a typical convertible equity instrument, in general the legal fees associated with a convertible equity financing should be lower than those for a convertible note transaction. Machida, *supra* note 130, at 23. Classified stock typically includes a wider array of negotiated terms in addition to requiring an amendment to the company's charter and subjecting the raised capital to a corporate capital registration tax, making it the most expensive fundraising tool. *Id.* at 22.

²¹⁵ Admittedly, this comparison assumes that the attorneys involved in the transaction are at least somewhat familiar with the concept of convertible equity. If not, the legal fees associated with a convertible equity transaction would likely increase.

²¹⁶ This point was raised by a Japanese investor interviewed for this Article, who also commented that Japanese accelerators typically invest in the range of ¥2 million to ¥3 million (about \$20,000 to \$30,000) in their portfolio companies. Interview with Investor 2, Vice President, Venture Capital Investment Firm (Mar. 13, 2018) (on file with author). Recent survey data on the average size of Japanese seed-stage financings is not available. One compilation of publicly available data calculated an average investment size for Series A financings of ¥260 million (about \$2.3 million); however, this calculation is not limited to data based on recent years. Sawayama, *supra* note 166. In the U.S., the median 2018 Series A round was approximately \$9 million as of mid-2018. Clark, *supra* note 21.

²¹⁷ See *supra* text accompanying notes 25 and 144.

²¹⁸ This is due to relatively low valuations for Japanese companies at the seed stage, the robust rights available to Japanese stockholders, and the difficulty of recruiting staff to startups. See *supra* Part II.D.i.

²¹⁹ See *supra* text accompanying notes 43 and 181.

²²⁰ See *supra* Part II.D.iii.

²²¹ See *supra* text accompanying note 166.

certain meaningful differences, in the aggregate the technical features of Japanese convertible equity offer advantages over other fundraising instruments that are remarkably similar to those offered by the Safe. Accordingly, the failure of convertible equity to proliferate in the Japanese market to date must be the result of environmental or other external factors and not characteristics of the Japanese legal system.

ii. Comparative Analysis of Relevant Characteristics of the Startup Ecosystems in Silicon Valley and Japan

a) Effective Channels of Informal Control

The availability of informal sanctions that function effectively as a check on opportunistic behavior appears to be an important consideration for at least some Japanese investors. Despite the rarity of convertible equity in Japan, one of the Japanese VCs interviewed for this Article described a frustrating experience in which a convertible equity-based investment provided no legal remedies to address material inaccuracies in information disclosed by a startup investee during the due diligence process.²²² As discussed in Part B, contract theory proposes that the underlying factors that enable the effective functioning of these informal sanctions are complex and multilayered.

Part II.B.i notes that rich relationship networks in Silicon Valley make reputation maintenance important for investors who want access to tomorrow's best deals and for founders who want future investment. Part II.B.iii describes how these relationship networks, in turn, are supported by (1) investment accelerators that pull startup mentors and founders into a single community with a clear set of norms, and (2) influential investors' and founders' use of communications platforms to quickly disseminate information about norms. How do these features of Silicon Valley compare to their analogues in the Japanese market?

To some extent, these relationship networks exist in Japan as well,²²³ and the growing number of startup incubators and investment accelerators in Japan is likely to strengthen this aspect of the Japanese startup ecosystem.²²⁴ But deeper analysis reveals that the Japanese market still lacks certain key elements necessary for informal sanctions to be fully effective. Brad Bernthal, in a synthesis of contract theory as applied in the Silicon Valley context, proposes that the following three factors are necessary for social sanctions to displace contractual remedies as the

²²² Interview with Investor 4, Vice President of a Venture Capital Investment Firm in Tokyo, Japan (Apr. 12, 2018) (on file with author).

²²³ VEC YEARBOOK 2016, *supra* note 122, at I-50, (“[T]here exist[] well-developed networks within the startup space and the community shares not only which entrepreneur is trying to disrupt which area, the strategies of each startup, and technology portfolios, but also which investor is worth dealing with[.]”).

²²⁴ One company, Creww Inc., said that it alone had implemented or was scheduled to implement over 200 corporate accelerator programs. *Id.* at I-52.

primary constraint for opportunistic behavior by participants in a given community: “First, behavioral norms must be well-established in [the] community over time. Second, circumstances must exist for reputation to police behavior that deviates from community norms. And third, informal norms are frequently embedded within formal structures.”²²⁵

A review of these factors offers insight into why the Japanese startup community’s relationship networks appear unable to provide the robust support necessary to sustain a new, founder-friendly investment instrument. For example, two Tokyo-based venture capitalists interviewed for this Article, as well as Masujima (commenting in a media interview), described Japanese founders as often lacking knowledge about the technical structure of seed investments,²²⁶ while investors demanding a return of capital upon a convertible note reaching maturity remains a real concern for founders in Japan.²²⁷ The overall picture of the Japanese seed financing market reveals a lack of clear, generally accepted standard terms and norms. According to Masujima, founders routinely come to view as exploitative the investment terms they accepted at an early stage, and that alone (if broadly representative) would be strong evidence that the market suffers from a lack of broadly accepted standards.²²⁸

The apparent lack of shared standards in the Japanese market may not be surprising, given that behavioral norms can take “decades or longer” to become sufficiently established to regulate behavior.²²⁹ However, respected and influential investment accelerators (and perhaps other institutions) can speed the establishment of behavioral norms through use of communications platforms such as blogs and the promotion of norms among professional service providers, such as lawyers and accountants, in the startup community.²³⁰ The early stages of this effort are visible in Japan. For example, Masujima runs a blog similar to Silicon Valley lawyer Yoichiro Taku’s well-known “Startup Company Lawyer” blog, with a focus on disseminating information about legal topics relating to startups and venture finance;²³¹ 500 Startups Japan (rebranded as Coral Capital in March 2019) also runs an active blog;²³² and the Tokyo-based accelerator Incubate Fund runs an “Incubate School” educational program for founders hoping to

²²⁵ Bernthal, *supra* note 74, at 174.

