Using Business Entities to Manage Farm Liability Risk

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Today's farms are more susceptible to legal liability than ever before. This liability exposure comes in many different forms, such as moving large machinery on roadways, inviting people onto the farm, and handling fertilizers and pesticides. While farm liability risk cannot be eliminated, it can be managed. Business entities such as Corporations and Limited Liability Companies (LLCs) can be valuable tools for limiting liability exposure. This bulletin explains the liability protection attributes of these entities and describes how they can be part of a comprehensive plan to mitigate a farm operation's liability risk.

Limited liability and business entities

The concept of limited liability means an individual is not personally liable for the actions of a business simply by being an owner of that business. Ohio law grants limited liability in certain situations, and the type of business entity determines if limited liability is available to an owner. **Table 1** below shows common business types and whether they provide limited liability to their owners.

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Table 1. Comparison of liability protection for business entities

Does not provide limited liabiity	Provides limited liability
• Sole Proprietorship • General Partnership • Limited Partnership (general partners)	• Limited Liability Company • Corporation • Limited Partership (limited partners)

The following explains liability protection characteristics for these different types of business structures. The examples focus on personal injury liability, a common liability issue for farms.

1. General Partnerships and Sole Proprietorships

Neither a General Partnership nor a Sole Proprietorship provides liability protection to its owners because the law sees no distinction between the business and its owners. When the business is subject to liability, the business owners are also personally subject to liability--even if they were not involved in creating the liability. Consider the following examples.

Example 1. A farmer who has not formally organized as a business entity runs a stop sign while driving her tractor and collides with a vehicle. The driver of the vehicle suffers serious injuries, sues the farmer and receives $1 million for the injuries.

Example 2. Partner 1 and Partner 2 form a General Partnership called XYZ Farms. While Partner 1 is driving the partnership's tractor, he runs a stop sign and collides with another vehicle. The driver of the vehicle suffers serious injuries, sues XYZ Partnership, and receives $1 million for the injuries.

Who is liable for the accidents, and for how much? Let's assume in both cases that there is not sufficient insurance to cover the $1 million award for the injuries.[1] In Example 1, the farmer is not a formal business entity and simply operates her farm as a Sole Proprietorship. In the eyes of the law, she is the farm business. She will owe the injured party the $1 million award, and both her farm assets and personal assets at risk for that liability.

In Example 2, the Partnership is liable because Partner 1 was acting on behalf of the Partnership at the time of the accident. All Partnership assets are at risk and could be liquidated to pay the damage award. But the partners are also personally liable because partners in a General Partnership do not have limited liability. Since Partner 1 caused the accident, Partner 1 would be subject to liability regardless of the business structure. But because it is a Partnership, Partner 2 would also be liable

[1] For demonstration purposes, sufficient liability insurance is not included in these scenarios. Liability insurance would affect the outcome of the scenarios and should be the primary liability protection strategy. We discuss the role of liability insurance later in this bulletin.

even though Partner 2 did not cause the accident. The Partnership and personal assets of both partners are at risk of being liquidated to pay the harm caused by Partner 1.

Partnerships are subject to **"joint and several liability,"** a legal concept that makes all parties responsible for the entire liability rather than being responsible only for their proportional share. In Example 2, both partners are responsible for the full amount of the liability. If Partner 1 does not have sufficient personal assets to cover any of the liability but Partner 2 does, the injured party could go after Partner 2 for the entire $1 million in damages. This is referred to as "going after the deep pocket," when an injured party seeks compensation from the partner who is most able to pay the amount of the liability. Joint and several liability creates high liability exposure for partners.

2. LLCs and Corporations

Unlike Sole Proprietorships and General Partnerships, LLCs and Corporations do provide limited liability for business owners. An owner of an LLC (a "member") or an owner of a Corporation (a "shareholder") is not personally liable for the entity simply by being an owner. This is because the law considers the entity to be a separate "person," distinct from its owners. An LLC or Corporation protects the owners and their personal assets from the liabilities of the business.

