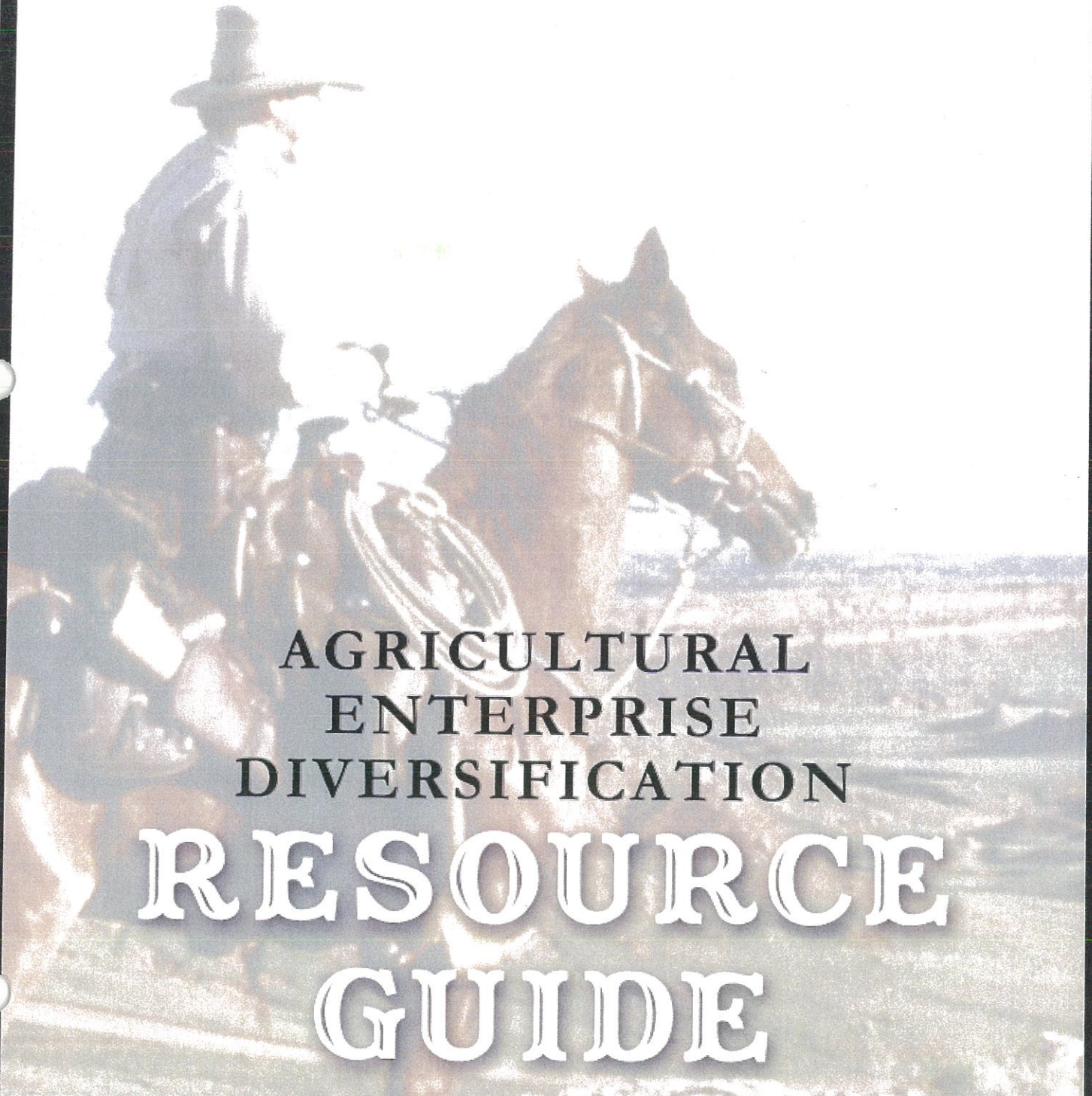




Sustaining Western Rural Landscapes, Lifestyles & Livelihoods



AGRICULTURAL
ENTERPRISE
DIVERSIFICATION
**RESOURCE
GUIDE**

To Whom It May Concern:

The *Sustaining Western Rural Landscapes, Lifestyles and Livelihoods* partnership completed the comprehensive agricultural diversification resource guide as a valuable tool in assisting professionals in delivering technical assistance to agricultural producers as they evaluate their current operations and research the feasibility of diversifying.

