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AN ANALYSIS OF HOUSE BILL 782: THE LATEST ATTEMPT TO REPEAL NORTH DAKOTA'S BAN ON CORPORATE FARMING

Many thought-provoking, well-reasoned articles have been written presenting the advantages and disadvantages of incorporating a farming operation.¹ Among the most frequently-mentioned advantages are:²

1. Limited liability;
2. Flexibility in the expansion of business;
3. Facility in estate planning.

Some of the disadvantages frequently mentioned are:³

1. The danger of double taxation;
2. The disadvantage of fixed salaries.

Many more reasons for incorporating or not incorporating could be investigated and discussed. It is not, however, the purpose of this note to conduct such an inquiry. Rather, this is an attempt to analyze critically House Bill 782, passed by the 40th North Dakota legislative assembly which repealed the thirty-five-year-old ban on corporate farming. In analyzing House Bill 782, this writer will first examine the conditions and circumstances which surrounded the passage of the first anti-corporate farming bill, and secondly examine the provisions of the current act and discuss how these provisions may be improved by future legislation. At all times it should be remembered that this writer views House Bill 782, despite some disagreements concerning various provisions, as a necessary first step in giving farmers the vehicle of incorporation which has up to now been denied them.

1. White, *Taxation of the Family Farm Corporation and Partnership: Variations on a Theme*, 36 N.D. L. REV. 87 (1960); McElroy, *North Dakota's Anti-Corporate Farming Act*, 36 N.D. L. REV. 96 (1960); O'Keefe, *The North Dakota Anti-Corporate Farming Act: A Dissenting Opinion*, 41 N.D. L. REV. 333 (1964); Note, *Incorporating the Farm Business: Part I*, 43 MINN. L. REV. 305 (1958); Note, *Incorporating the Farm Business Part II: Tax Considerations*, 43 MINN. L. REV. 782 (1958).

2. White, *Taxation of the Family Farm Corporation and Partnership: Variations of a Theme*, 36 N.D. L. REV. 87, 88 (1960).

3. *Id.*

On June 27, 1932, the voters of North Dakota went to the polls and by a vote of 114,496 to 85,932 passed the initiated measure which was to become known as North Dakota's anti-corporation farming law.⁴

In the closing days of the 40th legislative session, in 1967, the North Dakota Legislature overrode Governor William L. Guy's veto of House Bill 782 which substantially repealed North Dakota's anti-corporation farming law of 1932. House Bill 782 as passed would have become law on July 1, 1967, if it had not been referred to a vote of the people. Now it will be placed on the ballot at the next election.

Greater insight into the problems and considerations which went into the drafting of this act could be gained by examining some of the reasons that prompted the passage of the first initiated measure in 1932. Further, it would be beneficial to see how these problems and considerations have changed over the years, thus bringing about a different legislative attitude toward farmers using the corporate form of business organization.

Agriculture in general, and North Dakota farmers in particular, were not sharing in the post World War I prosperity with the rest of the nation. By the time the stock market crashed on Black Monday in 1929, North Dakota was in the midst of an agricultural depression which immediately deepened. During 1925, the state's farming income was at an all time high of \$299,201,000. By 1929, the total farm income in North Dakota had dropped by \$61,832,000 from the 1925 figure and stood at \$237,369,000. The total income dropped \$70,000,000 in 1930 and \$75,000,000 more in 1931. By that time the total farm income was approximately \$93,600,000, or less than one-third of the total income a short six years before. In 1932 it dropped even further to \$71,417,000.⁵

With income dropping, it became necessary for most farmers to secure loans by mortgaging their land. With the continued drop in income fewer and fewer farmers were able to meet their loan payments; many mortgages were foreclosed. A brief look at some statistics will paint a very clear picture of the situation. In 1925, seven percent of the Federal Land Bank loans were delinquent. In 1930, the number was 9.3 percent. By 1931, the total was 15 percent and in 1932 the number jumped to 47 percent. By 1933, the number had increased to the point that 78 percent of all Land Bank loans were delinquent.⁶

4. N.D. Session Laws 1933, ch. 495.

5. KRISTJANSON & HELTESMES, HANDBOOK OF FACTS ABOUT NORTH DAKOTA AGRICULTURE, (North Dakota Agricultural Experiment Station Bulletin 357) 54 (1950).