However, an LLC or Corporation only provides limited liability, not complete liability. An owner's investment and ownership value in the business are still at risk. And an LLC or Corporation does not protect an owner from an owner's individual actions. That is, if an LLC or Corporation owner causes an accident, personal liability will result regardless of the business type.[2]

Example 3. In this scenario, XYZ Farms is organized as an LLC, [3] owned by Member 1 and Member 2 Using the same scenario as Example 2, Member 1 causes an accident while driving the LLC's tractor.

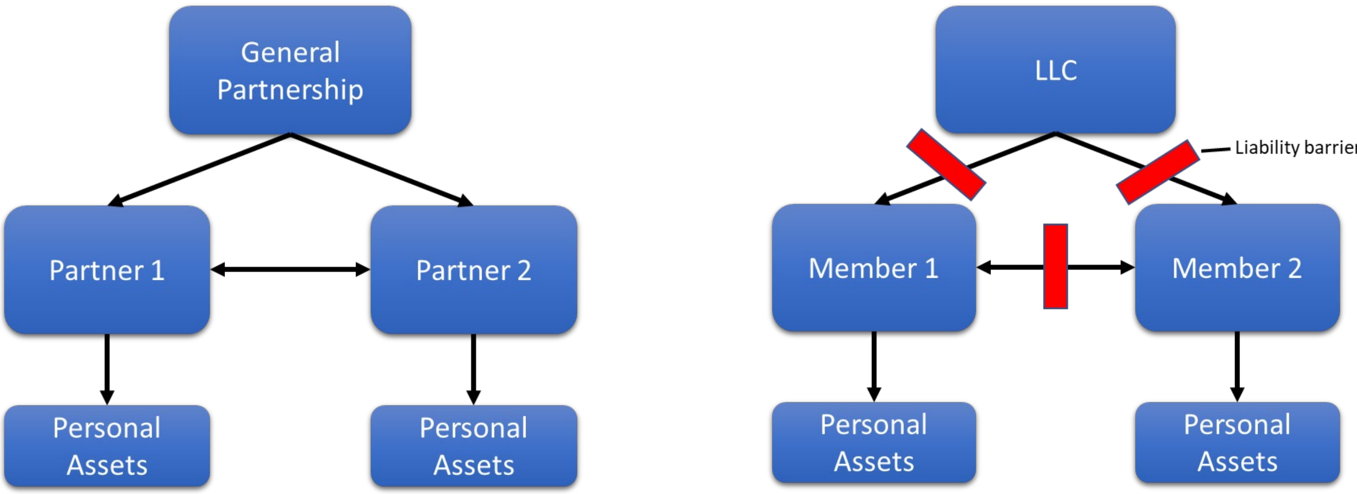
As in Example 2, the LLC and Member 1 are both fully liable for the $1 million award. The LLC is liable because Member 1 was acting for the LLC, and Member 1 is also personally liable because he was at fault for causing the accident. But the difference between the Partnership structure in Example 2 and the LLC structure in Example 3 is the reduced liability exposure the LLC gives Member 2. Member 2's ownership interest in the LLC is subject to liability but the liability stops there. Member 2's personal assets are not in jeopardy because the injured party cannot pursue Member 2 personally for any of the damages. Example 3 illustrates the concept of limited liability: the LLC shields an owner from personal liability for the actions of other owners.

Diagram 1 on page 4 illustrates the difference between entities that provide no liability protection and entities that provide limited liability protection.

[2] Personal liability for one's own actions can only be mitigated by adequate liability insurance. Using an LLC should not substitute for good liability insurance.

[3] For simplicity of discussion, we use an LLC for our examples. A Corporation can be substituted for an LLC with the same results.

Diagram 1. Comparison of liability for a General Partnership (left) and an LLC (right)



As the diagram illustrates, liability can flow between the partners in a General Partnership and downward to each partner's personal assets. Conversely, an LLC provides a liability barrier that protects each owner's personal assets from the liabilities of the LLC and other LLC owners.

3. Limited Partnerships

A Limited Partnership is a unique business entity that provides limited liability for some owners and no liability protection for other owners. A Limited Partnership has two classes of owners: limited partners and general partners. The limited partners have no management rights and typically have limited or no voting rights. They are effectively "silent" partners. On the other hand, general partners manage the Limited Partnership and have full authority to act for the Limited Partnership. Due to this difference in management authority, limited partners have limited liabilities for the Limited Partnership, but the general partners do not have liability protection. This structure allows Limited Partners to invest in the Partnership without being subject to personal liability.