The information, at first glance, may look overwhelming, but is divided into the following sections:

- Foreword
- Introduction to Agricultural Enterprise Diversification
- Enterprise Assessment
- Enterprise Feasibility
- Enterprise Implementation (Business Planning, Legal, Finance, Marketing, Human Resources, Natural Resources and Community)

If you would like further information on how to best use this guide please don't hesitate to contact me at the following address. In addition we have access to professionals who can assist agricultural producers develop an agricultural diversification strategy, so please don't hesitate to contact me.

Sincerely,

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A. Selecting the right legal form for an alternative agricultural business

1. Introduction

Selecting the right legal form to operate any agricultural business requires careful planning. This is particularly true for farmers and ranchers who are considering high risk or nonconventional enterprises like specialty crops, ranch recreation, or value-added activities; bringing in young family members as co-owners to operate such businesses; or soliciting investors to finance them. Which legal form—sole proprietorship, partnership, corporation, limited liability company, statutory trust, or their hybrids—can best address the needs of these producers?

The purpose of this article is to aid readers and their customers in weighing which legal form might best serve their alternative agricultural businesses. Section II describes five legal forms and five hybrids. Section III discusses several reasons producers might select a particular form and tie these objectives to particular characteristics of the legal forms previously discussed. The article concludes with two checklists producers might use in preparing to work with their attorneys and accountants in making this decision.

This article is based upon a longer draft extension bulletin on the same topic.¹ The article provides an overview of very complicated legal issues. It does not discuss how state and federal securities laws might impact this decision and only briefly touches on some of the tax questions involved. Farmers and ranchers are encouraged to work closely with their legal and financial advisors in selecting the best legal form for their businesses. This article is not intended to provide legal advice or substitute for competent professional assistance.

¹ ALAN SCHROEDER & GAY GEORGE, SELECTING THE RIGHT BUSINESS FORM FOR YOUR AGRICULTURAL BUSINESS (Draft September 2001).





2. **Legal forms currently available to operate alternative ag enterprises in Wyoming.**

a. **Five different legal forms:**

1) *Sole proprietorships*

A sole proprietorship is established the moment an owner begins operating a business for him or her. Sole proprietors are not obligated to file any documents, either locally or with the Wyoming Secretary of State, to commence operations.

Sole proprietors are entirely responsible for management decisions (though they may employ various sales and purchasing agents to help conduct their businesses). Sole proprietors are personally liable for any unpaid business obligations. Income from sole proprietorships is included on the owners' individual federal tax returns and is subject to self-employment taxes.

Sole proprietorships end when their owners stop operating, sell their assets, become incapacitated, or die. Personal and business creditors and others may also seek to terminate sole proprietorships involuntarily through court actions that seize the business's assets.

2) *General partnerships*

A general partnership is created when two or more persons agree to operate a business together for profit. No specific documents need be filed with the Wyoming Secretary of State to create general partnerships. Partners typically prepare a General Partnership Agreement, either orally or in writing, that details the partnership's purpose and duration, outlines the partners' relative rights and duties in the business, allocates profits and losses, and





provides for partner's voluntary or involuntary withdrawal and reimbursement.

Absent contrary terms in the Partnership Agreement, statutory provisions authorize general partners to jointly manage the business and split profits and losses equally among the partners, regardless of their relative contributions. Under these statutory defaults, the majority rules when conflicts over day-to-day management decisions arise. Unanimous consent is required when the decision involves the addition of a new partner, modification of the Partnership Agreement, or matters outside the ordinary course of business. Partners are individually and jointly liable for any obligation of the partnership.

Partnerships are pass-through entities for federal income tax purposes. This means the partnership entity pays no taxes and only files an information return; individual partners pay federal income and self-employment taxes on their allocated share of the partnership's profits.

Partnerships-at-will (partnerships with no fixed duration and no specific activity to be completed) may be terminated at any time, either by an exiting partner or any recipient of that partner's interest (e.g., a purchaser, creditor, heir, ex-spouse). Durational partnerships (those with a fixed duration or a specific purpose to be accomplished) are terminated, among other reasons: a) when the duration or purpose is completed; b) upon consent of the partners; c) upon the happening of a terminating event, specified in the Agreement; or d) upon the request of a current partner following the exit of another.





3) General business corporations

Incorporators establish a general business corporation by filing its Articles of Incorporation with the Wyoming Secretary of State. Incorporators are not required to be shareholders. Day-to-day business operations are normally governed by the corporation's Bylaws, adopted by the corporation's board or shareholders, in accordance with its Articles and the Wyoming statutes.

