Partnership Disputes and Remedies

David Bartos,

Advocate,

Fellow of the Chartered Institute of Arbitrators

Bartosarbitration.com

DISCLAIMER

Please note that the author does not assume any responsibility or duty of care whether contractual or delictual towards any person in respect of anything either written in this document. What is so written is offered strictly on that basis.

PARTNERSHIP DISPUTES AND REMEDIES

by

David Bartos, Advocate, Fellow of the Chartered Institute of Arbitrators

SCOPE OF THIS TALK

This paper is concerned with disputes between partners (or partners, ex-partners or their executors) in an unlimited liability partnership.

It is not concerned with :

(1) whether partnership exists; or

(2) liability of partnership or partners to third parties; or

(3) LLPs

A DIFFERENCE OR DISPUTE: THE BASICS

When a difference or dispute arises between partners what is the starting point ?

(1) the Partnership Act 1890;

(2) the written partnership agreement (if there is one)

The 1890 Act provides the <u>default</u> rules for the mutual rights and duties of the partners.

E.g. Section 19: "The mutual rights and duties of partners, whether ascertained by agreement or defined by this Act, may be varied by the consent of all the partners, and such consent may be express or inferred from a course of dealing"

E.g. Section 21: "Unless the contrary intention appears, property bought with money belonging to the firm is deemed to have been bought on account of the firm."

E.g. Section 24 : "The interests of partners in the partnership property and their rights and duties in relation to the partnership shall be determined, subject to any agreement express or implied between the partners, by the following rules…"

Gaps in a partnership agreement are inevitably filled in by the Act (as encrusted by the case law).

The Act, though written in 1890, was written as a code of partnership law and the language is intended to be relatively user-friendly.

The "course of dealing" provision in s.19 is important, particularly in relation to any practice in the accounts that is accepted, e.g. the allocation of profits, payment of a salary (prohibited under the default rule (s. 24 rule (6)).

DECISION MAKING

(A) The general default rules – s.24

"Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners". (s. 24 (rule (8))

"Every partner may take part in the management of the partnership business" (s. 24 (rule (5)).

That last rule is an expression of the principle that partnership is a relationship of "*uberrima fides*" – utmost good faith.

". . . the Court presupposes in every contract, and if there can be a difference, more especially in every contract of partnership, a basis of good faith, upon which all the stipulations contained in the deed must rest." **Blisset v. Daniel** (1853) 10 Hare 493, 522 per Sir W. Page Wood V.C.

"This [a fiduciary duty to fellow partners] is elementary in contracts of partnership. "*In societatis contractibus bona fides exuberet*"; partners must act in the utmost good faith. "For a majority of partners to say: We do not care what another partner may say, we, being the majority, will do what we please, is … what this Court [of Equity] will not allow"—Lord Eldon in Const v. Harris, (1824) Turn. & Russ. 496, at p. 525. In Beveridge's case (1872) 10 M (H.L.) 1) —a co-partnery case—the same law was laid down by Lord Justice-Clerk Patton. The Court may interfere "if there was not the exercise of discretion" but "something done plainly beyond and in excess of what was right for the administration of the company." In the leading case of Blisset v. Daniel related to the expulsion of one partner by the partners holding a majority of the copartnery shares, Vice-Chancellor Page Wood (afterwards Lord Hatherley) stated (at p. 524) that "A power so conferred by the co-partnery articles exercised by partners holding a majority of shares must be understood to exist, not for the benefit of any particular parties holding two-thirds or more of the shares, but for the benefit of the whole society." The purported expulsion was held by the Vice-Chancellor, at the instance of the expelled partner, to be in the equity sense "a fraud upon the power" vested in the majority of the partners." **Harris v. A. Harris Ltd** 1936 S.C. 183, 204 – 205 per Lord Murray.

So if a partnership meeting is to be held all partners must be invited to attend. To fail to do so is to breach the utmost duty of good faith contained in the default rules.

At the meeting the partners must be heard out – the power of the majority must be exercised in good faith for the benefit of the partnership and taking account of minority views

Minority does not have a right to talk to obstruct the meeting (**Const** (above); and **Wall v. London and Northern Assets Corporation** [1898] 2 Ch 469, 480). No obligation to give more than a reasonable time for the expression of a point of view.

(B) Introduction of a partner

For introduction of a partner the default rule is that the consent of all partners is required (s. 24 (rule (7)).

(C) Expulsion of a partner

For expulsion the default rule is that "no majority of the partners can expel any partner" (s. 25). For expulsion there must be an express provision in the partnership agreement.

For expulsion utmost good faith and fairness requires

- The power to be exercised only for the benefit of the partnership, and not other motives;
- the partner in question to be given notice of the general grounds of proposed expulsion (**Blisset** (above)), and
- the partner in question to be given an opportunity of a hearing or to make representations.