²²⁶ Interview with Investor 2, *supra* note 216; Interview with Investor 4, *supra* note 222; Convertible Equity Will Change Japan’s Startups, *supra* note 140.

²²⁷ Takeuchi & Ogawa, *supra* note 14, at 43.

²²⁸ See Convertible Equity Will Change Japan’s Startups, *supra* note 140.

²²⁹ Bernthal, *supra* note 74, at 145.

²³⁰ *Id.* at 186-87.

²³¹ See generally *Startup Innovators ni tsuite [About Startup Innovators]*, STARTUP INNOVATORS, <https://startupinnovators.jp/about> (last visited Apr. 21, 2018).

²³² See generally *Insights – Kigyōka no tame no kontentsu [Insights – Content for Founders]*, CORAL CAP., INC., <https://coralcap.co/insights> (last visited June 17, 2019).

raise funds in the future.²³³ However, given that knowledge of market norms has not yet permeated the founder and investor communities, these activities must not yet be sufficiently advanced to have installed widespread standards throughout the market.

The second requirement Bernthal identifies, effective reputational enforcement, is also largely unmet in Japan. For reputational enforcement to be an effective tool to curb opportunism, there must be “shared expectations about appropriate behavior,” among other factors.²³⁴ With the lack of widespread standards in the Japanese seed financing market, there do not appear to be consensus expectations regarding key aspects of participant behavior, such as whether it is appropriate for investors to demand the return of principal of a convertible note at maturity.²³⁵ This complication may be exacerbated by the practices of certain players in the Japanese startup community. For example, some Japanese CVCs have a practice of seconding employees to startup portfolio companies and later bringing these employees back to the corporate institution.²³⁶ If these employees are not given startup-related assignments once they are returned to the corporate investor, this practice can effectively sever—or at least greatly reduce the utility of—the business relationships developed by the employees within the startup community.²³⁷ Furthermore, once they are pulled out of the startup community, these seconded employees are likely no longer in a position to use their relationship network to punish founders, or be punished themselves, for behavior that violates the community’s norms.

Nonetheless, there is reason to be optimistic that in time the Japanese market will develop the features necessary for effective reputational enforcement. The intense concentration of startups and investors in Tokyo facilitates repeat transactions between market participants and makes participants’ behavior more easily observable to others in the market, two additional factors Bernthal identifies as necessary for effective reputational policing.²³⁸ Additionally, an increasing number of large events in Tokyo cater to startup founders and investors, including the

²³³ See generally *Incubate School Daiyonki [4th Incubate School]*, PEATIX, <https://incubateschool4-4.peatix.com/view> (last visited Apr. 21, 2018). One of the interviewees for this Article identified Incubate Fund, Skyland Ventures, and East Ventures as leading investment accelerators in Japan. Interview with Employee 1, Startup Service Provider in Tokyo, Japan (Jan. 19, 2018) (on file with author).

²³⁴ Bernthal, *supra* note 74, at 175.

²³⁵ Takeuchi & Ogawa, *supra* note 14, at 43.

²³⁶ See VEC YEARBOOK 2016, *supra* note 122, at I-51.

²³⁷ Consider the case of Asahi Glass Ventures, which established an office in Silicon Valley and had a practice of sending employees from Japan for three-year rotations to Silicon Valley. The result was that the Silicon Valley office consistently lacked a strong connection to local networks of founders and investors. See ANDREW ROMANS, MASTERS OF CORPORATE VENTURE CAPITAL 41-42 (2016).

²³⁸ Bernthal, *supra* note 74, at 175. Tokyo-based startups accounted for approximately 61% of all Japanese VC investment by investment amount in 2016. VEC YEARBOOK 2017, *supra* note 12, at I-15.

Infinity Ventures Summit, Tech in Asia Tokyo, Slush Tokyo, and the New Economy Summit.²³⁹ Besides promoting communication among members of the startup community, these events host discussions and panels with influential community members, providing an opportunity to build shared expectations about behavior.²⁴⁰ The final factor Bernthal identifies as necessary for a functioning reputation market is that “consequences exist for social norm violations.”²⁴¹ This factor is likely to be present in Japan (at least in circumstances where widely shared norms exist), as the means of informal sanction available to American angel investors discussed in Part i above are equally available to Japanese angels and VCs.²⁴²

Finally, the short-term outlook in Japan for the embedding of informal norms within formal structures—which Bernthal identifies as the third necessary condition for informal sanctions to displace contractual remedies—is relatively positive. The rapidly-growing number of startup incubators and accelerators in Japan has the potential to provide a large number of formally structured organizations through which community norms can be effectively disseminated,²⁴³ especially because a few key consultants are responsible for helping companies establish hundreds of these structures.²⁴⁴ Even if informal norms are not yet widely agreed within the seed financing market, much of the infrastructure necessary to disseminate norms, once they achieve consensus, may already be in place.