General business corporations are distinct entities from their shareholder-owners. They may, among other things, sue and be sued, acquire and transfer property, establish debt, make contracts, and transact any lawful business. General business corporation affairs are managed by three groups:

- Shareholder-owners who exercise their rights by electing directors, establishing Bylaws, and voting on certain other matters.
- Directors who exercise their powers by establishing general policies and naming the officers and employees.
- Corporate officers and employees who are in charge of the day-to-day management of the business.

Typically, shareholders are only liable for corporate debts and obligations to the extent of their required contributions. Corporate profits are distributed, following a declaration of dividends by the board of directors, based upon the types and numbers of shares each shareholder owns.





General business corporations may be taxed for federal income tax purposes in two ways: as regular Subchapter C corporations or as specially designed S corporations. Under Internal Revenue Service (IRS) rules:

- Subchapter C (regular) corporations: Pay income taxes on their corporate earnings. Dividends distributed by Subchapter C corporations are also taxable income for their shareholders.
- Subchapter S (specially designated) corporations: Designated corporation is taxed like a partnership. No income taxes ordinarily paid at the corporate level. Share owners must pay income taxes on their proportionate share of any corporate earnings, even though the corporation does not distribute any dividends. Unlike general partners Subchapter S shareholders are not obligated to pay self-employment taxes on their share of the corporate profits.

To become a Subchapter S corporation, the shareholders must file a request with the IRS. To qualify for a Subchapter S designation, the corporation must have: a) no more than seventy-five (75) shareholders; b) only one (1) class of stock; c) no nonresident aliens as shareholders; and d) only natural persons (other than certain estates, trusts, and tax exempt organizations) as shareholders.

General business corporations may be terminated in three ways. First, the corporation's board of directors and shareholders may terminate them voluntarily. Second,





the Wyoming Secretary of State may terminate them administratively, among other reasons: a) for failing to maintain a registered agent in the state; b) for failing to submit annual license taxes and/or annual reports; or c) following a determination that cessation would be in the public interest. Third, general business corporations may be terminated judicially if, among other reasons, a petitioner can show: a) the directors are deadlocked, the shareholders cannot break this deadlock, and irreparable injury has or will occur to the business or shareholders; b) the shareholders are deadlocked and have not been able to elect successors to directors for at least two annual meetings; c) illegal, oppressive, or fraudulent actions by the board or those in control; or d) misapplication or wasting of corporate assets.

4). *General limited liability companies*

General Limited Liability Companies (LLCs) have characteristics of both general partnerships and corporations as well as attributes unique to themselves. LLCs are separate legal entities from their member-owners, having all the powers necessary or convenient to accomplish the purpose(s) for which they are established. LLCs are established by filing Articles of Organization with the Wyoming Secretary of State.

Member-owners of general LLCs also prepare Operating Agreements, setting out the rules governing day-to-day management, transfers of rights, dissolution, and allocating powers among member-owners. LLCs may be member-managed or manager-managed, depending upon the terms of the Articles of Organization and Operating Agreements. Absent contrary terms in these documents, the default provisions in the Wyoming statutes provide





that LLCs are to be member-managed and authority proportionally based upon each member's relative contributions. The Operating Agreement may also specify how profits and distributions will be handled. If the Operating Agreement is silent, the default provisions provide that distributions will be based upon the member-owners' contributions. Member-owners of LLCs generally have limited liability. Member-owners can choose whether to have their LLC taxed either like a C corporation or a general partnership.

Member-owners' interests in a general LLC may be transferred or assigned as provided in the Operating Agreement. Transferees of this interest receive the transferor's rights to any profits or distributions from the LLC. However, transferees receive no right to participate in the company's management, unless unanimous written approval is given by the remaining member-owners or the Operating Agreement provides otherwise.

The Wyoming statutes provide that the life of a general LLC is thirty years or the period specified in the Articles of Organization. A LLC is dissolved and its affairs must be wound up: a) if its duration or purpose expires; b) member-owners unanimously agree in writing to dissolve it; or c) a member-owner dies, retires, resigns, is removed, becomes bankrupt, dissolves, or any other event occurs that terminates the member's continued membership unless the remaining member-owners unanimously agree to continue, in accordance with rights specified in the Articles of Organization.





