



“Building for the Successful Transition of Your Agricultural Business” Fact Sheet Series

Using Liability Limiting Entities to Manage Liability Exposure for Ohio Farms

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Today’s farms are more susceptible to liability claims than ever before. This liability exposure comes in many different forms such as moving large machinery over roadways, inviting customers and vendors onto the business property, and environmental issues. While liability exposure cannot be eliminated, it can be managed. Liability limiting entities, such as corporations and limited liability companies (LLCs) can be valuable tools in managing liability. This fact sheet will address the liability protection attributes of these entities and how to design a comprehensive business plan for liability protection.

Corporations and LLCs

A corporation provides liability protection to its shareholders in a nearly identical manner as LLCs provide liability protection to its members. For simplicity of discussion, only LLCs will be referred to hereafter. However, throughout this fact sheet, a corporation can be substituted for an LLC and shareholders can be substituted for LLC members interchangeably.

What is Limited Liability?

An LLC provides limited liability for its members (owners). The concept of limited liability means that a person

is not liable for the actions of a business just by being a member or owner of that business. Conversely, having full liability, such as being a partner in a general partnership, does mean that the partner has full liability for the actions of the partnership merely by being a partner. Consider the following examples:

Example 1. Partner 1 and Partner 2 decide to combine their farming operations into a general partnership called Ohio Farms Partnership. While Partner 1 is driving to the local implement dealer to pick up a part for the partnership’s tractor, he negligently runs a stop sign and collides with another vehicle. The driver of the vehicle is seriously injured and is awarded \$1 million by a court for injuries resulting from the accident. (Assume the \$1 million in damages is above and beyond the liability insurance the Partnership or Partner 1 may have.) Who is liable and for how much?

Because Partner 1 was acting on behalf of the partnership at the time of the accident, all of the assets in the partnership are at risk. Any and all of the partnership assets may be liquidated to pay the damages.

Partner 1 is personally liable. The person who causes the accident is always liable, regardless of the business structure. Here, Partner 1 caused the accident and he is

therefore liable. All of his assets, including personal residences, bank accounts, and investments can be liquidated in order to pay the damages.

Partner 2 is personally liable. Because Partner 1 was acting on behalf of the partnership at the time of the accident, Partner 2 is fully liable for his actions. Therefore, the damaged party could go after Partner 2 for the damages. All of Partner 2's assets, including all personal assets are at risk of being liquidated to pay the injured party. Even though Partner 2 did not cause the accident, he is still liable for the actions of Partner 1.

The partners are also subject to a concept known as joint and several liability. This allows for the injured party to receive the entire damages from both or either of the partners. For example, if there were no assets in the partnership, the damaged party could collect all \$1 million from either Partner 1 or Partner 2. This means that the injured party could potentially collect all \$1 million from only Partner 2. This is often referred to as going after the "deep pockets."

Assume the above scenario is changed to where Partner 1 was driving to the grocery store on his own time and was not acting on behalf of the company. Driver would still be able to collect damages from Partner 1's personal assets. However, neither the Partnership nor Partner 2 would likely be liable in this situation since Partner 1 was driving for a personal reason and not a business reason.

The above example shows the risk of organizing the farm business as a partnership. When one partner acts on behalf of the partnership, all other partners are completely and fully liable for his actions.

Example 2. In this scenario, the farm business is organized as a LLC, Ohio Farms LLC, with Member 1 and Member 2 as the owners. Using the same scenario as Example 1, Member 1 is involved in a vehicle accident.

Just like Example 1, the LLC and Member 1 are fully liable for the damages to Driver. The LLC is liable because Member 1 was acting on its behalf and Member 1 is liable because he caused the accident.

The difference between the examples is the liability exposure of Member 2. All of Member 2's ownership interest in the LLC is subject to the damages. Therefore, Member 2 could potentially lose all his ownership interest in the LLC. However, his liability likely stops there as Member 2's personal assets are likely not at risk. The damaged driver cannot go after Member 2 personally for any of the damages. This is the concept of limited liability. Member 2, as a member of an LLC, has limited liability for the acts of his fellow members. Member 2 is not liable for Member

1's action simply by being a fellow member of the LLC. In effect, the LLC shields Member 2's personal assets from the actions of Member 1.