6. TAYLOR, HELTESMES & ENGELEKING, NORTH DAKOTA AGRICULTURAL STATISTICS, (North Dakota Agricultural Experiment Station Bulletin 408) 91 (1957).

The number of forced sales per 1000 farms reached highs of 76 in 1932, and 93 in 1933.⁷ In other words, approximately one-tenth of North Dakota farmers were forced to sell their farms in 1933 alone. It is estimated that approximately one-third of the North Dakota farmers lost their farms between the years of 1930 and 1944.⁸

Many of the persons who were forced to foreclose the farm mortgages were corporations. In 1929, 5.8 percent of the agricultural land was owned by corporations. In 1934 the figures stood at 8.2 percent and that figure rose to a high of 9.7 percent in 1939⁹ before it began to decline as a result of the ten-year provision of the 1933 measure. Some of these corporations were private banks, the Federal Land Bank, the Joint Stock and Land Bank, Investment Companies, and Religious and Fraternal Orders.¹⁰ In addition, much of the land owned by corporations was owned by the insurance companies because people could not pay back the money that they had borrowed on their insurance policies.

Because of these factors, the people passed the initiated measure which would protect their lands from these corporations. McElroy put it this way:

At the time of its (the initiated measure) adoption by the people of this state, North Dakota was at the bottom of the great depression and I believe it is safe to say that the act was aimed in large measures at life insurance companies and out of state corporate lenders which had foreclosed on thousands of acres of North Dakota agricultural lands.¹¹

Protection from outside corporations was an important and large reason for the people's enacting such a measure. There is one other major factor in the adoption of and maintenance of such a law. The institution of the "family farm" has always been sacred to the farmers of North Dakota. This is shown in many ways. Years ago the farmers banded together in cooperatives and associations to prevent one another from being exploited by railroad men, grain millers, etc.¹² This is still true today. In a recent survey done in connection with his doctoral dissertation, Ross Talbot sent a questionnaire to a cross section of Farm Bureau and Farmers Union members. One of the questions asked was: "Why

7. *Id.* 90.

8. SCHICKLE & ENGELKING, *LAND VALUES AND THE LAND MARKET IN NORTH DAKOTA*, (North Dakota Agricultural Experiment Station Bulletin 353) 43 (1949).

9. WALLIN & ENGELKING, *LAND OWNERSHIP TRENDS IN NORTH DAKOTA SELECTED YEARS 1929-1944*. (North Dakota Agricultural Experiment Station Bulletin 337) 4 (1945).

10. *Id.*

11. McElroy, *North Dakota's Anti-Corporate Farming Act*, 36 N.D. L. REV. 96 (1960).

12. E. ROBINSON, *HISTORY OF NORTH DAKOTA*, (1966) 383.

did you join the Farm Bureau or the Farmers Union?" There were seven or eight reasons listed and the member was to choose one. In each case, the reason that most of the farmers gave for joining the organizations was to maintain the "family farm." Twenty-six farmers in the Farmers Union sample gave that reason for joining the Farmers Union. The greatest response that any other reason received was three. In the Farm Bureau sample eight farmers selected maintaining the family farm as their reason for joining. The next highest reason for joining was to benefit from the Farm Bureau insurance plan. Seven listed that reason. All the other reasons received three or fewer votes.¹³

Both of the aforementioned reasons are still very prevalent. In fact, the Farmers Union is opposed to the present act because they feel it will open the door to large corporations snatching up good North Dakota farm land.¹⁴ Governor Guy gave substantially the same reason for his veto of the bill as sent to him.¹⁵

Opposition to the original anti-corporate farming legislation arose almost immediately. As early as 1937, a committee of the North Dakota House of Representatives reported out a measure to repeal the law. The committee vote was ten to seven, but the measure failed to pass the House. Opponents of the act tried, unsuccessfully, again in 1941 to amend it.¹⁶ It was only after the Farmers Union waged a vigorous vocal fight that the bill to repeal the measure was defeated.¹⁷

Today, many of the reasons for passing the 1932 measure still linger on; but the memory of the depression has dimmed, and many people now accept the fact that a farm operator must become more efficient, which in turn means larger farms with fewer farmers. Consequently, in 1967, after much debate and political bantering, the legislature of North Dakota passed House Bill 782 repealing the old anti-incorporation law. Since House Bill 782 has been referred, it must be voted upon by the electorate of North Dakota. The primary objection to enacting this bill, or any bill which would allow farmers to incorporate, is that it is opening a door; and once that door is open it is just a matter of time until the law would be amended to allow large corporations to take over huge tracts of farm land in North Dakota. This argument is met very well in the following quote.

