

Unravelling partnership disputes

The extent to which partnerships codify the relations between partners varies considerably: some have complex partnership deeds whereas others work on an informal basis. All partnerships, however, may experience disputes between partners and, even if a partnership deed exists, it may not address the issue which is the cause of a particular dispute. This newsletter discusses the financial aspects of four common issues which may cause disputes between partners.

Assets provided by the partners

If one or more partners lease premises to a partnership, there may be disputes as to whether the rent is fair and/or the extent to which specific costs are to be met by the landlord partners or by the partnership tenant. It may then be necessary to obtain expert evidence of market rent levels, to ascertain “normal” levels of service charges payable to third-party landlords and to seek advice on the division of costs such as refurbishment between landlord and tenant.

Individual partners may provide loans to a partnership and advice may be needed on interest and/or repayment terms. Alternatively, if funds provided by partners are credited to their capital accounts, there may be a dispute as to whether interest should be paid on these accounts if the partnership agreement does not provide for this. It will be important in such cases to consider whether interest has been paid in previous periods and whether all partners have been paid interest.

Division of profits between the partners

Disputes may arise from ambiguities in existing profit-sharing arrangements or if there is pressure for change, whether resulting from the prolonged absence of a partner or because one or more partners feel that there is a mismatch between contribution and earnings. It will be necessary in such cases to determine whether income and expense items have been treated consistently in the partnership’s accounting records from year to year and between the partners.

Profit-sharing disputes may require an independent review of accounting records and documents such as correspondence with third parties. Financial modelling techniques may be needed to assess the financial and tax implications for each partner of changes in profit-sharing arrangements.

Changes in the composition of the partnership

When partners leave a partnership, those remaining may be required to buy the outgoing partners' share of the firm's goodwill. There may be disputes over the valuation of goodwill unless a methodology has been established by precedent or by the partnership deed. If the computation of goodwill is based on turnover and/or profits over recent years, it may be necessary to exclude significant "one-off" items of income or expenditure or for the partners to agree on how these will be treated in addition to ensuring that the financial statements have been prepared on a consistent basis. In any event, the departure of one or more partners may cause difficulties if the outgoing partners wish to withdraw capital. The remaining partners may then need advice on financing options and on ways in which the partnership's cash flow can be improved.

If it is discovered that a partner has been diverting work, the other partners may expel the partner concerned and take action to recover the lost profits. These are likely to comprise the diverted turnover less the directly related costs (often staff costs) of producing that output.

Valuations of partnerships

Several factors need to be taken into account in valuing partnerships on a prospective sale, including valuation "norms" specific to the industry sector (e.g. professional practices may be valued on the basis of a multiple of turnover), proposals that part of the consideration be deferred, valuations of comparable businesses in recent sales and the possibility that an offer received may place too much emphasis on "one-off" factors affecting the business's past profitability.

Conclusion

In relation to the issues discussed above, it is often necessary to assess whether partners' capital and current accounts have been computed on an accurate and consistent basis. It is also essential to define the "real" issues in a dispute as exactly as possible and independent forensic accountancy advice may be required to help those involved to resolve the situation.

To obtain further details of our activities or to benefit from the firm's experience and expertise, please contact George Sim or Rakesh Kapila.

Please note that this newsletter has been written for the general interest of readers and is intended for guidance only. It is therefore essential to take specific professional advice before taking any action.

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