REMEDIES FOR BREACH OF MANAGEMENT RULES

General: Court or arbitrator

Many partnership agreements have arbitration clause. Arbitrators have all of the powers to grant interdict (including provisional interdict), specific implement, reduction, declarator or damages that a court has (which can be enforced by the court under r.46 of the Scottish Arbitration Rules (in the Arbitration (Scotland) Act 2010)).

(A) Interdict and Specific Implement

Partnership is a contract. Reasonably apprehended future or ongoing breach by a partner or partners to another partner, involves a wrong which can be interdicted, if urgent, by interim interdict.

Will be unusual for the court to grant specific implement but in principle it is possible.

(B) Suspension, Reduction, and Declarator

If a decision has been already taken, then its effect can be suspended by an order of interim suspension and permanently annulled through raising an action for reduction of the decision.

An action of declarator may be another flexible remedy to have the unlawful conduct declared null and void e.t.c..

(C) Dissolution

"On application by a partner, the Court may decree a dissolution of the partnership . . .

. . .

(c) When a partner, other than the partner suing, has been guilty of such conduct as, in the opinion of the Court, regard being had to the nature of the business, is calculated to prejudicially affect the carrying on of the business:

(d) When a partner, other than the partner suing, wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable for the other partner or partners to carry on the business in partnership with him:

. . .

(f) Whenever in any case circumstances have arisen which, in the opinion of the Court, render it <u>just and equitable</u> that the partnership be dissolved."

(s. 35 of the 1890 Act)

"just and equitable" can include the loss of mutual confidence between the partners rendering continuation of the business impossible (**Atwood v. Maule** (1868) 3 Ch.App. 369, 373)

e.g. where the partners disagree over the handling of a serious court action against the firm (**Harrison v. Tennant** (1856) 21 Beav. 482)

e.g. breach of duties of utmost good faith mentioned earlier

Some guidance can be had from quasi-partnership company cases.

Procedure is by petition (Court of Session) or summary application (sheriff court)

If there is a sufficiently wide arbitration clause (or other arbitration agreement) it may be possible to obtain a declarator of dissolution from an arbitrator (**Hackston v. Hackston** 1956 S.L.T. (Notes) 38)

(D) Appointment of Judicial Factor

"On the dissolution of a partnership every partner is entitled, as against the other partners in the firm, . . . to have the property of the partnership applied in payment of the debts and liabilities of the firm, and to have the surplus assets after such payment applied in payment of what may be due to the partners respectively after deducting what may be due from them as partners to the firm;

and for that purpose any partner or his representatives may on the termination of the partnership apply to the Court to wind up the business and affairs of the firm."
(s. 39 of the 1890 Act).

This can be sought at the same time as dissolution or later. Winding up is by means of the appointment of a judicial factor. But court will only appoint the factor if there is no other satisfactory means of winding up the affairs of the firm e.g. fear of dissipation of or damage to assets, or deadlock between the partners. Court will view this a judicial factor as a last resort.

An interim judicial factor may be appointed (**McCulloch v. McCulloch** 1953 S.C. 189) in situations of urgency.

(E) Damages

Unclear if this is competent since the loss from a decision will affect principally only the partnership property (the firm being a separate entity from its partners) and only indirectly the partner's share.

RETIREMENT/RESIGNATION AND DISSOLUTION BY NOTICE

Default rules for retirement/resignation are in s. 26.
Default rules for dissolution by notice are in s. 32.

Relationship between them is not entirely clear. Often they are viewed together. Perhaps notice of intention to determine under s. 26 relates to a wish not to have the partnership as a whole dissolved and wound up but simply to have his role terminated and his share paid out while allowing the partnership to continue.

A right to retire or resign from a partnership may be excluded by agreement (**Moss v. Elphick** [1910] 1 K.B. 846 – excluded for lifetime of the partners)

A right to dissolve under s. 32 may be excluded in the partnership agreement by provisions providing for duration to be until termination “by mutual agreement” (**Maillie v. Swanney** 2000 S.L.T. 464)

Default rules draw distinction between –

- “fixed term” partnerships
- “no fixed term” or “undefined time” partnerships.

For the “fixed term” partnerships resignation/retirement and dissolution are excluded.

For “no fixed term” or “undefined time” partnerships the default rule allows retirement/resignation under s.26 with a written notice. <u>The notice should be given to all of the other partners.</u>

Thus important that these default rules be remembered when drafting or considering the effect of a partnership agreement, to see (a) whether they should be excluded; or (b) whether they have in fact been excluded with appropriate buy-out provisions of the retiring partner.

DEATH AND BANKRUPTCY

The default rule (s. 33) is that death and bankruptcy dissolves the whole partnership.

Often excluded to allow the surviving partners to buy out the executor or trustee of the deceased or bankrupt partner. Similar to retirement.

However, if s. 33 is not excluded (or other settlement with the executor or trustee reached) remember: the default rule will apply and the dissolution of the firm will take place – with consequent restrictions on carrying on business - and winding up must begin (if not by the partners then by a judicial factor).

