Ham–fisted

Luke Busbridge considers the lessons from a recent case on handling farming partnerships

Luke Busbridge is a consultant at Muckle LLP

It is a regrettable fact that among farming families, the death of a parent frequently leads to the break-up of the family farm. Family farming partnerships are often informal, and in many cases the way in which they operate is undocumented. Why, some families will ask themselves, might a written agreement be needed when there are only a few partners and everyone knows how the business operates? Others may have a written agreement, but that document may be antiquated and may not reflect current working practices, or indeed the identity of the current partners. Many of these families will wonder why they should instruct expensive professionals for the sake of what they feel is simply a paper exercise.

However, this approach can be fraught with pitfalls. The background to historic transactions may become hazy in the surviving partners' minds, or only be partially understood in the first place. With the death of a long-serving partner, a wealth of knowledge can be irretrievably lost. An operating procedure that may have a perfectly justifiable reason can end up being regarded as the norm for no other reason than 'We've always done it this way'. Worse still, significant questions can arise over how assets are to be valued and divided, or indeed whether certain assets are or are not partnership assets, when a partner exits the business. If there is no written partnership agreement, this can lead to significant complexity, not to mention litigation.

As we shall see, *Ham v Ham* [2014] and *Ham v Bell* [2016] are each a case in point, as well as a salutary lesson for farmers and practitioners to 'do things properly' when documenting arrangements between partners.

'It is essential to have a properly drafted partnership agreement that sets out what are and are not partnership assets, and defines the basis on which they are to be valued.'

Background and facts

Ronald and Jean Ham were lifelong dairy farmers. After marrying in 1967 they acquired a modest holding of just over 12 acres and farmed it in partnership. The success of the business enabled them to buy Lower West Barn Farm, in Somerset, in 1986. The new farm originally comprised the farmhouse, farm buildings, and around 220 acres of land. Over the years Ronald and Jean expanded the holding by buying in and renting additional land, so that it eventually grew to around 550 acres of owner-occupied land and about 350 acres of rented land.

Ronald and Jean had three children: Judith, Catherine and John. All three children had worked on the farm, but Judith and Catherine ceased to do so when they left home. John, having started working on the farm at around the age of eight, left school at 16 to work full-time with his parents. On 1 October 1997 Ronald and Jean brought John (who was 19 at the time) into the business as a partner, and the three of them signed a farming partnership agreement on 15 December 1997.

In 2009, differences of opinion began to arise over the direction of the partnership, and John served notice to dissolve the partnership on 27 February of that year. Under the partnership agreement, this (as we will see) enabled him to be bought out by Ronald and Jean. However, a dispute arose between John on the one hand and his parents on the other hand as to the basis on which the buyout was to be effected. At first instance, the trial judge ruled that as a matter of interpretation of the partnership agreement, John was to be paid out by reference to the book value of the partnership assets as shown in the partnership accounts, and not by

reference to their market value at a particular date.

The market value of the land occupied by the partnership had risen considerably since John had joined the business, and was significantly higher as at 27 February 2009 than at its book value in the accounts. Somewhat unsurprisingly, John appealed against the trial judge's decision.

The partnership agreement

The written agreement between the partners – and the intention of the parties – is central to this dispute. Given its centrality throughout the litigation, the relevant parts have been reproduced in full:

> 3.1 The capital of the partnership shall consist of the following items:
>
> (a) Such assets as are specified in a statement of affairs to be prepared by Messrs Hucker & Booker Chartered Accountants… which assets shall be credited to the Partners as therein specified
>
> (b) Any further sums or assets which any Partner may with the consent of the others from time to time contribute for capital purposes which shall be credited to his or her capital account
>
> 3.2 The Partners shall keep books of account and such other records as are usual in a business of the same type as the partnership business and such accounts shall in addition show the account of each Partner in respect of his or her share of the capital and the profits of the partnership
>
> […]
>
> 3.5 The financial year of the partnership shall end on 28th February each year and an annual balance sheet and profit and loss account shall be prepared as at that date and as soon as possible afterwards showing what is due to all Partners in respect of the capital and profits of the partnership. Such balance sheet shall forthwith be signed by all Partners who shall be bound by the contents of the balance sheet and the profit and loss account unless some manifest error is found within 6 months after he or she has signed in which case such error shall be rectified
>
> 3.6 All Partners shall be entitled to draw out of the partnership bank account on account of his or her share of the profits such monthly sum as shall be agreed between the Partners. As soon as the Partners have signed the balance sheet they shall agree to make such further drawings (or repayments as the case may be) in respect of profits or capital or both as are prudent in the circumstances having regard to the requirements of the partnership business
>
> […]
>
> 4.1 The partnership may be terminated by any of the Partners giving to the others not less than three months' notice in writing at any time
>
> 4.2 If the partnership is terminated in any way then the partners to whom notice is given or the surviving or solvent Partner or Partners on whose application an order for the dissolution of the partnership was made may within twenty-one days after the notice was given or the event occurred which gave rise to the termination give notice to the other Partner or Partners or his or her personal representatives trustee or receiver as the case may be electing either to have the partnership wound up under the Partnership Act 1890 or to purchase the share of the other Partner or Partners [at] the net value of such share
>
> 4.3 The net value for the purpose of clause 4.2 shall be agreed between the Partners or their respective successors (as the case may be) or in default of such agreement shall be determined by the partnership accountants. In so determining the accountants shall act as experts and not as arbitrators and their professional charges shall be borne by the Partners in equal shares…