13. R. TALBOT, *THE POLITICS OF FARM ORGANIZATIONS IN NORTH DAKOTA*, 1953 (unpublished dissertation in Univ. of N. D. Library).

14. Letter from Robert E. Sanders to Nell W. Fleming, March 29, 1967.

15. Veto Message, Gov. Wm. L. Guy to 1967 Legislative Assembly.

16. H. KNIGHT, *GRASS ROOTS: THE STORY OF THE NORTH DAKOTA FARMERS UNION*, 58 (1947).

17. *Id.*

are these: First, that we are opening a door that has long Of the objections raised against allowing farmers to incorporate, three are the most deserving of consideration. They been closed, and that while it creaks a great deal in the process, it will open easier next time. We must, I feel, again given a reasonable bill to start with, entrust to future legislators the burden of deciding by a 2/3 majority whether or not to further change this. This I maintain, is part of our basic trust in the democratic system.¹⁸

This writer will analyze House Bill 782 and attempt to determine if it provides ample protection from outside exploitation while initially opening the door to allow farmers to use the corporate vehicle.

As enacted, House Bill 782 is drawn so that every agricultural corporation in North Dakota will qualify as a Subchapter S corporation under the Internal Revenue Code. A corporation which qualifies as a Subchapter S corporation may elect to be taxed as a partnership or as an individual proprietorship. In order to qualify as a Subchapter S corporation, the corporation must meet the following standards:

1. It must be a domestic corporation.
2. It must not be a member of an affiliated group as defined in section 1504 of the Internal Revenue Code.
3. It must have no more than ten stockholders.
4. Each shareholder must be either a natural person or the estate of a natural person. No shareholder may be a non-resident alien.
5. It can have only one class of stock.

In addition to meeting the above standards, the election of the corporation to be taxed as a Subchapter S corporation must be a unanimous vote of all of the shareholders.¹⁹ For the purpose of this note, one need only be concerned with the last three standards listed.

There is little or no justification in making every agricultural corporation in North Dakota qualify as a Subchapter S corporation. This is especially true when such action thwarts some of the very reasons and advantages that would make it beneficial for a farmer to incorporate. This becomes very apparent upon examination of the restrictions included in House Bill 782.

The first standard that a corporation must meet in order to carry on farming or ranching operations under the statute is that

18. Testimony of George Sinner, Agricultural Committee, North Dakota House of Representatives, 39th Legislative Assembly (unpublished).

19. INT. REV. CODE OF 1954 § 1371.

the stockholders of the corporation shall not exceed ten in number. One main reason given in support of the restriction is that it keeps the ownership of land from becoming too diverse. The argument is made that if you have too many people owning a small parcel of land, there won't be enough income from the land to give each stockholder a significant amount.

This argument may be valid if all of the owners were relying on the profit from the lands as their sole income. Such a situation is seldom the case. Usually one or two of the majority stockholders would actively farm the land. For this they would be paid salaries which would be considered an expense of the corporation. After all of the expenses had been met, then the profit might or might not, depending on the shareholders, be distributed to all of the shareholders in the form of dividends.

Another reason given for arriving at such a restriction is simply one of convenience of definition. Representative Stuart McDonald of Grand Forks seemed to think that the number ten was arrived at because this is the number that the Internal Revenue Code uses in defining a small corporation. Discussion with other members of the legislature substantiates that assertion. All of the legislators this writer has contacted agree that ten is an arbitrary number.