5). Statutory trusts

A statutory trust is established by filing a Certificate of Trust with the Wyoming Secretary of State. Statutory trusts are like ordinary trusts, with trust property held by the trust, trustee(s) named to manage the property, a trust document prepared governing the trust's operation, and beneficiaries established to whom benefits from the trust are to be distributed. Unlike ordinary trusts, however, statutory trusts are created to operate a business.

Trustees of statutory trusts typically have more day-to-day management responsibilities and face greater risk than trustees of ordinary trusts. The creator of a statutory trust also prepares a Governing (Trust) Instrument, outlining the trust's purpose and allocating authority, rights, and duties among the trustee(s) and beneficial owners. While trustees normally are charged with the day-to-day management of the business, the beneficial owners may also be authorized to vote on certain matters.

Depending upon the terms of the Governing Agreement, beneficial owners may: a) make an initial contribution to; b) buy into; or c) be granted a beneficial interest in it by the trust's creator. Beneficial owners have the same level of liability as shareholders of a general business corporation. Profits and other distributions are determined by the Governing Instrument. If the Governing Instrument is silent, the default provisions of the Wyoming statutes base distributions upon each beneficial owner's proportionate share of the total beneficial interests in the trust. The trustee, acting in accordance with the relevant documents, may specify whether earnings from the statutory trust will be taxed like a regular C corporation or a partnership.





Beneficial interests are transferable in accordance with the Governing Instrument. In the absence of unanimous consent from the trustee(s) and other beneficial owners or a specific provision within the Governing Instrument, a subsequent transferee has no right to participate in, be kept apprised of, or become a beneficial owner in the statutory trust.

Statutory trusts will terminate in accordance with the Governing Instrument. Beneficial owners may also seek judicial dissolution based upon general trust principles.

b. Hybrid forms

1). Limited partnerships

A limited partnership consists of one or more general partner(s) and one or more limited partner(s). To establish a limited partnership, the co-owners must file a Certificate of Limited Partnership with the Wyoming Secretary of State. The name of a limited partnership must include, without abbreviation, the words "limited partnership." Owners of a limited partnership also prepare a Limited Partnership Agreement, outlining the purpose of the business and fixing their relative rights and responsibilities. The Agreement may be oral or in writing.

The general partners are responsible for managing the limited partnership's business. General partners are absolutely liable for any unpaid obligations of the limited partnership. Limited partners are essentially passive investors in the limited partnership. Their liability is normally limited to their required contributions to the business.





The Limited Partnership Agreement normally establishes how profits and losses are to be distributed among the owners. Absent a specific term in the Agreement, statutory defaults allocate profits and losses based upon the co-owners' relative contributions to the business. Earnings of the limited partnership are not taxed at the entity level but the partners will be obligated to pay federal income taxes on their allocated shares. Earnings allocated to general partners will normally be subject to self-employment taxes; earnings of limited partners typically are not.

General partners may dissociate (leave) a limited partnership at any time, even though such actions constitute a breach of contract. Limited partners may only withdraw in accordance with the Limited Partnership Agreement.

Limited Partnerships normally must dissolve and their affairs be wound-up when: a) their duration or purpose ends; b) an event specified in the Limited Partnership Agreement occurs; or c) the limited partners fail to appoint a general partner after the last general partner(s) withdraws. Except in the last instance, the partners may unanimously agree to continue the business. Partners may also request that the district court dissolve their limited partnership following a finding that it is not reasonably practicable to carry on its business in conformance with the Limited Partnership Agreement.

2). *Registered limited liability partnerships.*

A Registered Limited Liability Partnership (RLLP) is a general partnership that provides limited liability to all its partners. It is created by filing a Statement of Registration with the Wyoming Secretary of State. Its





business name must end with "Registered Limited Liability Partnership," "Limited Liability Partnership," or a statutorily authorized abbreviation (e.g., "R.L.L.P.," "L.L.P.," "RLLP," or "LLP"). The Wyoming Statutes authorize professionals to use the RLLP form, if neither the applicable licensing statute nor licensing body prohibits it.

Aside from the broad limited liability protections afforded their general partners, RLLPs are subject to the same rules governing general partnerships. Partners of this form remain liable for their own negligent acts and the negligence of those whom they are supervising. Partners of RLLPs may also be liable for any obligations they personally guarantee or for any obligations that a majority of the partners agree to be responsible for, unless otherwise provided for in any agreement between the partners.

