

# Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.



## ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at [www.alexanderdavie.com](http://www.alexanderdavie.com).

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

## How is an LLC governed differently from a corporation?

One of the first decisions new business owners face is what type of entity they should use to form their new company. Most likely, this involves a choice between a limited liability company (LLC) or a corporation. These two types of entities differ significantly in how they are governed.

### Corporations

In a corporation, each owner owns shares of stock and is called a shareholder. Each shareholder's portion of ownership is measured in how many shares of stock each shareholder has. The shareholders elect a board of directors, which has the ultimate management control over the company. Shareholders may also be directors, but there is no requirement that they be. In some states, the board of directors is permitted to have only one director, while in others, there must be more than one. All major decisions of the company must be made by the board and approved by a vote. These decisions are documented as formal resolutions and minutes of meetings of the board must be taken. Boards delegate day-to-day management of the corporation to officers, who are responsible for carrying out the decisions of the board. There is no requirement that someone be a shareholder or a director in order for them to be an officer. Thus all three groups (shareholders, directors, and officers) could theoretically consist of completely different people, although in practice there is usually some degree of overlap.

Corporations are governed by a certificate of incorporation (sometimes also called a charter or articles of incorporation) and a set of bylaws, which set out board election and voting procedures. In addition, there can be one or more shareholder agreements, which set forth the rights that shareholders have vis-a-vis each other (e.g. transfer restrictions, options, or rights of first refusal). Usually, corporations are required to hold annual shareholder and/or board meetings, even if there is no significant business to discuss.

The overarching theme of the way corporations are governed is that they are formalistic and structured. In some situations, this can be beneficial. In a company with a significant number of owners or people involved in its governance, the corporate structure provides an established template for decision-making processes. If the company were to be governed more like a partnership, where each owner is actively involved in making decisions and executing them, company governance and decision-making could get chaotic. The disadvantages of the corporate form is that the formalities involved may be overkill for a small business with just one or a few active owners.

### Limited Liability Companies

In an LLC, each owner is called a member. Each member's portion of ownership is often measured in percentage interests, although LLCs can emulate corporations by issuing units of ownership, which are similar to shares of stock. An LLC may be governed directly by the members, similar to the way a partnership is often governed, in which case the members would vote to approve



major decisions. Generally, a member can act on behalf of an LLC and sign and execute contracts. It is possible for the members to delegate authority to a non-member, but that is rarely done in a member-managed LLC.

LLCs can also elect to be manager-managed. In this case, the members will have no governance rights over the company but have the power to elect one or more managers, who are given the ultimate decision-making authority over the company. Some state LLC acts provide for board-managed LLCs, which approximate the governance structure of corporations. In a board-managed LLC, the members elect a board of governors (sometimes also called directors or managers), which manages the company like a board of directors would manage a corporation. Even in those states that do not have board-managed LLCs, a corporation-like structure can still be approximated by having a group of managers who act as the board of the company. The managers can delegate day-to-day authority to officers, just as a board would do in a corporation.

LLCs are governed by a certificate of formation (sometimes also called articles of organization) and an operating agreement. The operating agreement is a comprehensive contract between the members (and sometimes the managers) which covers economic rights (i.e. division of profits, losses, and cash flow), governance issues such as manager election and voting procedures, and rights between the members such as restrictions on transferability.

The overarching theme of the way LLCs are governed is flexibility. Generally, the parties can organize an LLC however they would like. They can run it in the structured manner that a corporation is governed, run it informally, or operate some kind of hybrid of the two. LLCs permit a high degree of creativity in structuring a company.

#### Some Rules of Thumb

Below are some general rules of thumb to follow in making your decision on whether to form your business as an LLC or a corporation. Please note that these suggestions only take into account governance issues and there are other issues to consider, such as taxation and asset protection issues.

#### Contact Information

Alexander J. Davie  
Attorney at Law  
1109 Davenport Boulevard, # 211  
Franklin, TN 37069  
Phone: (615) 585-3546  
Email: [adavie@alexanderdavie.com](mailto:adavie@alexanderdavie.com)

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- For a company with a single owner, an LLC often is the easiest organization to manage. The owner can operate the business largely the same way as he did as a sole proprietor (except he should take care not to commingle assets and make sure all business is done in the name of the company). No annual meetings are necessary nor are any formal resolutions.
- For a company with a small number of owners who are active in the business, an LLC is also an excellent option. The small size of the group lends itself well to the informality of the LLC structure. Major decisions will need to be made at member meetings, but there are no requirements for annual meetings.
- For a company with multiple owners but where only one owner makes the decisions, an LLC is once again the best option. The company would elect to be a manager-managed LLC and the members would either elect their manager or he or she would be appointed in the operating agreement. This manager could also be a member (called a member-manager or a managing member). This structure is very similar to a limited partnership, except that the manager would not be liable for the debts of the company like the general partner of a limited partnership would be.
- For a company with a large number of decision-makers or owners, a corporate structure is often best. Once the number of "cooks in the kitchen" gets large enough, the structured nature of a corporation begins to make sense. Please note, the owners may want to consider setting up a board-managed LLC or some other LLC structure that imitates a corporation if they desire that the entity to be taxed as a partnership (which a corporation cannot be) or if they want to take advantage of the asset protection benefits of an LLC.

Please note, your choice in entity selection should be based on your own specific situation. Therefore, before making any final decisions on your form of business, you should speak with your attorney and/or accountant.