Employees and Agents

Generally, an employer is responsible for the actions of an employee while that employee is performing his work related duties. Therefore, if an employee triggers some type of liability event, the employer will often be liable as well. Since many Ohio farms have employees, the employer–employee relationship is a significant source of liability exposure for Ohio farms.

Example 3. Ohio Farms Partnership hires Employee to assist with its grain operation. While moving large tillage equipment on the roadway, Employee negligently injures the driver of a passenger vehicle. Who is liable?

Employee is liable because he caused the accident. The Partnership is liable because it is the employer of Employee. Partner 1 is liable because he is fully liable for the actions of the partnership. All of Partner 1's assets, including personal assets, are exposed to damage claims. Partner 2 has full liability, the same as Partner 1.

An LLC provides liability protection to Employers. If we assume the same facts as Example 3 above except that Ohio Farms is organized as an LLC instead of a partnership, how does the use of an LLC affect the liability of the parties involved?

Employee is still fully liable for the accident he caused. The person causing the accident will be fully liable regardless of the business structure. Ohio Farms LLC will be fully liable. As discussed before, Ohio Farms LLC is the actual employer of the Employee. Therefore, due to an employer being liable for an employee's actions, the LLC is likely liable for the driver's damages and all its assets will be fully exposed. Member 1's ownership interest in Ohio Farms LLC is at risk. However, Member 1's personal assets are not at risk. The LLC shields Member 1 from personal liability. Member 2's liability issues are the same as Member 1's.

Financial Liability of an LLC

An LLC is considered to be separate and apart from its members. That is, an LLC is considered by the law to be a "person." The LLC as a person is responsible for its actions.

Example 4. Ohio Farms LLC purchases a tractor from the local tractor dealer. John Doe, managing member of the LLC, signs the loan papers on behalf of the LLC allowing Ohio Farms LLC to purchase the tractor on credit.

(Note: the same scenario for a corporation could involve the President of the corporation signing on behalf of the corporation.) Ohio Farms LLC later defaults on its payments. Who can the tractor dealer go after to collect the debt?

The Tractor dealer can only go after the LLC. The LLC is the “person” that bought the tractor and signed the loan documents. John Doe signed the documents on behalf of the LLC, not as John Doe individually.

Therefore, if the LLC is unable to pay the note, the Tractor Dealer cannot seek payment from any of the LLC members. It is the LLC that is liable for the debt, not the LLC members. If the LLC has no money or no assets to liquidate or attach to, the tractor dealer will not be able to collect the debt.

The above scenario illustrates how the members of an LLC can make business decisions for the LLC, yet not be held personally responsible for their actions. Persons and businesses dealing with LLCs are usually aware of this dilemma and deal with it by making one or more LLC members sign the loan documents personally.

Using the previous example, Tractor Dealer would almost assuredly require John Doe to sign the note twice: once as managing member of the LLC, and once as John Doe, the individual. Now if the LLC cannot pay the loan, the tractor dealer can collect the debt from John Doe personally.

Another potential source of financial liability is one owner/partner acting on behalf of the business without the other owner/partner’s knowledge.

Example 5. Partner A in Ohio Farms Partnership, unbeknownst to the other partners, commits a large amount of money to a risky business venture on behalf of the partnership. The business venture fails and Ohio Farms Partnership now has substantial debt due to Partner A’s activities. Who is liable?

Even though the other partners did not know about Partner’s A activities, the partnership may be liable for the debt. If so, the partnership is liable for the debt and if the partnership cannot pay the debt, all partners are personally liable.

Using the above example with an LLC instead of a partnership, the LLC and Member A may still be liable for the debt. However, the other members of the LLC will not be personally liable for the debt and thus have limited liability for the actions of the other member’s actions.