LLCs have made Limited Partnerships largely obsolete for farm operations.[4] LLCs provide limited liability protection and also offer the business and tax advantages a Partnership provides. Many Limited Partnerships formed prior to LLCs being available still exist today, but it is possible to convert a Limited Partnership to an LLC and gain liability protection for all owners.

Business entities and other liability exposures for farms

The examples above illustrate how a farm's business structure affects liability for personal injuries, but farms face many other liability risks. Three additional risks are important to consider when deciding on the appropriate entity for managing liability risk: employer liability, financial and contractual obligations, and external liabilities.

[4] Ohio law allows LLCs to own farmland. However, some states do not. Be sure to consult with an attorney before establishing an entity to hold farmland.

1. Employer liability

Under the legal doctrine of "respondeat superior,"[5] an employer is legally responsible for the actions of an employee who is performing work-related duties. If an employee triggers a liability event, the employer is at risk of being responsible for that liability. Since many Ohio farms have employees, employer liability is a significant source of liability exposure for farms.

Example 4. XYZ Farm Partnership, a General Partnership owned by Partner 1 and Partner 2, hires an employee to assist with its grain operation. While moving large equipment on the roadway, the employee misjudges a turn and injures the driver of a passenger vehicle.

Who is liable? Both the employee and the employer have liability risk in this situation. The employee can be liable because his mistake caused the accident but XYZ Farm can also be liable because the employee was performing a job duty. Also, both Partner 1 and Partner 2 are subject to joint and several liability because a Partnership does not provide limited liability to its owners. Each partner's business and personal assets are at risk due to the accident.

Example 5. Assume the same facts as Example 5 above except XYZ Farm is organized as an LLC instead of a General Partnership.

The employee in Example 6 remains at risk for liability because his mistake caused the accident, and XYZ Farm LLC could also be liable as the employer of the employee. However, neither owner of the LLC is likely to be personally liable due to the limited liability protection of the LLC.

2. Financial and contractual obligations

A farm's financial and contractual liability risk can also transfer to its owners in certain business structures. The partners of a General Partnership and the owner of a Sole Proprietorship can be fully liable for the financial liabilities of their businesses, while members of an LLC have limited liability for the LLC's financial and contractual obligations.

Example 6. XYZ Farms LLC purchases a tractor from Equipment Dealer. Member 1 signs the loan papers on behalf of the LLC. XYZ Farms LLC later defaults on its loan payments.

Who can Equipment Dealer pursue to collect the debt? Because the LLC is the "person" that entered into the loan, Equipment Dealer can pursue only the LLC. Member 1 signed the documents on behalf of the LLC, but not in a personal capacity. If the LLC is unable to pay the loan, Equipment Dealer cannot seek payment from any of the LLC members. If the LLC has no money or assets, Equipment Dealer simply might not be able to collect the debt. However, if XYZ Farms was a General Partnership, Equipment Dealer could seek payment from any and all of the partners.

[5] Latin for "Let the superior answer". This concept applies similarly in all states.

3. External liabilities

In the context of this bulletin, external liabilities refer to liability that may be experienced by a farm operation but is not the direct result of an owner or employee's actions. External liability can come in the form of visitors, product defects and unknown property dangers, to name a few. LLCs can provide significant liability protection from external liabilities.

Example 7. A farm market is owned by one person. The owner establishes an LLC and operates the farm market through the LLC. The farm market includes a petting zoo to entertain children while their parents shop. A goat bites a customer's child, and the child is injured.

Example 7 shows how an external liability might arise. Neither the LLC owner nor an employee was directly responsible for the child's injury. Instead, the injury was caused by an animal owned by the LLC. The LLC will be liable for the injuries because it owned the goat and operates the farm market. The owner of the LLC is not likely to have personal liability. If the owner had operated as a Sole Proprietorship, however, the owner could have personal liability for the incident.