Staged financings are also relevant in Japan as a tool that larger seed round investors (such as VCs that make seed stage investments) may utilize to exert informal control over a portfolio company and discourage opportunistic founder behavior.²⁴⁵ Although “the rate of continuous investments over different rounds by the same VC is much lower in Japan than in the United States,”²⁴⁶ in 2016 approximately one quarter of capital invested by Japanese VCs was used for follow-on investments, so staged financing does play a significant role in the Japanese market.²⁴⁷ Staged financing as a market practice offers an additional benefit: because these

²³⁹ VEC YEARBOOK 2016, *supra* note 122, at I-86; *NEST2019 TOKYO - NEST2019*, NEW ECON. SUMMIT, <https://nest.jane.or.jp/tokyo> (last visited Apr. 21, 2019).

²⁴⁰ Bernthal, *supra* note 74, at 175.

²⁴¹ *Id.*

²⁴² See *supra* text accompanying note 73.

²⁴³ Bernthal, *supra* note 74, at 177.

²⁴⁴ VEC YEARBOOK 2017, *supra* note 12, at I-33. In addition, according to a Tokyo-based lawyer and a Tokyo-based investor interviewed for this Article, a substantial amount of startup legal work in Japan is concentrated in the AZX Professionals Group law firm, which might be able to exert significant influence on the use of a particular form contract in the market if it so desired. Interview with Attorney 2, *supra* note 49; Interview with Investor 2, *supra* note 216.

²⁴⁵ Shishido, *supra* note 78, at 1117-18.

²⁴⁶ *Id.* at 1118.

²⁴⁷ This calculation is based only on the survey responses of VCs who provided information on new and follow-on investments; some declined to provide this information. VEC YEARBOOK 2017, *supra* note 12, at II-12.

financing arrangements “are costlier for low-quality companies,” which are more likely to fail to achieve the required milestones for follow-on investment, such arrangements allow investors to mitigate adverse selection in the funding process in addition to exerting informal control over the investee.²⁴⁸ In an environment of high informational asymmetry, such as the seed financing market, a practice of staged financing could be particularly valuable by helping to screen low-quality companies or founders inclined toward opportunistic behavior.

Writing in 2014, Professor Zenichi Shishido identified bank- and securities firm-affiliated VCs making “one-shot portfolio investments” (perhaps in part to diversify risk)²⁴⁹ and the lack of syndicate financing led by a single investor as being the principal reasons for the comparatively low rate of staged financing in Japan.²⁵⁰ One of the Japanese VCs interviewed for this Article described syndicated financings with a lead investor as typical in the current market, suggesting that this practice may have changed since 2014.²⁵¹ In light of this and the significant portion of overall VC investment dedicated to follow-on rounds in Japan, the Japanese market may be moving generally toward an American model where staged financings are the norm.²⁵² If so, this may become an important factor in supporting a broader use of convertible equity in the Japanese market.

Despite the currently limited effectiveness of informal sanctions in the Japanese market, two measures that Ibrahim identifies as informal substitutes for contractual protections among angel investors are readily available in Japan.²⁵³ First, the concentration of startups in Tokyo provides angel investors a wide selection of potential investees that are physically close to the investor, allowing active participation in the investee’s business.²⁵⁴ Second, the physical proximity of startups, investors, and events facilitates in-person introductions of potential investees to angels by trusted parties.²⁵⁵ These factors can help angel investors screen out opportunistic founders and then maintain close contact and ongoing bilateral information-sharing with their investees. However, although these tools are available to angels in Japan, the small number of angel investors in the country may reduce the extent to which these factors impact the overall willingness of seed-stage investors to accept reduced formal contract protections.

In summary, the relationship networks in the Japanese startup community lack certain key features that contract theory suggests are

²⁴⁸ Williams, *supra* note 39, at 133.

²⁴⁹ Shishido, *supra* note 78, at 1118-19.

²⁵⁰ *Id.*

²⁵¹ Interview with Investor 3, Vice President of a Venture Capital Investment Firm in Tokyo, Japan (Apr. 11, 2018) (on file with author).

²⁵² Shishido, *supra* note 78, at 1117-18.

²⁵³ See *supra* text accompanying note 67.

²⁵⁴ See *id.*

²⁵⁵ See *id.*

necessary for informal sanctions to serve as an effective extralegal constraint on opportunistic behavior. In particular, a lack of established norms and a lack of shared behavioral expectations appear to be the greatest impediments to effective informal sanctions. In contrast, the abundance of startup accelerators in Japan offers a sturdy infrastructure for the dissemination of community norms (once established), and the significant deployment of VC capital to staged financings indicates that some investors are already developing alternative avenues of informal control over their portfolio companies.

b) Seed-Stage Investor Preferences

The intense focus on big hit investments that prevails among Silicon Valley investors is largely absent in Japan. Japanese VCs, for example, are much more interested in small exits than a typical Silicon Valley investor.²⁵⁶ The prevalence of founder buy-back provisions and their frequent use by Japanese VCs is evidence of how much importance Japanese VCs attach to a return of capital, even when they realize no significant return on investment.²⁵⁷ And this impacts the seed financing market as well; in 2016, Japanese VCs invested about 25% of their funds in seed stage companies.²⁵⁸ Furthermore, many Japanese angel investors take a similar approach to their investments.²⁵⁹

The Safe's general lack of investor protections is not well suited to an environment where investors prioritize a return of their invested capital across all investments. As unsuccessful startups almost always lack sufficient assets to return their investors' capital, an investor hoping to claw back its funds from a failing investment will want a means of influencing the company's decision-making before the company fails completely and becomes insolvent.²⁶⁰ The Safe offers investors no such tools.