LEAVER'S RIGHT TO CAPITAL AND INTEREST/PROFIT SHARE

Important to distinguish:
(1) where partnership is continuing (because default rules have been excluded); and
(2) where partnership has dissolved.

In situation (1) the default rule is :

"Subject to any agreement between the partners, <u>the amount due</u> from surviving or continuing partners to an outgoing partner or the representatives of a deceased partner in respect of the outgoing or deceased partner's share <u>is a debt accruing at the date of the dissolution or death</u>."
(section 43)

Despite the reference to "dissolution or death" the right to capital/obligation to pay capital also applies to a retiring partner (**Sobell v. Boston** [1975] 1 W.L.R. 1587, **Beckman v. I.R.C.** [2000] S.T.C. (SCD) 59).

The right to capital will apply to an expelled partner unless it is excluded (or possibly, if the expelled partner has materially breached the partnership agreement before his departure, regardless of any loss caused to the partnership).

(A) Capital

That sum of capital must be ascertained by reference to the accounts as at the date of departure.

General default rule is that accounts be “true” (s. 28) and therefore the assets must be revalued as at that date.

Default rule reflected in many partnership agreements by words such as “Proper books shall be kept and balanced” (**Noble v. Noble** 1983 S.L.T. 339 (appendix to **Thom’s Executrix** 1983 S.L.T. 335).

This means that if assets are not to be revalued the default rule must have been excluded by express agreement or a course of dealing giving rise to the inference that non-market values are to be used for asset valuations at dissolution (as in **Thom’s Executrix**).

English examples of exclusion of true value:
In re **White** [2001] Ch 393 (Court of Appeal)
Drake v. Harvey [2011] EWCA Civ 838
(both cases where non-market values were used – in **Drake** Arden LJ did not have s.28 referred to her)

(B) Interest/Profit share

The default provisions are in section 42:

> “(1) Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with its capital or assets without any final settlement of accounts as between the firm and the outgoing partner or his estate,
> then, in the absence of any agreement to the contrary,
> the outgoing partner or his estate is entitled at the option of himself or his representatives
> - to such <u>share of the profits</u> made since the dissolution as the Court may find to be attributable to the use of his share of the partnership assets, <u>or</u>
> - to <u>interest at the rate of 5 % per annum</u> on the amount of his share of the partnership assets.

> (2) Provided that where by the partnership contract an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised,
> the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits;
> but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section."

So not applicable in general where default dissolution provisions have been excluded to provide an option to purchase which has been exercised.

But where not exercised or complied with, outgoing partner is entitled to interest or profit share – more relevant to type (2) cases with dissolution.

The right to capital can be enforced by means of an action for production of the dissolution account and then payment of the capital account.

RIGHTS TO CAPITAL AND INTEREST/PROFIT SHARE ON DISSOLUTION

This is situation (2). Here the partnership has been dissolved.
Expectation of the law is that the partnership should be wound up by the partners and that it should cease to trade.

Its assets should be sold, its debts paid, and then the capital divided in accordance with the default rule in s. 44.

In the dissolution situation, the true value of assets and liabilities (and thus of capital) will not be known until the assets have been sold and debts paid. Thus the extent of the partners' entitlements will in general not be in terms of the accounts as at the date of dissolution (**Duncan v. The MFV Marigold** 2006 S.L.T. 975).

It will be contained in the accounts at the end of the winding up.

However usually, if the business is profitable, someone will wish to continue with it despite dissolution. In that case **section 42** will apply (already discussed).

Innocent partner will be entitled to make an <u>informed</u> election on the basis of accounts, to receive from the continuing partners either interest at 5%/annum or a share of the profit based on net assets of the firm as provided for in s. 42 from the date of dissolution until he receives his capital (**Sandhu v. Gill** [2006] Ch 456).

He may raise an action to force the production of the accounts to allow him to make the election.

As an ultimate threat the innocent partner (or any partner seeking payment) can petition for winding up of firm by the court and the appointment of a judicial factor, with further expense to all concerned, not to mention the loss of a functioning business. The factor would then liquidate the business, carry out the sales, payment of creditors e.t.c..

For that reason if unwelcome dissolution is threatened, early and informed action and agreement, at least on the means to resolve any dispute, is always desirable to preserve the business, its goodwill and the value of partners' shares.

INSPECTION OF THE BOOKS

An important remedy, often overlooked by silent partners. Section 24 rule (9) contains the default rule that the books are to be kept at the principal place of business of the partnership and that every partner may when he thinks fit, have access to and inspect and copy any of them.

Right may be enforced by action of exhibition for production to the court or for an order to allow inspection (order of implement/*ad factum praestandum*). The right of inspection can be exercised by an agent see eg **Till v. Morris** February 28, 2012 ChD available on Westlaw.

The right in rule (9) is in addition to the right of the partner and his legal representatives to full information (Section 28).

D.B. 01. 07. 2014