A Comprehensive Business Plan

Managing liability exposure for a farm business can best be accomplished with a comprehensive business plan.

Using multiple entities to separate and divide liability exposure can be the most effective strategy.

Single Entity Plan

In Diagram 1, the owners of Ohio Farms have organized into an LLC. All of the farm assets have been put into the LLC including checking accounts, grain, machinery, and real estate. The owners’ personal assets are outside of the LLC.

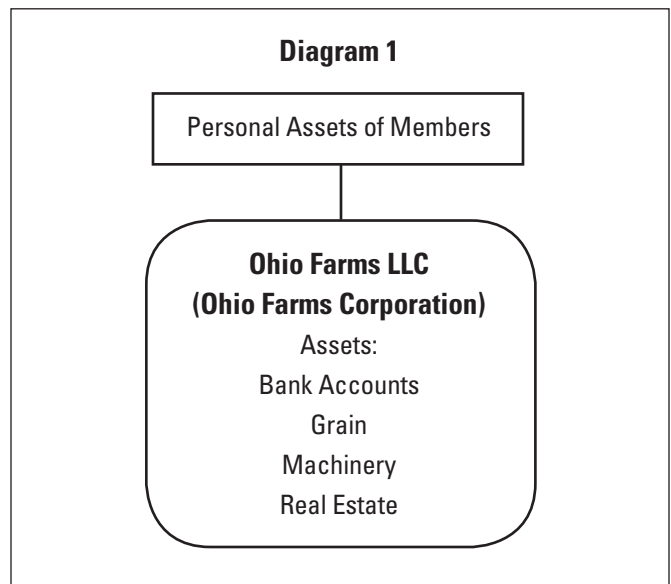
Using the similar scenarios as above, assume an employee of Ohio Farms LLC causes an accident while operating machinery over the road. Ohio Farms LLC, as the employer of the employee, will likely be liable for the accident. Thus, all of Ohio Farms’ assets are subject to be liquidated to pay damages to the injured party. The personal assets of the owners are not at risk.

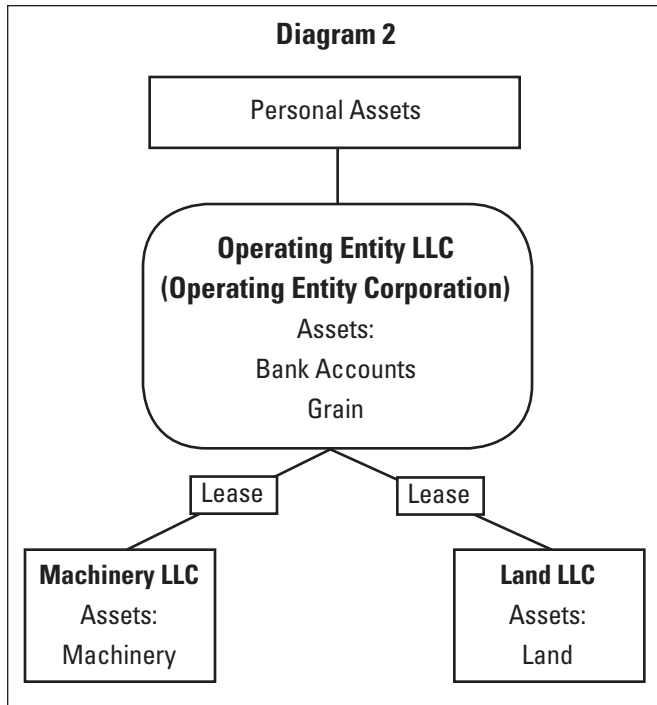
The problem with this situation is that most farmers’ assets are in their land. In the above scenario, while the owner’s personal assets are not at risk, their land is. So while the farmer’s house and other personal assets are safe, the majority of his wealth is still at risk because it is in the LLC. A single entity plan is better than no plan at all but still may put much of a farmer’s wealth at risk.