The relative scarcity of ex-founder angel investors in Japan also has an important implication for seed-stage investor preferences.²⁶¹ Recall that angels who are ex-founders often have some non-financial motivations

²⁵⁶ This topic came up in interviews with a Tokyo-based lawyer and a Tokyo-based investor. Interview with Attorney 4, *supra* note 81; Interview with Investor 1, *supra* note 81. Masujima addressed this point somewhat obliquely in a public interview, noting that if Silicon Valley investors demanded a return of capital on a convertible note, they would be cut off from the startup angel investing ecosystem—implying that Japanese investors sometimes do this without suffering such negative consequences. *Convertible Equity Will Change Japan's Startups*, *supra* note 140.

²⁵⁷ See *supra* text accompanying notes 137-139. The use of this provision demonstrates that many Japanese VCs are willing to forego the opportunity to develop a founder-friendly reputation simply to get a return of their investment capital.

²⁵⁸ VEC YEARBOOK 2017, *supra* note 12, at I-11.

²⁵⁹ Interview with Attorney 4, *supra* note 81; Interview with Investor 1, *supra* note 81.

²⁶⁰ See, e.g., Coyle & Green, *supra* note 3, at 161 (“Security interests also largely fell by the wayside, as they provided little to no protection for investors in a seed-stage company, few of which would have had any meaningful assets to serve as collateral.”)

²⁶¹ ISOZAKI, *STARTUP EQUITY FINANCE*, *supra* note 133, at 69.

for investing (such as excitement about an investee's vision), making them less focused on financial outcomes and detailed contractual protections, at least as compared to other investors.²⁶² As discussed in Part II.B.ii above, in an environment where founders enjoy considerable leverage, these angels may find founder-friendly convertible equity contracts to be a convenient signaling mechanism by which they can distinguish themselves from other investors and gain access to high-demand financing deals. In contrast, founders in Japan enjoy neither large numbers of ex-founder angels nor a favorable investment environment, which weakens the appeal of a Safe-like instrument.²⁶³

Nonetheless, a more investor-favorable market is not, by itself, a bar to the use of convertible equity in Japan. Convertible equity instruments can be structured flexibly, and the standard form of 500 Startups Japan's Keep It Simple Security (typically called the "J-KISS"), for example, includes various investor-friendly provisions that the standard form of Safe does not.²⁶⁴ By employing these or similar terms, a more investor-favorable form of convertible equity could be designed for the Japanese market.²⁶⁵ However, one of the principal benefits of the Safe is that its exceptionally founder-favorable terms provide time and cost savings for investors as well as founders.²⁶⁶ If convertible equity in Japan requires detailed investor protections, such as those in the J-KISS, in order to reflect the balance of negotiation leverage between Japanese founders and investors, that would

²⁶² Ibrahim, *supra* note 11, at 1439.

²⁶³ It is hard to quantify to what extent founders enjoy negotiation leverage in a given startup investment market, in particular because the number of highly promising startups (i.e., prime investment targets) is key but evaluating what constitutes a "highly promising startup" is extremely difficult. However, the large difference in valuations offered to startups in seed financing rounds in Japan versus the United States is an important indicator of the relatively high investor leverage in Japan. *See* discussion *supra* Part II.D.i. Additionally, interviews conducted for this Article evidenced a shared view in Japan that the Japanese market remains more investor-favorable than Silicon Valley. Interview with Investor 1, *supra* note 81; *see also* Interview with Founder 3, Chief Executive Officer of a Tokyo-based Startup (Mar. 8, 2018) (on file with author). A Silicon Valley founder and Silicon Valley lawyer both described an environment in Silicon Valley where investors want to get into the top startups' seed funding rounds with as little burden as possible on the founders. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

²⁶⁴ The standard form of the J-KISS includes relatively detailed (compared to the Safe) company representations and warranties, a most favored nation provision, information and participation rights for major investors, and a maturity date at which a majority of the J-KISS investors may elect to convert their J-KISSes into common stock if no Series A financing has occurred. *See* The J-KISS, *supra* note 204.

²⁶⁵ Notably, the terms of the J-KISS were not selected specifically to match the balance of negotiation leverage in the Japanese market. Instead, the instrument was designed principally mirror the terms of 500 Startups' Keep It Simple Security in a way that would comply with Japanese corporate law. Sawayama believes that the introduction of a seed funding contract in Japan that closely tracks a Silicon Valley standard will benefit the Japanese startup ecosystem. Interview with Yohei Sawayama, *supra* note 12.

