Differences Between Japanese GK Entity and US LLC

On May 1, 2006, a new type of Japanese legal entity named the Godo Kaisha (GK) was born. Although it is commonly referred to as the “Japanese LLC,” a GK differs from a US LLC in several important respects.

**Taxable Entity in Japan**

The GK is taxed like a corporation in Japan, and therefore is not a disregarded entity for Japanese tax purposes, unlike the disregarded entity tax status of an LLC in the US. Tax practitioners do believe, however, that the IRS will allow taxpayers to “check the box” for GKs and therefore a GK can be a disregarded entity for US tax purposes.

**Partnership Governance Concepts Apply**

The creators of the GK wanted to discourage use of the GK to avoid the mandatory governance and other formalities of a Japanese kabushiki kaisha (KK) corporation. The Japanese Ministry of Justice has explicitly stated in its outline of the new Company Law (Law No. 86 of 2005) that it intends Japanese partnership concepts to apply to GK governance rather than KK corporate governance concepts.

One manifestation of this is that, unlike with a US LLC, a GK does not have the legal capacity to act on its own, and instead only acts through its members. In this respect, the GK is more like a Japanese partnership (which only acts through its partners) than an LLC (which is a separate legal entity that can act on its own).

A GK must have at least one “executive member,” *i.e.*, a member that implements the business of the GK. Where there is more than one member of the GK, all members, certain members or only a single member can be designated as executive member(s). Only an executive member can conduct the business of the GK. If the executive member is a corporation, it has the duty to appoint a person with the title of Executive Manager (described below) to act on its behalf with respect to the GK.

**No GK Board**

Another manifestation of the application of Japanese partnership governance concepts to a GK is that in a GK there is no separation between the investors and management (*i.e.*, the investors are the management). While an LLC may have self-governance institutions such as a board of directors or managers of the LLC which are separate from the investors, this concept does not work in the case of a GK because the GK acts only through its members, in particular the executive members.
The current view of the Ministry of Justice is that a GK may not appoint an independent third party to manage the GK; rather it must be managed by the executive members directly or by the Executive Managers that act on behalf of the executive members.

Applying this logic, it appears that a GK cannot have a true board of directors. This limits options for governance of the GK as compared to an LLC.

**Executive Managers**

The persons designated to act on behalf of a GK executive member with respect to the business of the GK are designated as shokumu shikkousha (literally, "person who is to perform duties of the member who executes the GK business," which we refer to here as an "Executive Manager"). The Executive Manager(s) is responsible for performing the duties of the executive member. The Executive Manager can represent the GK (if so specified in the GK Articles), as well as act on behalf of the executive member who appointed him/her.

The Executive Manager of the GK is different from the Representative Director of a KK in that:

- While the Representative Director has the inherent legal authority to represent and bind the KK, the Executive Managers can represent and bind the GK only if so specified in the GK Articles. If the Articles are silent, the executive member has the legal authority to represent and bind the GK, not the Executive Manager per se;
- While the Representative Director implements the business of the KK, the Executive Manager performs the duties of the corporate executive member of the GK.

There must be at least one Executive Manager resident in Japan. The employment status of an Executive Manager who works full time for a GK is not fully clear. While an Executive Manager can be paid a salary directly by the GK, it is likely that he/she will not be classified as an "employee" of the GK for social insurance or similar employment benefit purposes. In addition, we doubt that the Executive Manager will have the employment protections of an "employee" under Japanese labor law, and in this respect will be treated more like directors of a KK.

**Supervision of Executive Managers**

In the case of a GK with multiple members, the executive members can agree to create a Board of Executive Managers to make decisions regarding the GK business. Because the GK can only act through the acts of its executive members, however, this will be an institution of the executive members rather than an institution of the GK itself.

In the case of a GK that is a 100 percent subsidiary of foreign company, for governance purposes (i.e., oversight of the Executive Manager resident in Japan) it is likewise advisable to create a Board of Executive Managers to approve important decisions with respect to the GK. However, since the GK only acts through its members, the Board of Executive Managers must be an institution of the parent company, not of the GK. Parent companies will need to create such organizations internally rather than relying on the subsidiary board as in the case of a Japanese KK corporation.

**Permanent Establishment Issue?**

Difficult permanent establishment taxation issues can be imagined since the Executive Manager resident in Japan is legally deemed to be acting for the executive member (i.e., the parent company), not the GK. If the Executive Manager engages in contract negotiation and other income generating activity while acting on behalf of the parent company, does that create a permanent establishment in Japan for the parent company? This is one of the unresolved issues of the GK entity.
**Imperfect Limited Liability**

Unlike an LLC, the GK does not provide a complete liability shield for the member/shareholder. Japanese law provides that the GK executive member who acts on behalf of the GK will be jointly and severally liable for damages caused to a third party due to any act of gross negligence or willful misconduct by the executive member in conducting the business of the GK. Moreover, an Executive Manager who performs the duties of the executive member will be jointly and severally liable for damages caused to a third party due to any act of gross negligence or willful misconduct that he/she commits.

Since the GK only acts through the actions of its members, and the members act by their appointed Executive Managers, this means that an executive member is vicariously liable for damages caused to a third party due to acts of gross negligence or willful misconduct by their appointed Executive Manager. For example, if an Executive Manager commits a fraud in the course of the GK business and causes damage to a third party, the executive member who appointed him/her is vicariously liable for such damage. This would not be true, however, for frauds committed by a mere employee of the GK, since the employee acts on behalf of the GK and not the executive member.

**Summary**

In many ways, the GK is more akin to a partnership than to an LLC or corporation. This may surprise foreign investors since a GK is often called the “Japanese LLC” and is taxed in Japan as corporation rather than as a partnership. Care must be taken in drafting the organizational documents and establishing the governance of the GK to compensate for these differences.

---

**Endnotes**

1. L&W: We refer to the shareholders of the GK as “members.”
2. L&W: Company Law, Art. 590(1)
3. L&W: Company Law, Art. 590(1), 591(1)
4. L&W: Company Law, Art. 598(1)
5. L&W: Id.
7. L&W: Company Law, Art. 599(1)
8. L&W: Id.
9. L&W: Company Law, Art. 599(4)
10. L&W: Company Law, Art. 598(1)
11. L&W: Company Law, Art. 598(2), 593(4), Civil Code (Law No. 89 of 1896, as amended), Art. 648(1)
12. L&W: Company Law, Art. 597
13. L&W: Company Law, Art. 598(2), 597
Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorneys listed below or the attorney whom you normally consult. A complete list of our Client Alerts can be found on our Web site at www.lw.com.

If you wish to update your contact details or customise the information you receive from Latham & Watkins, please visit www.lw.com/resource/globalcontacts to subscribe to our global client mailings program.

If you have any questions about this Client Alert, please contact Michael J. Yoshii or Kuang Hung Tang in our Tokyo office or any of the following attorneys.