Resolving Rural Disputes: common partnership problems

Alexandra Smith, an Associate in our rural property and infrastructure team, explores common partnership problems and recommended methods of resolving disputes.

Many farms in Scotland are farmed by family group businesses who work together in partnership, whether harmoniously or otherwise! In Scotland, a partnership has a separate legal identity. It can own property, it can be a debtor and it can enter into contracts with its partners.

Even though Scots law partnerships have these attributes, any change in the membership of the firm means that a new firm is created. However, if the business being 'taken over' by the new firm is substantially the same as the old firm, it takes over the whole liabilities and assets of the old firm. In essence, the new partners take on the responsibility for the old partners' actions. Already, there is potential for a variety of disputes to arise simply because of the nature of the business.

The mere fact that the parties involved in farming partnership are often family members, means that it is a particularly sensitive and, therefore, ultimately contentious area of our practice. There can often be power struggles between parent and child or between siblings; or even between spouses who are in partnership together.

In the majority of cases, partners fall out with one another because of a lack of communication. Frank, open conversations that could address underlying issues are simply not had; whether that be due to the lack of time, the inability of the family head to pass on responsibility or because of the reluctance to have a difficult conversation.

Issues that are never addressed will invariably cause resentment between the partners, and result in a partnership fall out at a future date.

It is of utmost importance, therefore, that the partners should make time to have these open, transparent and sometimes difficult conversations to settle and address any underlying concerns before they fester into something that cannot be fixed. Although, perhaps such conversations are best not had around the Christmas dinner table!

Partnerships are created in two ways. Firstly, by virtue of a written partnership agreement. The partnership agreement should (amongst other things) contain the following provisions:

1. Detail the assets belonging to each party. This is extremely important if, for example, one partner has purchased an asset from their personal savings, but that the partnership has thereafter used that asset in the course of the business. That could include anything from a vehicle, to a piece of machinery or land. If the agreement does not specify that a certain asset belongs to an individual partner, but that it is reflected in the partnership accounts, then it may be construed that the asset belongs to the partnership, and upon dissolution of the partnership, its value would be divided between the partners according to their interest in the firm.

2. The agreement should regulate the division of the capital and income profit and losses. If the agreement is silent on this, then all of the partnership assets are deemed to be held in equal proportions. In reality, though, this may not be the case.

3. The partnership agreement should be clear as to when, or if, a partner can be expelled (whether that be because of behaviour, insolvency or otherwise) and what happens to their interest on such expulsion. Notice provisions should be included, and followed correctly.

4. The provisions in the expulsion clause would be similar for the clause detailing the death and retirement of a partner. The agreement should contain provisions for valuing the exiting partner's interest in each of these circumstances – this might either be on their 'book value', as provided for in the latest set of accounts, or to be re-valued at the date of exit.

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Accordingly, careful consideration should be given in each partnership agreement to reflect the agreement between the parties at that time. Particular consideration should be given to reflecting the assets owned by each partner in the agreement, alongside how these should appear on the balance sheet. In addition, it should be borne in mind whether provision for any exiting partner's share in the partnership to be paid out over a number of years is required to ensure that the business can carry on.

The agreement should be reviewed and updated regularly. There are countless times when we have been asked to provide a view on a partnership agreement clause that is simply out of date, or does not serve the purpose for which it was intended. As circumstances in both the business and family change, so should the partnership agreement.

A partnership can also be formed without a formal partnership agreement, but simply where two or more people carry on business together. This creates a partnership at will, governed by the Partnership Act 1890. This means that the partners will not have any carefully considered clauses to fall back on in the event of a fall out. A partnership governed by the 1890 Act alone may be dissolved by any of the partners at any time. If relations are hostile then this may lead to court action to resolve any dissolution arguments. Likewise, the only provision for expelling a partner for behavioural reasons is to dissolve the partnership if agreement cannot be reached. This puts the misbehaving partner in a better position than they would be if there was a partnership agreement to prescribe the method for expulsion.

In our experience acting for various acrimonious partnership dissolutions, the partnership agreements were woefully out of date and unhelpful in deciding how to deal with the exit from the partnership. Without taking a court route, agreements governing each partner's exit from their respective partnerships were drawn up. Such agreements detailed how land, stock and plant and machinery were to be split between each party with payment provisions for any short falls. This exercise involves tax, accountancy and valuation advice. If parties cannot agree terms such as this, then an alternative solution to resolving such a dispute would be to go to arbitration to seek to have the proper meaning of an ambiguous clause determined. Often, a partnership agreement will have a clause requiring partners to go to arbitration to resolve differences. Such a clause is contractually binding on the partners.

Of course, Court action is an alternative remedial forum in determining arguments. We have advised clients who have taken the monumental decision to apply to the Court of Session to have the Court appoint a judicial factor to wind up the firm. A judicial factor will, essentially, step in to the shoes of the partners and take control of the business, either operating it by making all necessary decisions or, more likely, winding it up, selling its assets and distributing the net proceeds between the partners.

Instructing a judicial factor is a way out for any partner who is in a difficult position, but heed the warning that this option should only be exercised if the partner has the appetite to see it through, and is willing to take the risk that Court action inevitably poses.

The final, and for some the most controversial and undesirable, option is to have open and frank conversations with the partners! If partners are not on the same wavelength, then such conversations can nip any issues in the bud at the outset, and will certainly avoid the need for future litigation. Effective planning, consulting and consideration in partnership agreements will, hopefully, pave the way for the future generations. Having clear, concise and up to date partnership agreements should be the first and foremost priority to ensure a smooth running of the business.

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