²⁶⁶ Abramowitz, *supra* note 35.

weaken the incentive for market participants to adopt the instrument by diminishing the cost and speed incentives.²⁶⁷

Despite these differences in the Japanese and Silicon Valley markets, convertible equity may nonetheless become an appealing medium for many seed investments in Japan. This is, in part, because convertible notes face unique challenges in the Japanese market by virtue of their nature as indebtedness.²⁶⁸ And because common stock remains the most commonly used seed investment instrument, convertible equity is not necessarily an inferior instrument with respect to allowing investors to recover their investment capital in the event that the startup fails.²⁶⁹ At the same time, convertible equity would allow angels to send a positive signal to founders and allow founders to avoid the many disadvantages associated with common stock discussed in Part II.D.i above. Furthermore, this founder-friendly approach could be increasingly useful over time, as investor competition over seed-stage deals is increasing in Japan.²⁷⁰

c) Accelerators as Champions for Convertible Equity

In Silicon Valley, the existence of a single, highly standardized and well-known form of convertible equity (*i.e.*, the Safe) is an important contributor to the cost and time savings associated with convertible equity investments.²⁷¹ Y Combinator's public form of the Safe enjoys such a high level of trust that Silicon Valley investors and startups frequently negotiate the investment amount, discount, and cap, and then execute and fund the Safe without the use of legal counsel.²⁷² This means that once the investor is satisfied as to due diligence, the negotiation, finalization, and execution of the legal documentation for a Safe investment can be completed in a matter of hours at virtually no cost to the founder or investor. The registration obligation for convertible equity in Japan is only required after the investment is completed, so a similar level of speed and cost efficiency is technically possible under Japanese corporate law, but in an environment

²⁶⁷ Importantly, according to Yohei Sawayama of Coral Capital (formerly 500 Startups Japan), despite its investor-favorable terms (relative to the Safe), use of the J-KISS significantly shortens the time necessary to close a seed funding investment in Japan. Sawayama says that the process of preparing and finalizing J-KISS documentation generally takes less than one week, while in the case of common stock it often takes about one month. Interview with Yohei Sawayama, *supra* note 12. In Japan, the consummation of VC investments can take between one month and one year from the first VC contact with the investor. SHIMAUCHI, *supra* note 126, at 120.

²⁶⁸ See *supra* text accompanying note 180.

²⁶⁹ See *supra* text accompanying note 130. Note, however, that common stock investors will enjoy the benefits of Japan's strong protections for capital stockholders, discussed in Part II.D.i, and holders of convertible equity will not.

²⁷⁰ VEC YEARBOOK 2017, *supra* note 12, at I-14. Masujima believes that some seed investors, especially investment accelerators, do use founder-favorable investment structures as means of marketing themselves and competing for the most favorable investments, but it is unclear how widespread the practice is. Interview with Masakazu Masujima, *supra* note 193.

²⁷¹ Interview with Attorney I, *supra* note 19. The lawyer has represented parties in more than 100 startup financing transactions over the past three years.

²⁷² *Id.*

where many investors are unfamiliar with the concept of convertible equity, such speed remains unlikely.²⁷³

Perhaps Y Combinator's most important contribution to the Safe's success is the accelerator's work²⁷⁴ to build widespread knowledge of the Safe among founders and investors, which appears to be a critical factor in the instrument's prevalence in Silicon Valley.²⁷⁵ This broad awareness not only reduces the time and cost required to consummate Safe-based investments, it also mitigates the risk that venture capital investors will find the Safe confusing and decline to invest in subsequent funding rounds because a company has Safes in its capitalization table.²⁷⁶ The Japanese market, in contrast, has not yet coalesced around a single, definitive convertible equity instrument, let alone built a broad understanding of such an instrument among founders and investors. The J-KISS is Japan's closest analog to the Safe in that the standard form of the J-KISS is publicly available and Coral Capital (formerly 500 Startups Japan) provides an annotated version of the documentation as well as a free explainer for the instrument.²⁷⁷ Masujima has also added a more general convertible equity explainer to his startup blog to help build awareness of this relatively new mechanism for investment.²⁷⁸ Indeed, there are some small signs of broader market adoption of the J-KISS.²⁷⁹

However, despite these efforts, interviews for this Article confirmed that the terms of the J-KISS are not yet broadly understood in the Japanese market and many angel investors and venture capital firms still do

²⁷³ A more realistic timeframe for an expedited investment in the Japanese market would be about one week, which is still substantially faster than a typical common stock seed investment. *See supra* note 267.

²⁷⁴ Among Y Combinator's activities in this regard, the use of the Safe in Y Combinator's own investments stands out. *See* discussion *supra* Part II.B.iii.

²⁷⁵ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. *See also* discussion *supra* Part II.B.iii. In fact, the Safe is now so widely known in Silicon Valley that multiple law firms and legal services companies have created their own forms of Safe or tools to assist with the drafting and execution of Safes. For example, Cooley LLP, Clerky, and Practical Law Company all offer either a Safe-generation tool or their own version of the Safe form contract. *See, e.g.,* Matthew Bartus, *Generate Your Y Combinator Safe Financing Documents*, COOLEYGO, <https://www.cooleygo.com/generate-y-combinator-safe> (last visited Apr. 22, 2019); *Fundraising*, CLERKY, <https://www.clerky.com/fundraising> (last visited Mar. 30, 2018); THOMSON REUTERS, *supra* note 102.