Unfortunately, clause 4.3 does not set out the basis on which 'net value' was to be assessed; and that was the main source of the dispute.

The market value of the land occupied by the partnership had risen considerably since John had joined the business.

The partners' capital

Before John joined the partnership, Ronald and Jean had owned all the land occupied by the business, along with all the buildings, farm machinery, and live and dead stock. John did not introduce any capital of his own on becoming a partner.

The partnership accounts dated 28 February 1997 showed:

- fixed assets consisting of freehold property, plant and machinery, vehicles, agricultural buildings, and milk quota;
- current assets and current liabilities; and
- long-term liabilities.

Once the liabilities had been deducted, the accounts showed a balance of around £1m, represented by Ronald and Jean's partnership capital account. The land was included at book value.

The accounts for the first year after John had joined the partnership were in a similar format to the previous set. The main difference was that John's capital account, having started at zero, showed an adjustment for his share of profits made during the year. A similar pattern continued in subsequent years. Periodically the milk quota and stock were revalued and the partners' capital accounts were adjusted to reflect that, but the land was never revalued and remained in the balance sheet at book value. Any further acquisitions of land also went into the accounts at book value.

In 2004, following discussions with the partnership accountants, most

of the land farmed by the business was removed from the accounts, and Ronald and Jean's capital accounts were reduced accordingly. We will consider this point further below.

The partnership accounts

After serving his dissolution notice, John contended that he had to be paid out by reference to the market value of his 'share' of the partnership assets. He also argued that he and his parents had intended the land and buildings to become a partnership asset when he joined the business. By that reasoning, the amount due to him should have included the cash value of a fractional interest in the land, at *market* value, as well as his share of profits.

Ronald and Jean's argument was that John's payout had to be calculated by reference to the *book* value of the partnership assets, because that was what the accounts showed. The land had never been revalued in the accounts prior to its removal in 2004, and John had never contributed any land to the business. Ronald and Jean also argued that the land had never become a partnership asset in 1997: it had been included in the accounts by mistake, and its removal in 2004 was simply in order to iron out that error. On that basis, what was due to John, in their view, was a cash sum in respect of his share of profits and of any capital assets owned by the business, based on their respective *book* values shown in the accounts.

Book value or market value?

John's argument had significant ramifications. On the one hand, if the book value approach was taken, then after John's departure, Ronald and Jean would probably have been able to retain the land intact and farm it until their deaths, having paid him cash in accordance with the accounts. John argued that this would have disadvantaged him considerably, because of the wide disparity between the market value of the land and the book value shown in the accounts, and that he would have been short-changed. On the other hand, though, if the market value approach was taken and the accounts were disregarded, the farm would have to be broken up and sold in order for John to be paid out, because the business did not have enough liquidity to achieve that in any other way.

The court rejected the notion that an outgoing partner's 'share' on a buyout should be restricted to a proportion of profits and capital cash.

The Court of Appeal (in *Ham v Ham*) acknowledged that the wording of clauses 3 and 4 of the partnership agreement was far from straightforward. In particular, clause 4 was inconclusive by itself as to the amount to be paid to an outgoing partner, because 'net value' and 'share' were not clearly defined expressions in the context of a buyout. The court rejected the notion that an outgoing partner's 'share' on a buyout should be restricted to a proportion of profits and capital cash, because in the event of a winding-up under clause 4.2 (as opposed to a buyout), all the partnership assets would have to be sold anyway, and their proceeds distributed between the partners along with undrawn profits and capital cash. Instead, it confirmed that 'share' included a proportionate part of the value of the underlying business assets as well as profits.