3). Close corporations

A close corporation is a Wyoming business corporation with thirty-five (35) or fewer shareholders whose filed Articles of Incorporation and stock indicate that the business is being operated as a close corporation. The Wyoming Statutes permit shareholders of close corporations to modify the typical rules governing general business corporations in several ways:

- Formalities: The shareholders may eliminate directors and officers for the corporation as well as bylaws and annual meetings and operate the business like a partnership.
- Transferability: The shareholders may impose limits on the transferability of the close





corporation's stock, by: a) giving the corporation a right-of-first-refusal, whenever a shareholder attempts to sell his/her stock; b) requiring the corporation to buy a decedent's or his/her co-owner's stock; and c) authorizing buy-sell agreements, unanimously consented to by the shareholders.

- Minority rights: The Wyoming statutes establish special rules protecting minority shareholders' rights (see discussion of minority rights below).

Close corporation stock may only be transferred to "qualified shareholders." These are purchasers whose ownership is permitted under state or federal tax law and will not impose personal holding or other penalties on the corporation. Otherwise, close corporations are governed by the same rules outlined earlier for Wyoming general business corporations.

4.) Flexible limited liability companies

Flexible Limited Liability Companies (FLLCs) are created by including within their filed Articles of Organization a specific statement indicating that the business will be operated under Wyo. Stat. Ann. § 17-15-144. This statute provides:

- Ownership: FLLCs may have a single owner member (general LLCs must have at least two owner-members).
- Transferability: Interests in FLLCs are freely transferable, except as provided in the





Operating Agreement. The Operating Agreement may automatically authorize transferees to participate in management of the business.

- Continuity: FLLC Operating Agreements may also provide for the business's continuation, following the occurrence of events, which would otherwise terminate a general LLC.
- Liability: The Articles of Organization for a FLLC may allow for the personal liability of officers, agents, managers, or members. Otherwise FLLCs are subject to the same rules governing a general LLC.

5). Close limited liability company

Wyo. Stat. Ann. § 17-25-103 defines a "Close Limited Liability Company" (CLLC) as "a limited liability company whose Articles of Organization contain a statement that the company is a close limited liability company." The CLLC must also place this statement in a conspicuous manner in the Operating Agreement and upon any certificates of ownership in the business. The FLLC provisions, described above, may not be applied to businesses organized as CLLCs.

The rules governing the establishment and operation of CLLCs look very much like those for the general LLC. CLLCs may have a single member-owner. CLLCs may be either member- or manager-managed.

The rules governing withdrawal from a CLLC and its dissolution are significantly different from those governing a general LLC. A member-owner may only





withdraw from a CLLC in accordance with the terms of the Operating Agreement. If the Operating Agreement is silent regarding withdrawal, a member may only withdraw with the unanimous consent of all other members of the company. A withdrawing member-owner may only receive part or all of his contributions to the CLLC if the business assets are sufficient to cover all other obligations (other than those owed to other member-owners for their contributions) and: a) the remaining member-owners all consent; b) the CLLC is dissolved; or c) the Articles of Organization or Operating Agreement so provides. A CLLC must be dissolved: a) when the period fixed for its duration expires; b) upon unanimous written agreement of all member-owners; or c) at the time or upon the occurrence of an event specified in the Operating Agreement.

3. **Choosing among these forms for an alternative agricultural business: some points to consider**

a. **Rationale(s) or objectives in selecting a particular business form**

The best reason to select a legal form is that it satisfies the specific needs of producers and their families. For simplicity we will group these requirements/objectives into eleven categories. No attempt is made to prioritize this listing as to which objective might be most important. Table 1 contrasts these objectives with selected characteristics of the ten legal forms discussed.

1). **Legally available**

All 10 forms described in this article may be used by a Wyoming farm or ranch. However, producers who also farm or ranch in South Dakota or Nebraska must be





careful; both states impose restrictions on the use of multi-ownership forms like corporations and LLCs.² Readers with customers in this situation should alert them to this fact and make sure they inform their attorneys of their out-of-state agricultural lands as well as any out-of-state business they might conduct.

2). Easy to enter and operate

Sole proprietorships and general partnerships are the with the Wyoming Secretary of State and the general business corporation and close corporation forms also require submission of annual reports to the Secretary of State. Table 2 describes some of the state licensing or filing fees associated with each of these forms.

In reality the major expense, in establishing a legal form for a multi-owner business will be in preparing the necessary agreements governing the business's operation (e.g., the Partnership Agreement, Operating Agreement, Bylaws, or Governing Instrument). Reality also indicates that spending money up front for a good agreement will save farmers and ranchers headaches in the long run.