²⁷⁶ Two interviewees for this Article described the Safe as "low friction" for both founders and investors. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. As noted in Part II.A.iii, this does not always yield perfect results. Founders are sometimes surprised at the degree to which their shares are subject to dilution, and investors are sometimes frustrated by their lack of rights as holders of convertible equity. *See* Green & Coyle, *supra* note 33, at 169.

²⁷⁷ *See* The J-KISS, *supra* note 204.

²⁷⁸ *See generally* Masakazu Masujima, *Convertible Equity ni tsuite* [About Convertible Equity], STARTUP INNOVATORS (Nov. 26, 2015), <https://startupinnovators.jp/blog/178>.

²⁷⁹ For example, the J-KISS has been used by at least a few investors, such as Asahi Shinbun, in deals that were not led by 500 Startups. Convertible Equity Will Change Japan's Startups, *supra* note 140.

not have the experience of investing in a company that has received investment via J-KISSes.²⁸⁰ In part, this may reflect the relative complexity of the J-KISS as compared to the Safe.²⁸¹ A more complex agreement requires increased time and effort on the part of market participants before they can fully grasp all the key terms of the instrument. The lack of understanding of the J-KISS in the Japanese market also means that a founder or investor seeking to use the J-KISS may need to invest time and effort in explaining the terms of the J-KISS to the counterparty and convincing them of the instrument's merits, which would impede, rather than facilitate, speedy financing transactions.²⁸²

The lack of widespread awareness of the J-KISS presents additional obstacles. Traditional-minded VC investors, and especially CVCs, are still resistant to the instrument.²⁸³ Masujima and others speculate that this is because it remains difficult to convince internal decision-makers at CVCs and other traditional firms, who are typically somewhat removed from the startup community and are mostly unfamiliar with convertible equity.²⁸⁴ CVCs also generally have a different business model than VC firms and this may cause CVCs to evaluate investment risks differently.²⁸⁵ Additionally, the risk of a poorly structured seed investment frustrating subsequent fundraising rounds is a legitimate concern for both founders and seed investors.²⁸⁶ Accordingly, using a seed instrument with mechanics that are not well understood or are seen as inconsistent with market practice is a risky decision for founders and may increase the difficulty of securing subsequent investment.

The confusion around convertible equity in Japan prompts an important question: could Coral Capital or other market players actively build an awareness in the Japanese market comparable to what Y Combinator has built in Silicon Valley? There is no single incubator, accelerator, or investment fund that holds a position in Japan fully analogous to Y Combinator's role in Silicon Valley, meaning that even the support of a respected investment accelerator would likely not have the same effect in Japan as Y Combinator's support of the Safe in the Silicon

²⁸⁰ Interview with Investor 2, *supra* note 216; Interview with Employee 1, *supra* note 233.

²⁸¹ See discussion *supra* Part II.E.i.

²⁸² Interview with Investor 1, *supra* note 81; Interview with Employee 1, *supra* note 233; see also Machida, *supra* note 130, at 23.

²⁸³ Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁸⁴ *Id.*; see also Machida, *supra* note 130, at 23.

²⁸⁵ ROMANS, *supra* note 237, at 77 ("Unlike a financial VC a corporate VC that is trying to create commercial and strategic relationships with startups cannot afford to have just one success that carries the fund. This will not be seen as a success by the business as there is a high internal cost for all the failures."). A Silicon Valley startup executive interviewed for this Article who had fundraised from both financial VCs and CVCs raised the same point. Interview with Startup Executive 1, *supra* note 19.

²⁸⁶ Ibrahim, *supra* note 11, at 1430; Convertible Equity Will Change Japan's Startups, *supra* note 140 (noting the risk of overvaluation in seed investments).

Valley community.²⁸⁷ With Y Combinator and Paul Graham, “the closest thing the start-up world has to a pre-eminent guru,” promoting the Safe and using it to invest in hundreds of top-shelf startups every year, the instrument quickly became something that investors would need to understand in order to access some of the choicest deals.²⁸⁸ Also, Y Combinator’s and other top accelerators’ role in screening a large number of startups likely helps investors get comfortable with the limited protections offered by the Safe.²⁸⁹

Notably, convertible notes began to displace common stock in Silicon Valley seed financings without significant help from Y Combinator or any other accelerator (as no others existed at the time), so a single accelerator with powerful market influence is clearly not a precondition for widespread seed-stage contractual innovation.²⁹⁰ This suggests that a “Japanese Y Combinator” backing convertible equity is not a prerequisite for its proliferation in Japan. This is fortunate, because it is extremely unlikely that any one accelerator in Japan could speed the widespread