The court – somewhat reluctantly – concluded that the accounts were not, by themselves, definitive as to how the partners had intended to value the partnership assets on dissolution or buyout. Given the wording of clause 4.2, it ruled that John was entitled to a share of the partnership's entire asset base, 'fairly ascertained as the nearest reasonable approximation to what [he] would have received on a winding-up' (Lewison LJ at para 56). In other words, the market value approach applied.

To assist in the decision-making, one of the judges, Rimer LJ, consulted the reasonable person for their opinion (para 67).

He concluded that the reasonable person would think it manifestly unfair if John was not paid out on a market value basis, because otherwise he would be hugely short-changed if Ronald and Jean later sold up and pocketed all the gains, having paid him out at book value. Furthermore, he noted, if the parties had intended a different outcome, they could have expressly provided for that in the partnership agreement.

All three Court of Appeal judges expressed some regret at reaching their conclusion, not least because as one of them – Lewison LJ, at para 40 – noted, John was likely to receive a substantial windfall in taking a share of the land. However, it noted that the quantum of any such windfall would depend on whether or not the land had been a partnership asset. That question was considered when the case returned to the High Court in *Ham v Bell*, by which time Ronald had died.

Another pig's ear?

Judge McCahill QC (who had also been the trial judge at first instance in *Ham v Ham*) considered whether the farmland and buildings had become a partnership asset when the new partnership began on 1 October 1997, because of their appearance in the partnership accounts from 1998 to 2003. John argued that they had. Ronald and Jean's case was that they had not, and that their appearance in the accounts was an error that was only ironed out in 2004, when they were removed. Furthermore, it was argued, John had always known that they did not intend the land and buildings to become partnership assets when he became a partner.

John argued that there was an implied agreement between himself and his parents that the land and buildings had become partnership assets, based on the conduct of the parties and the 1998-2003 accounts. Not only had the land and buildings been in the accounts between 1998 and 2003, but the partnership had purchased additional land and paid for improvements to the buildings during the same period. As a result, John argued, he had acquired a fractional share of the farm and the land and buildings had to be shown in the partnership accounts, because it was partnership property.

Judge McCahill QC identified three main questions that needed to be decided (paras 17-20):

(1) Did the inclusion of the farm in the accounts at book value between 1998 and 2003 mean (by itself) that the farm had become a partnership asset on 1 October 1997?

(2) If the answer to (1) above was yes, was that the result of a mistake that Ronald and Jean could have rectified, either by agreement or by the court?

(3) Did the fact that all the parties had signed the partnership accounts from 2005 to 2008 (which omit the farm from the balance sheet) prevent John from claiming that the farm was a partnership asset?

Accounts, improvements and land purchase

John contended that the partnership accounts were wrong: although they had been signed by all three partners between 2005 and 2008 (when the farm was *not* shown in the balance sheet), they should in his view have been signed for the 2002 and 2003 accounting years as well (when it was). Furthermore, he argued, the partnership had paid for improvements to the land between 1998 and 2003, which was further evidence of the implied agreement above. Ronald and Jean countered, however, that as the landowning partners, they were simply making the farm available to the partnership rent-free; the fact that the partnership had purchased additional land and paid for improvements did not prove anything either way and nor did the accounts.

The court found that the accounts, improvements and land purchase were not sufficient evidence of the implied agreement posited by John. Judge McCahill QC noted that John was not called upon to pay any rent for use of the farm. He also considered it to be in all the partners' interests that the business should spend money improving fixed equipment, particularly since those improvements enabled the partners to make further profits. The judge observed in particular at para 48:

> Of course, any court which infers or implies an agreement is doing so on the basis of outward and objective signs or appearances of such an implied agreement. Yet the law does not impose an agreement on parties where subjectively neither of them intended to create one, even if objectively it appears as if an agreement was made.

The judge went on to note that partnership accounts can *help* to establish whether or not an asset is owned by a partnership if (say) one partner argues that there was an express agreement to that effect, and another argues the opposite. In that situation, he observed, accounts can help the court to decide whose recollection is more reliable. However, in his view, accounts were 'no more than evidence, and if they do not reflect what was agreed, they fall to be disregarded', thus following the reasoning in earlier cases such as *Miles v Clarke* [1953] and *Barton v Morris* [1985].

The court found that the accounts, improvements and land purchase were not sufficient evidence of the implied agreement posited by John.

Intentions of the accountants, Ronald and Jean

The judge also considered the intentions of the accountants and of Ronald and Jean. He noted that the land had remained in the accounts between 1998 and 2003. However, he also considered it significant that there had been a change of accountants in 2004, when a different firm was appointed and the land was removed from the accounts. The previous accountants had prepared partnership accounts for the old partnership prior to John's admission to the business, and then from 1998 to 2003. In 2004, however, the new accountants removed the land from the accounts after taking instructions from Ronald and Jean, conducting their own enquiries, and noting the absence of any holdover relief elections.