There are at least two reasons why the provision limiting the number of shareholders should be reconsidered in future legislative sessions. The first reason for reconsideration is that the restriction actually hinders the estate planning of the North Dakota farmer for whom the statute was drawn. One of the main advantages advanced for farmers incorporating is the facilitation of estate planning.²⁰ The point can best be made by an illustration: A farmer is in partnership with his brother and his brother-in-law. They run a successful cattle-feeding operation, in addition to raising grain. Among other reasons, these farmers would like to incorporate to insure that the operation will be held intact on the death of any of them. There is, however, one roadblock which prevents them from incorporating even if House Bill 782 becomes law. These three farmers have a total of twenty-seven children. One of their main reasons for incorporating is thereby thwarted. This perhaps is an unusual situation, as most farmers don't have an average of nine children. However, even if the original incorporators above had only four children each, the same roadblock would be present. The farmer, in order to give each of his children an equal share in his estate, would have to arrange to dissolve the corporation, sell his land, and then distribute the estate; or he would have to

20. *Supra* note 18.

leave each child a certain parcel of land. In either case, the farming unit would be broken up. This situation certainly would not aid estate planning. There is no reason why maintenance of the production unit must be sacrificed to achieve equal distribution of an estate, or vice versa.

A second reason for reconsidering the restriction of ten shareholders is that it could give a minority shareholder almost a veto power over the affairs of the corporation. The dissatisfied shareholder could achieve this end by threatening to sell some of his shares to several other persons, and thereby raising the number of shareholders to more than ten. Under 10-06-06 of the NORTH DAKOTA CENTURY CODE any corporation which violates any section of the act shall have the title to their land escheat to the county and the land will be sold to the highest bidder, with the proceeds after expenses to be paid to the corporation. Thus, any shareholder for purely vindictive reasons could, without a great deal of difficulty, dissolve the corporation. This would tend to create great instability and may hurt the corporation's chances of obtaining loans, etc., as many banks and other lending agencies would not have any positive assurance that the corporation would continue to exist. This second problem could be solved by a provision in the articles of incorporation or by-laws requiring the selling shareholder to first offer to sell his shares to the corporation. However, unless the articles of incorporation and the by-laws were carefully drafted, such a situation as outlined could easily develop.

This problem can be solved, while still providing the necessary protection desired, by raising the number of permissible shareholders to twenty-five or thirty. This would make the law much more flexible and usable. It would greatly aid in estate planning. Referring to the earlier example of the three farmers who have twenty-seven children, these farmers could incorporate and, barring a common disaster that takes all three, each could make provisions to leave his children his shares in the corporation. The productive unit would not be disrupted, and the estate could be closed faster and with less expense. In all probability, in time, one or two of the children would buy out the interest of the other children. Or perhaps the original shareholders would buy out the children's interests. All this time, the production unit would be undisturbed.

This limitation of twenty-five or thirty shareholders would still provide protection from the influx of large land-holding corporations. The argument is made that the same result as outlined above could be obtained by the formation of several corporations. The corporations could all hire the same manager and operate as

a single productive unit. This may be true to a certain extent. However, one of many answers that can be made to that argument is that such a procedure is too expensive. The cost of incorporating and maintaining several corporations is prohibitive to most family farmers for whom this statute was drawn. This avenue of multiple corporations is available only to the very large farmers or to large corporations, and in the event of death the unit would be broken up with, for example, one corporation going to each child. Thus, only these people could achieve the desired results. Why not give the small operator the same advantages and keep his cost down?

Senator Grant Trenbeath summed up the situation in the following statement:

The purpose of the ten shareholder limitation, that of eliminating out-of-state corporations from owning land in North Dakota, could just as effectively be achieved by allowing more than ten shareholders to incorporate. This would be done by restricting shareholders to natural persons or the estates of natural persons and by limiting the income that a corporation could receive from rent, royalties, dividends, interest, and annuities, such as is done in the present act. At the same time we would be giving the farmer a lot more legal latitude.²¹

Senator Trenbeath did state that he would still favor a limit on the number of shareholders, although he did not specify the number.

The second standard that House Bill 782 requires is that "the corporation shall not have as a shareholder a person, other than an estate, who is not a natural person." This would disqualify a trust from becoming a shareholder for longer than ten years. This section protects the farm lands of North Dakota from the invasion of, among others, huge foreign machine and food processing corporations. This is the protection of which Senator Trenbeath speaks in his earlier quote. This section tends to keep ownership and control of the North Dakota farm lands in the hands of the people of North Dakota.