²⁸⁷ Among many distinctions, Y Combinator was the first startup investment accelerator in the United States, and although its unique position in Silicon Valley is difficult to quantify, it stated in 2017 that its portfolio companies now have an estimated aggregate value of \$100 billion. Bernthal, *supra* note 74, at 151; Steven Melendez, *Y Combinator says its companies are on target for \$100B total valuation*, FAST COMPANY (Feb. 16, 2017), <https://www.fastcompany.com/4030834/y-combinator-says-its-companies-are-on-target-for-100b-total-valuation>. Compare Y Combinator’s scale to that of Samurai Incubate, which the Japanese Ministry of Economy, Trade, and Industry identified in a 2016 report as one of the country’s most notable, long-surviving startup accelerators. KABUSHIKI KAISHA UZU GURŪPU, HEISEI 28 NENDO WAGAKUNI NI OKERU DĒTA KUDŌGATA SHAKAI NI KAKARU KIBANSEIBI (IoT SUTĀTOAPPU SHIEN NI KANSURU GURŌBARU RENKEICHŌSAIJGYŌ) CHŌSA HŌKOKUSHO [2016 SURVEY REPORT: FUNDAMENTAL INFRASTRUCTURE IN JAPAN FOR A DATA-DRIVEN SOCIETY (SURVEY BUSINESS WITH GLOBAL COLLABORATION ON SUPPORT FOR IOT STARTUPS)] 8 (Feb. 2, 2016) (available at http://www.meti.go.jp/meti_lib/report/H28FY/000156.pdf). Although the estimated value of Samurai Incubate’s portfolio is not public, in 2017, the accelerator raised its sixth fund of ¥3 billion (about \$30 million) with an intention to invest in about 150 companies. PR Times Henshūbu, *Samurai Inkyubēto ga 30 oku kibo no rokugō fando sosei, nihon, isuraeru, afurika no sutātoappu wo taisho* [Samurai Incubate Creates Sixth Fund, Targeting Startups in Japan, Israel, Africa], THE BRIDGE (July 24, 2018), <http://thebridge.jp/2018/07/samurai-incubate-6th-fund>; *Samurai inkyubēto ga shin fando* [Samurai Incubate’s New Fund], NIHON KEIZAI SHINBUN (July 19, 2018), <https://r.nikkei.com/article/DGXMZO33155250Z10C18A7000000>. In contrast, Y Combinator invests in over 200 companies per year and runs a continuity fund that makes single investments of up to \$50 million. Roy, *supra* note 92; Harry McCracken, *Y Combinator is Launching A “Grad School” For Booming Startups*, FAST COMPANY (Feb. 8, 2018), <https://www.fastcompany.com/40524163/y-combinator-is-launching-a-grad-school-for-booming-startups>.

²⁸⁸ John Herrman, *Have the Tech Giants Grown Too Powerful? That’s an Easy One*, N.Y. TIMES (July 11, 2018), <https://www.nytimes.com/2018/07/11/magazine/facebook-google-uber-tech-giants-power.html>.

²⁸⁹ See discussion *supra* Part II.B.iii.

²⁹⁰ Convertible notes assumed a prominent role in seed funding in 2005. Coyle & Green, *supra* note 3, at 136. Y Combinator began just that same year as a small-scale experiment. Paul Graham, *How Y Combinator Started*, Y COMBINATOR (Mar. 15, 2012), <http://old.ycombinator.com/start.html>.

understanding and adoption of convertible equity to the degree that Y Combinator has in Silicon Valley.²⁹¹

III. POSSIBLE MEASURES TO MAKE CONVERTIBLE EQUITY MORE WIDELY AVAILABLE IN JAPAN

While Working from the analysis in Part E, it is possible to propose certain concrete steps that are likely to make convertible equity a more readily available tool for Japanese founders and investors. Importantly, these steps are not intended to encourage the use of convertible equity when other instruments would be superior, but rather to create an environment in which participants in the Japanese startup community have the opportunity to benefit from the strengths of convertible equity in appropriate transactions. This, in turn, would increase the speed and efficiency at which Japanese startups can raise funds and improve their chances of surviving until they can secure Series A financing.

First, it bears emphasis again that there do not appear to be major legal impediments to the broader use of convertible equity in Japan, meaning that changes to the Companies Act or other regulations are not necessary to achieve this goal. In examining the environmental factors discussed in Part ii above, the most salient difference in the Japanese and Silicon Valley markets is the lack of effective informal sanctions as means of limiting opportunistic founder behavior in the absence of contractual protections.²⁹² Currently, Japan appears to lack the deep and mature startup relationship networks as well as the community consensus around norms for seed-stage financings that contract theory proposes are necessary for such sanctions to function effectively. Although the former characteristic may be largely a function of time and the natural growth of formal associations, informal groups, and networking opportunities, the latter can be addressed at least in part through a more proactive use of communications platforms, such as blogs, panel discussions, and other internet media, by Japanese investment accelerators, angel investors, and founders to broadcast their views on appropriate founder and investor behavior and build a public consensus through open dialogue.²⁹³

²⁹¹ Nonetheless, startups that have graduated from Japan's most prestigious accelerator programs could emphasize that fact to boost their credibility when trying to convince investors to use convertible equity for an investment. In this respect, well-known accelerators that lack Y Combinator's unique market position could still indirectly contribute to a broader use of convertible equity.

²⁹² Although this Article argues in Part II.E.ii.b that simplicity is not a necessary precondition to the proliferation of convertible equity in Japan, simplicity and speed would certainly increase the value that convertible equity offers to Japanese founders and investors.

²⁹³ For example, in Silicon Valley, "[investment accelerator] principals aggressively shape startup culture through communications that include books, prominent blogs, and an industry group." Bernthal, *supra* note 74, at 145.