The court paid particular attention to the lack of any claim for holdover relief. The judge noted that if Ronald and Jean had intended to add the land to the partnership, they would have

FAMILY LAW JOURNAL

Clear and concise articles in plain English, tackling real and relevant issues in family law

For a **FREE** sample copy, call us on 020 7396 9313

made a deemed disposal for capital gains tax (CGT) purposes as per HMRC's Statement of Practice D12. That disposal would have had to be reported to HMRC, coupled with a claim for holdover relief in order to avoid an immediate CGT charge. In the judge's view, the lack of any such claim was a further point against any transfer of the land to the business, because otherwise Ronald and Jean would effectively have volunteered CGT. He therefore agreed that the removal of the land from the accounts in 2004 was simply a tidying-up exercise, to correct the error. The judge also noted, at para 64, that there had been other potential errors besides this: before 2004, some shares owned by Ronald and Jean personally had been included as partnership assets, and the dividend income from those shares had been (wrongly) treated as partnership income. Again, those issues were ironed out in 2004, when the new accountants took over.

The court then went on to consider whether Ronald and Jean had *ever* intended the land to become a partnership asset. In this regard the provisions of their wills were material, as they distinguished between the different classes of asset used in the business. Ronald's will, for example, made gifts of 'the whole of my interest in [the dairy herd and beef cattle] *belonging to the farming partnership of RW and LJ Ham & Son*' (emphasis added). On the other hand, it made separate gifts of '*the whole of my interest in the realty which I own* at the date of my death' and '*the whole of my interest* in the two blocks of agricultural land, formerly part of Lower West Barn Farm [as described in the Schedule thereto]' (emphasis added in both instances). Jean's will, which was drafted on mirror lines, contained similar gifts.

Judge McCahill QC found the wording of the wills persuasive, and found it noteworthy that the stock and land were described in different ways (para 78):

> Ronald and Jean in their mirror wills were distinguishing between the disposal of their interest in a partnership asset on the one hand and a gift of their beneficial interest in the farm on the other. The former was qualified by reference to the partnership name; the latter was not.

Ronald and Jean understood the stock to be owned by the partnership, and the land to be personally owned property.

In other words, Ronald and Jean understood the stock to be owned by the partnership, and the land to be personally owned property; and sought to dispose of those assets correspondingly. The land was found not to be a partnership asset.

The courts' decisions

Pulling the two cases together, the courts' observations can be summarised as follows:

- There was no evidence to suggest that the farm actually became an asset of the new partnership in 1997 or was intended to become partnership property.
- There was no evidence that John and his parents had agreed (either expressly or impliedly) that the farm would become a partnership asset in 1997; nor was there anything to suggest that the matter had even been discussed.
- The land had been rolled forward into the accounts of the new partnership by mistake in 1997, and its removal in 2004 was simply a tidying-up exercise to correct that error.
- John's entitlement following the dissolution was a contractual one under the family partnership agreement, the quantum of which depended upon the correct interpretation of that document.
- As a general principle, it is wrong to apply any special default rules or presumptions that might point towards one basis of valuation rather than another when valuing an outgoing partner's share of the business: the interpreter must start with the partnership agreement and work from there, taking account of any relevant and admissible background that might help an informed reader to understand what the partnership agreement means.
- Even though the market value approach was the correct one, it ultimately proved nugatory for John, because the land was found not to be a partnership asset.

Concluding observations

This is a finely nuanced pair of cases. At first sight, their application might appear slightly narrow, because of the particular facts involved. However, when looked at in the round, they contain clear messages for accountants and solicitors alike:

- It is essential to have a properly drafted partnership agreement that sets out what are and are not partnership assets, and defines the basis on which they are to be valued.
- The partnership's accounts should be reviewed regularly by the partners and their accountant, to ensure that the accounts and partnership agreement are on all fours.
- Clear notes of meetings and discussions between partners and their professional advisers should always be taken, to ensure that the parties' intentions are documented.
- Practitioners should meet regularly with their farming clients to ensure that their partnership documentation accurately reflects the parties' intentions. Older partnership agreements may become ossified through the passage of time, and to paraphrase Theresa May – albeit in another connection – no agreement is better than a bad agreement. ■

Barton v Morris
[1985] 1 WLR 1257
Ham v Bell & ors
[2016] EWHC 1791 (Ch)
Ham v Ham
[2014] WTLR 255
Miles v Clarke
[1953] 1 WLR 537