The third standard required by the statute is that "the corporation shall not have more than one class of shares." There are at least two reasons for such a provision. The first is that such a provision is a simple one that everyone can understand. The argument is made that if you put in a lot of complicated provisions, you will succeed in doing nothing except confusing the farmer and making him susceptible to some fast-talking promoter

21. Interview with Sen. Grant Trenbeath, April 1967.

that will take him for everything he has. This argument is fallacious for two reasons. The day of the uneducated farmer is gone. Modern farming techniques, government agricultural programs and the requirements of the Internal Revenue Service have helped bring this about. The modern-day farmer is, in actuality, a small businessman. The second flaw is that almost all farmers who are incorporated will have a lawyer with whom they consult.

The second and main reason for this standard is to prevent the separation of ownership and control. The belief that those who own the company should have control of the management is present all through the study of corporation law. This is true whether you are looking at voting or pooling agreements, classification of shares or whatever. This belief that the owner should control his farm is present in North Dakota as evidenced by the following testimony:

The second objection [to repealing the anti-farm corporation act] is that farming should be kept on a personal basis between a man and his soil; that the personal ownership of productive property will be jeopardized by revision of this law. It is my contention that the opposite of this has been true and may continue to be true in the future—that because fathers could not incorporate their sons into an efficient operating unit and pass it on as such, the property ended up being sold. And as we have seen in recent years, it has been sold to bigger units, or parceled out into uneconomical units and lent itself to a continued system of absentee land ownership.²²

There are two very good additional reasons for reconsidering this section. In considering these reasons one must keep in mind that one of the purposes of the farm corporation statute is to allow the farmer either to farm and manage his own land, or have it run in the manner which he designates. Under the present law, there is no way that a farmer can designate whom he wants to operate the farm after he dies unless he gives 51 percent of the stock to a designated individual. Here again, an example illustrates the point best: The farmer may want to leave his estate, consisting almost entirely of the farm, to his five children, three boys and two girls, equally. Since one son has shown an interest in the farm, the farmer would like to have him manage it after he has gone. Since the present statute prohibits a trust from acting as a shareholder, he could either leave 51 percent to the son whom he wants actively to manage the farm, with the other four children dividing the rest; or he could give each of the children 20 percent of the stock and hope that they will carry out his wishes.

22. *Supra* note 18.

The farmer should be allowed to carry out both of his wishes. This restriction should be repealed or modified to provide for different classes of stock. The farmer could divide his shares of stock into voting and non-voting shares, and still divide his estate equally among his children, while insuring that the son he wants to carry on the operation will be able to do so, and that the economical production unit will not be broken up.

The second reason for reconsideration of the single class of shares restriction will become more important as the Garrison Diversion Irrigation Project progresses. Many farms in the central and western part of the state will want to install irrigation systems. This costs a lot of money; sometimes as much or more than the land is valued at without irrigation. This will require a great amount of capital, more than the amount that most farmers will have. One of the best ways for a farmer to raise the necessary capital is to sell or pledge shares of stock as security for the loan. Under the present law the most that farmer could sell, and still be assured of retaining managerial control, is 49 percent. In some cases this amount might not be enough to construct an adequate irrigation system. If the farmer could sell non-voting stock, which is permissible in other North Dakota Corporations, he could still be assured of retaining managerial control. Perhaps it would be beneficial to require that at least a certain percentage of the stock must be voting and the rest may be non-voting. Such a restriction as is currently in the statute could be amended and still retain the control of the corporation in the hands of the active farmer where it belongs.

The fourth standard set up in the bill requires that "The corporation's income from rent, royalties, dividends, interest and annuities does not exceed twenty percent of the corporation's gross receipts." This section, along with the second restriction, prevents the farm operator from becoming nothing but a hired man and also seems to help prevent outside corporations from coming in, buying up the land, and then renting it out again. In other words, it keeps down absentee ownership of land. The legislators contacted felt that it was important to keep the ownership of land in North Dakota, and if possible in the farmer actually farming the land.

One major problem is created by this restriction. That problem has to do with income received from oil and mineral royalties. There are times when the income from such royalties will exceed the 20 percent allowed by the statute. This section could be amended to exempt income from oil and mineral royalties and still maintain the desired protection.