Although no single Japanese organization occupies a position equivalent to that of Y Combinator, several prominent accelerators and investors acting in concert, perhaps together with one or two law firms, could likely exert substantial influence on the Japanese seed financing market and lend credibility to a mutually agreed form document for seed financings. To some extent, Coral Capital and Masujima are already taking steps to this end with the J-KISS, but without buy-in from additional investors, the scale of these efforts is necessarily limited.²⁹⁴ If two or three more accelerators began using the J-KISS (or some other instrument) and a prominent startup law firm began to publicly promote the instrument, that would help establish the instrument as a standard form for the market rather than just one investor's preferred contract. In particular, well-regarded investment accelerators could play a critical role by using the instrument for their own investments and thereby quickly introduce the contract into the marketplace and create a strong incentive for other investors to gain an understanding of the instrument. However, parties pursuing this approach would be wise to follow Levy's example in seeking extensive input from both investors and founders to ensure that the ultimate form of the instrument used reflects the balance of negotiation leverage in the Japanese market. If the instrument's terms are inconsistent with market realities, resistance from either investors or founders could prove an insurmountable obstacle to its widespread adoption. This consideration is particularly important given that the most high-profile convertible equity instrument—the Safe—was developed with input from prominent Silicon Valley investors, whose core business model differs from that of the typical Japanese VC.

To be broadly successful, any coordinated effort by influential market participants to promote a specific instrument would likely need to be paired with extensive public education about the instrument's mechanics and benefits.²⁹⁵ This is because the market cannot develop behavioral norms around negotiation and performance of a contractual instrument's key terms without a broad-based understanding of those terms, and those norms are a prerequisite for the operation of effective informal sanctions.²⁹⁶ Once the

²⁹⁴ As of April 22, 2019, 500 Startups Japan (rebranded as Coral Capital in March 2019) listed 36 portfolio companies as “featured startups” on their website. *Portfolio*, CORAL CAP., INC., <https://coralcap.co/portfolio>, (last visited Apr. 22, 2019). In contrast, Y Combinator lists over 1,900 portfolio companies on their homepage. *YC Companies*, Y COMBINATOR, <http://www.ycombinator.com/companies> (last visited Mar. 30, 2019). This comparison is admittedly imperfect but the difference in scale is notable.

²⁹⁵ 500 Startups Japan (now Coral Capital), for example, has hosted in-person informational sessions about the J-KISS in addition to blogging about the instrument. Miyako Yoshizawa, *Yamaguchi bengoshi ni kiku, shōdo sutātoappu no tame no shikinchōtatsu – J-KISS no kōshōjīkō to keiyakusho*[*Fundraising for Seed-Stage Startups – Negotiation Points and Contracts for the J-KISS, According to Attorney Yamaguchi*], CORAL CAP., INC. (Sept. 29, 2017), <https://coralcap.co/2017/09/j-kiss-guide-for-early-stage-startups>.

²⁹⁶ Market participants will not be able to understand the substance of norms that promote certain behavior in respect of a contractual term if they do not understand the contractual term in the first place.

instrument's terms are generally understood in the market, the network of relationships and communications platforms necessary to enforce informal sanctions can provide infrastructure onto which new norms regarding the convertible equity instrument can be grafted. These networks can help disseminate as well as enforce the norms.

In summary, active use of communications platforms by community members to create a public dialogue giving rise to widely shared norms, concerted effort among several investment accelerators and possibly lawyers to promote a single form of instrument, use of the instrument in actual investments by these accelerators, and substantial public education about the instrument are all concrete steps that market players could take to help create an environment in which convertible equity is more readily available as a fundraising tool for Japanese startups. It may be challenging for several accelerators to agree on a single form document,²⁹⁷ but such an effort could be coordinated through an industry organization such as the Japan Venture Capital Association, which operates "Venture Ecosystem" and "Fund Ecosystem" committees.²⁹⁸

IV. CONCLUSION

Perhaps the most remarkable aspect of the Safe's rapid diffusion throughout Silicon Valley is the unprecedented nature of the instrument. Although Levy downplays the Safe's uniqueness,²⁹⁹ it is the first widely-used seed funding contract that was deliberately engineered by a single organization in order to help startups succeed. While the extent of the Safe's impact on the market is hard to measure, it has certainly simplified the process of seed financing (and thereby reduced transaction costs) for thousands of young companies. Given the disadvantages of early-stage fundraising with common stock under Japanese law, the small size of seed rounds in Japan, the informational asymmetries between Japanese founders and investors in respect of fundraising terms, and the reputational issues associated with debt fundraising, it would seem that convertible equity has a great deal to offer the Japanese startup community. However, as this Article's analysis indicates, a variety of important circumstances have helped create an environment in Silicon Valley that is particularly conducive to the use of a simplified, founder-friendly investment instrument. Replicating—or compensating for the lack of—these environmental factors is a daunting challenge. Indeed, participants in the Japanese startup community who seek to make convertible equity a widely

²⁹⁷ One of the Japanese VCs interviewed for this Article (who is also involved in an accelerator program) noted that Japanese investment accelerators tend to use their own forms of investment contracts, even when they use the same law firm. Interview with Investor 2, *supra* note 216.

²⁹⁸ *Committee*, JAPAN VENTURE CAP. ASS'N, <https://jvca.jp/committee> (last visited Apr. 22, 2019).

²⁹⁹ See Abramowitz, *supra* note 35.

available tool will likely have to convince competing investors to work together to overcome substantial obstacles if they hope to realize that ambition. By offering a clear view of those obstacles and the beginnings of a strategy to surmount them, this Article aims to help guide those ambitious participants at least a few more steps toward their goal.