3). Simplifying and sharpening day-to-day management

A good governing document will clarify day-to-day general business corporation requires annual meetings of the co-owners and formal meetings of the directors. Qualifying businesses may opt for the close corporation form and avoid most of these formalities by choosing to operate their corporate farms or ranches like a partnership.

²Matthew M. Harbur, *Anti-Corporate, Agricultural Cooperative Laws and the Family Farm*, 4 DRAKE J. AGRIC. L. 385, 387-91 (1999).





Some co-owners want to be involved in every decision. In contrast, many retired farmers and ranchers are not interested in managing the business's day-to-day operations. Other owners may want to specialize their management skills, delegating responsibilities for other aspects of the business to a co-owner or third party manager. The LLC and partnership forms (and their hybrids) offer great flexibility in allocating management authority. Owners may agree to centralized management (manager-management in the LLCs or a designated managing partner in the partnership), an entirely decentralized management shared by all the owners, or iterations in-between.

Readers should be particularly aware of the statutory default or gap-filling provisions that come into play when the relevant documents do not specifically address the question of authority. Under these defaults:

- Partnerships: General partners have equal management authority; disputes on ordinary business matters will be based upon majority rules.
- LLCs: Member-owners' authority and voting rights are based upon their relative contributions.
- Corporations: Shareholder voting rights are based upon the number and types of shares they own. The Articles of Incorporation and Bylaws may impose super-quorums or super-majority voting requirements for certain matters. Shareholders may also employ voting proxies,





voting trusts, and other agreements to alter voting rights.

Regardless of which noncorporate form (e.g., partnership, LLC, or their hybrids) is involved, co-owners must make sure that customers and other third-parties understand who is authorized to act on behalf of their businesses. General partnerships are particularly vulnerable, since partners are normally assumed to have authority to make agreements on behalf of the partnership in the ordinary course of business. Exiting (dissociating) partners should also notify former customers and the public to avoid personal liability for subsequent actions of the partnership. Wyo. Stat. Ann. § 17-21-703(b) makes exiting partners liable for up to two years, following dissociation, for most commercial nonreal estate credit transactions (other than agricultural liens) if creditors can show they:

- Reasonably believed the at the time of the transaction that the dissociated partner was a partner;
- Did not have actual notice of the dissociation;
- Did not have record notice of the dissociation, as a result of filed statements of dissociation or authority; and
- The obligation would have bound the dissociated partner if s/he had been a partner in fact.





The Wyoming statutes provide no instructions regarding the LLCs' liability if a member-owner—acting outside of his/her authority—attempts to obligate the company.

4). Limited liability

Aside from sole proprietorships and general partnerships, all other legal forms provide some (limited partners in limited partnerships) or complete limited liability to owners, at least theoretically. Why just theoretically?

First, Wyoming courts have indicated that they will disregard the corporate form and hold shareholders personally liable when, among other reasons:

- Corporate formalities have been disregarded (e.g., failure to hold stockholder or director meetings).
- Personal and business assets have been commingled.
- The corporation is under-capitalized, given the obligations it is reasonably expected to encounter.³

Similar arguments may be made for disregarding the limited liability company form in similar circumstances, though the Wyoming Supreme Court has yet to address this question. In contrast, the Wyoming legislature has specifically provided that failure to follow technical requirements shall not be grounds for disregarding the close corporation form and holding its shareholders personally liable.

³ *AMFAC Mechanical Supply Co. v. Federer*, 645 P.2d 73 (Wyo. 1982).





Second, practical problems lessen the benefit and promise of limited liability for many farms and ranches using these forms. For many producers, for example, their business property includes their most economically valuable assets. Moreover, under each of these forms owners will be held personally liable for any business obligation they might guarantee. Additionally, owner-employees are personally liable for their own negligent or criminal actions while working for the farm or ranch business. Furthermore:

- Limited partners will be treated like general partners for liability purposes if they participate in the control of the business;
- Partners in RLLPs remain liable for their own negligence and the negligence of those whom they supervise.
- Member-owners of FLLCs and partners of RLLPs can agree to be personally liable for their company's obligations.

Producers should not rely solely on their business's legal form to protect their personal assets from business creditors. Producers should:

- Have a separate risk management plan in place to address liability exposures.
- Make sure their business has adequate liability insurance to cover potential civil suits brought against the business and themselves, in their capacities as directors, officers, employees, and/or agents.