Personal guarantees and business entity liability

A business like the Equipment Dealer in Example 6 might require a "personal guarantee" from an LLC member. The personal guarantee is a "guarantee" or promise by the LLC member to assume personal liability if the LLC is unable to fulfill its financial obligations. It is a way for a business to have higher financial assurance by circumventing the limited liability protection an LLC offers.

Example 8. Same facts as Example 6, except Equipment Dealer requires Member 1 to sign a personal guarantee for the loan.

Who can Equipment Dealer pursue to collect the debt? Equipment Dealer can seek payment from both the LLC and Member 1. The personal guarantee signed by Member 1 allows the equipment dealer to avoid the limited liability protections of the LLC. Be aware that another business may not be willing to conduct business with an LLC without personal guarantees from the LLC members.

Strategies for using multiple entities

So far, the liability protection provided by a single business entity like an LLC, has been examined. However, there are significant benefits to using multiple LLCs. The vast majority of a farmer's wealth is usually in farm assets. A single LLC business structure will protect a farmer's personal assets but those are usually small in comparison to the farm assets.

Example 9. Mom and Dad own XYZ Farms LLC. They have a combined net worth of $5 million. Their farm assets are valued at $4 million and their non-farm assets are valued at $1 million. An employee of XYZ Farms LLC causes an accident on the road and a car driver is injured.

Example 9 illustrates the limitations to using only one entity. The LLC will protect Mom and Dad's personal assets from the liability caused by the employee's accident. However, 80% of Mom and Dad's wealth is in the LLC and therefore still exposed to the liability. While a single entity plan is better than no plan at all, using multiple entities often provides additional liability protection.

The following are several planning strategies using multiple entities.

1. **Land LLC plan**

An LLC to hold farmland is an often used and effective strategy to protect farmland from liability. In this structure, the farming operation is held in one LLC and the farmland is held in another LLC. The operating entity buys the inputs, sells the grain, manages the livestock and maintains the bank account. This entity will own the machinery, equipment, livestock, grain, crops and operating bank account. Land will not be held in this entity.

The second entity is the Land LLC and owns all the real estate.[6] The Operating Entity LLC leases the land from the Land LLC. Because the land is held in a separate LLC from the operating portion of the farm, the land is not associated with the liability of the farming operation.

Example 10. Using the same scenario as Example 10 except Mom and Dad transfer their farmland, valued at $3 million to Land LLC. XYZ Farms LLC holds machinery, grain and livestock valued at $1 million.

In Example 10, the Land LLC has significantly reduced Mom and Dad's exposure to liability. XYZ Farms LLC remains liable for the employee's action and all assets in that LLC are at risk. However, now, only 20% of Mom and Dad's total assets are at risk. Their $3 million of farmland in the other LLC and their personal assets are protected from employee's liability. By establishing Land LLC, Mom and Dad went from having 80% of their assets at risk to farm liability to only 20%.

2. **Machinery and truck LLC plan**

A common strategy among farm operations is to place machinery and trucks in a separate LLC. The Operating LLC then leases the machinery from the Machinery LLC or trucks from a Trucking LLC. While this strategy can provide some liability protection, the extent of the protection is often overstated.

Machinery LLCs hold machinery that is usually operated by the owners and employees of the Operating LLC. When an accident is due to operator error, the liability remains in the Operating LLC.

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[6] 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 tax liability.

Remember that anyone acting on behalf of the Operating LLC will create liability for the Operating LLC.

Example 11. XYZ Farms establishes an Operating LLC and a Machinery LLC. The Operating LLC leases the machinery from Machinery LLC. An employee of Operating LLC, while driving a tractor owned by Machinery LLC, causes an accident on the roadway.

Operating LLC will likely be liable because the employee was acting on behalf of the LLC when the accident occurred. Machinery LLC may or may not be liable depending on why and how the accident happened. If the accident can be linked to Machinery LLC, perhaps because of a mechanical problem on the tractor, Machinery LLC may be liable as well.

The above example describes how liability for machinery comes back to the Operating LLC even when the machinery is in a separate LLC. While machinery LLCs do help with liability in some cases, they do not provide a solid barrier to liability. Again, for this reason and others, business entities should not substitute for good liability insurance.