There is one area which should be of primary concern to future legislatures. This is the area which constitutes the penalty section of the statute, NORTH DAKOTA CENTURY CODE Section 10-06-06. As it stands now, if any corporation should violate any provision of the statute, title to the land would escheat to the county which would sell the land and remit the proceeds, minus expenses, to the corporation. This is too drastic a penalty, especially if the violation is committed by one shareholder out of spite or vindictiveness or even innocent intent. One possible solution is to incorporate into the statute a grace period of two or three years during which time the corporation could make an effort to reconform with the law. If they still haven't conformed after such a period, then the county state's attorney could take action. There would be less chance of innocent persons being injured this way. An adequate penalty clause is necessary to have an effective law but there is no adequate penalty clause presently. The clause as it presently stands was written for a bill that had the opposite intent of the present act.

There are a few alternative clauses which might be added which have not yet been mentioned, yet are worthy of consideration. The writer will not attempt to discuss them in detail, but thinks they should be listed. Some of these are incorporated into the laws of other states; some are not.

1. It might be well for us to investigate the possibility of allowing a person to be a shareholder in only one agricultural corporation.²³
2. Perhaps one could arrive at an acreage limitation based on the average size farm in a county and set a limit of five times the average acreage.²⁴ If a corporation owns land in more than one county, then perhaps the average of the two counties could be used. It would be foolish to attempt to apply the same acreage requirement for all farms, especially in North Dakota where the type of land is so different. Five-thousand acres in the Red River Valley is considerably more valuable for farming than five-thousand acres in the Bad Lands.
3. We could require that at least one of the shareholders actually have an active part in farming the land. This would tend to insure that the farm operator would be an owner, and thus have more than just a passing interest in his job.
4. One state has a requirement that all shareholders must be

23. KAN. GEN. STAT. ANN. §§ 17-2701 (1964).

24. Proposed amendment by George Sinner to H.B. 594, 1965 Legislative Session.

a resident of the state.²⁵ A provision like this would keep outside corporations from taking over large tracts of land. However, it would prohibit a farmer from leaving shares in the agricultural corporation to a son or daughter who lives outside the state. A section like this is not needed as long as we restrict shareholders to natural persons or estates of natural persons, and keep the requirement that a corporation can only earn 20 percent from rents, etc.

NEIL FLEMING*

25. *Supra* note 23.

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Howard L. Gorden, Executive Secretary, North Dakota Farm Bureau; Stuart McDonald, Representative, 18th Legislative District; Clifford Moquist, Representative, 11th Legislative District and Member of the House of Representative Agricultural Committee; Robert Sanders, Research Director, North Dakota Farmers Union; George Sinner, Former State Senator from Cass County; Grant Trenbeath, State Senator, 11th Legislative District and Member of Senate Agricultural Committee; and Serge Garrison, Code Revisor Legislative Research Committee.

APPENDIX

HOUSE BILL No. 782

For an Act to create and enact section 10-06-07 of the North Dakota Century Code, authorizing small corporations to engage in farming and ranching operations, providing limitations thereon, and to repeal section 10-06-01, 10-06-02, 10-06-03, and 10-06-05 of the North Dakota Century Code, relating to the prohibition of corporate farming.

SECTION 1. Section 10-06-07 of the North Dakota Century Code is hereby created and enacted to read as follows:

10-06-07. CORPORATIONS ALLOWED TO CARRY ON FARMING AND RANCHING OPERATIONS — LIMITATIONS.) Any corporation may own real estate and carry on farming or ranching operations, if such corporation meets the following standards:

1. The shareholders shall not exceed ten in number.
2. The corporation shall not have as a shareholder a person, other than an estate, who is not a natural person.
3. The corporation shall not have more than one class of shares.
4. The corporation's income from rent, royalties, dividends, interest, and annuities does not exceed twenty percent of the corporation's gross receipts.

Notwithstanding any provisions of this Act, a corporation prohibited from owning shares may hold such shares as acquired by bequest or devise or as are acquired in the regular course of business in partial or full satisfaction of any mortgage, lien, or other encumbrance held or owned by such corporation on such shares, provided such shares are sold or otherwise transferred within ten years to a person qualified as a shareholder under this Act. Any corporation not meeting the specifications and standards set out in this Act may not engage in the business of farming or ranching or own lands suitable for farming or ranching, which are not reasonably necessary for the conduct of its business.

SECTION 2. REPEAL. Section 10-06-01, 10-06-02, 10-06-03, and 10-06-05 of the North Dakota Century Code are hereby repealed.