Multiple Entity Plan

Diagram 2 shows Ohio Farms organized using multiple entities. The first entity is the Operating Entity LLC. This entity buys the inputs, sells the grain, and maintains the checking accounts. Other than grain and cash, this entity holds no other assets.

The second entity is the Machinery LLC. This entity owns all the machinery required by the farming operation.





The Operating Entity LLC and the Machinery LLC have a lease agreement wherein the Operating Entity LLC leases the machinery from the Machinery LLC.

The third entity is the Land LLC and owns all the real estate. The Operating Entity LLC leases the land from the Land LLC. (It is important to note that corporations are usually not ideal entities to hold real estate for tax planning purposes. LLCs taxed as partnerships allows a step up in tax basis of the land upon a member's death and has fewer tax implications for future land distributions out of the LLC. Corporations do not allow a step up in basis of the land, only the stock, and distributions of the land out of the corporation usually create higher tax liability.)

Using the same scenario, assume an employee working for the Machinery LLC injures someone while operating machinery. The Machinery LLC will be liable because it was the employer. The Operating Entity LLC may also be liable because it had a contractual relationship with the Machinery LLC via the machinery lease. The owners could possibly lose all the machinery and all assets in the Operating Entity LLC.

However, the land is not subject to the liability. The Land LLC had no contractual relationship with the Machinery LLC and its contractual relationship with the Operating Entity LLC had nothing to do with the accident. Therefore, while the owners may lose machinery, grain, and cash, the majority of their wealth is likely protected by the Land LLC.

The multiple entity plan has its limitations. If the same person owns all the entities or a majority of the entities, the plan has limited effectiveness. The reason being that if the owner causes a liability accident, all his ownership in all the entities are at risk anyway. The multiple entity plan is most effective when the various entities have multiple or varied ownership and employees are involved in the operation. In some situations, the farmer is better off foregoing multiple entities and increasing his liability insurance instead.

Liability Protection of Other Business Entities

Ohio farmers have many business entities from which to choose from. These various entities have different degrees of limited liability protection. The following is a brief description of the liability characteristics of these entities.

Sole Proprietorship. A sole proprietorship enjoys no limited liability protection. The owner of the business is fully liable for any actions of the business.

General Partnership. A general partnership offers no liability protection to its partners. The partners in a general partnership are fully liable for the actions of the business and the other partners.

Limited Partnership. A limited partnership is made up of at least one general partner and at least one limited partner. A limited partnership provides no liability protection for the general partner. A general partner of a limited partnership has the same liability exposure as a partner in a general partnership. A limited partnership offers liability protection to the limited partners. That is, a limited partner is not liable for the actions of the limited partnership or the other partners.

Other Factors to Consider

While liability protection is an important factor in selecting a business entity for a farm operation, it is only one of many. Other factors include taxation, management, ownership, transfer restriction, start-up costs, liquidation costs, and Farm Service Agency requirements. Of special note, operations that are eligible for more than one direct payment from the Farm Service Agency should not use a limited liability entity for its operating entity. Any entity that has limited liability protection may only receive one direct payment regardless of the number of owners.

Liability Insurance

Every business should have liability insurance as it is a relatively inexpensive means of managing liability exposure for injuries and physical damages. Liability insurance does

not make the business less exposed to liability but rather gives the business a means of paying damages in the event a liability incident occurs. The question becomes, “how much liability insurance should a farm operation have?” This question must be answered on a case by case basis by analyzing the potential liability exposure of an operation and the cost of the insurance premiums. In the event that the damages from a liability incident exceed the liability insurance, limited liability entities are the next line of defense to manage liability exposure.

Liability insurance offers no protection for financial liability created by the business or its owners. Therefore,

while liability insurance should be a key component of every business plan, it does not protect the business from all liability.

The above discussion is based on generalities of business and liability law. Both areas of the law are fraught with exceptions, and determinations of liability are always very specific to the particular incident. Readers should not rely on this publication for legal advice but merely as a presentation of some of the legal issues related to farm liability. Professional counsel should be sought before implementing any liability management plan or assessing liability.

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