It is possible, but challenging, to make a Truck LLC provide more thorough liability protection. The Truck LLC must have its own payroll and must pay the drivers directly. Then, the Operating LLC hires the Trucking LLC as a custom operator. A driver who also works on the farm must be careful to keep track work for the Truck LLC and work for the farming operation.

Example 12. XYZ Farms establishes an Operating LLC and a Trucking LLC. The Trucking LLC establishes its own payroll. Employees are shared between Operating LLC and Trucking LLC but the employees are required to keep track of the time they are driving trucks. The Employees receive two paychecks, one from Operating LLC and one from Trucking LLC. Operating LLC hires Trucking LLC to haul its grain on a custom basis, that is, Operating LLC pays Truck LLC on a per bushel basis for hauling grain. While hauling grain, Employee causes an accident.

In this example, Operating LLC is much less likely to be liable for the accident. Employee is working for and paid by Trucking LLC at the time of the accident. Operating LLC hired Trucking LLC as a custom hire or a contractor. Generally, there is no liability for a custom hire or contractor as there is for an employee. Example 12 shows how liability can be separated with a trucking LLC but it does require close management of payroll and employee hours. Many farms find it easier to purchase additional insurance than to set up a custom hire trucking LLC.

3. Using operating entities, machinery/truck entities and land holding entities together

The use of three or more entities may be necessary for the most comprehensive liability mitigation plan. Dividing the farm assets into various LLCs can help protect some assets from the liability created by other assets. Each entity must stand on its own and thus have its own income/ and expenses, bank account, accounting, and tax filing. A plan with multiple entities will require more management and expense but the additional burdens may be worth the added liability protection.

There are limitless combinations of entities that can be used for farm liability protection. Rather than explore each combination in this bulletin, we recommend seeking legal advice as to what structure and entities may work best for a specific farming operation. Some farms may obtain adequate liability protection with one entity while others may need several entities.

When an LLC is not helpful

Not every farming operation needs an LLC for liability protection. An LLC will provide little liability protection to farm operations that are owned by one owner, don't have employees, or don't have external liability exposure. If the owner causes a liability incident, an LLC will not provide much protection. Again, LLCs do not protect someone from liability for their own mistakes or negligence, LLCs protect owners from other owners, employees, and external liability exposure.

To summarize in another way, LLCs are most likely to provide liability protection for a farming operation when one or more of the following are present:

- Co-owners
- Employees
- Contractual or financial obligations
- External liabilities

Farm Service Agency programs and business entities

A business entity plan must also consider Farm Service Agency (FSA) programs. Most programs limit the amount of money a producer may receive, referred to as "payment limitations." For many programs, the payment limitation is $125,000. FSA considers any entity with liability protection as one producer. No matter how many owners it may have, that entity will receive only one payment limitation. Conversely, entities with no liability protection are allowed as many payment limitations as there are owners. The type of entity used for a farming operation can greatly affect participation in FSA programs. For a thorough discussion on business entities and FSA payments, see the *Farm Service Agency Programs and Business Entities* bulletin in this law bulletin series.

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 considerations. Other factors include taxation, management, ownership, transfer restriction, start-up costs and liquidation costs. Be sure to consider all of these factors when deciding upon business entities. For detailed discussions on other characteristics of farm business entities, see the following bulletins: *A Comparison of Business Entities Available to Ohio Farmers*; *Starting, Organizing, and Managing an LLC for a Farm Business;* and *Tax Characteristics of Business Entities Available to Ohio Farmers,* all a part of this *Structuring Your Farm Business* series.

Liability insurance

Liability insurance is a necessity. 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 damages from a liability incident exceed the liability insurance, limited liability entities are the next line of defense to manage liability exposure. It is a good investment of time to thoroughly review the farm liability policy with the issuing insurance agent to be sure all activities and assets are covered and adequate protection exists.

Seek legal counsel

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 specific to the particular situation. 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 legal counsel should be sought before implementing any liability management plan or assessing liability.

The *Structuring Your Farm Business* bulletin series is a project of the **OSU Agricultural & Resource Law Program**, Find other law bulletins in this series and all our resources on OSU’s Farm Office website, a one-stop shop for agricultural law and farm management information.

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