Resolving Rural Disputes: diversification on agricultural holdings

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Hamish Lean, Head of Rural Property and Business, examines diversification on tenanted holdings, addressing common questions posed by landlords and tenants.

Diversification is the term used for a non-agricultural activity carried out on a tenanted farm by the tenant. Prior to the introduction of a statutory right of diversification in the Agricultural Holdings (Scotland) Act 2003, tenants could only pursue a diversified activity on the farm without their Landlord's consent if it did not breach a specific prohibition in a lease and was on a very small scale. If a non-agricultural business became the predominant economic activity on the farm, the tenant was said to have "inverted possession", leading to the loss of the tenancy.

However, since 2003 agricultural tenants in all forms of agricultural tenancies – whether secure tenancies or short limited duration tenancies, limited duration tenancies and modern limited duration tenancies – all have a right to diversify subject to following the correct statutory procedures.

There is a wide range of diversified activities carried out on tenanted farms. Some have long pre existed the 2003 Act, some are carried out in accordance with the procedures under the 2003 Act and some have started informally since 2003 but without having gone through the statutory procedures.

In this article we will look at how to deal with all these situations. How do you treat the diversified activity for rental purposes? How do you best manage and run the diversified activity if you are the tenant? What do you do if you are the landlord faced with a Diversification Notice or want to bring an informal diversification to an end?

Notice of Diversification

First of all, a quick look at the statutory framework as set out in the 2003 Act. For those of you who enjoy reading statutory provisions they can be found in Part 3 of the Act, Sections 39 to 42. A tenant who wants to diversify must first of all serve a Notice of Diversification on a notice period of not less than 70 days. The notice has to specify what the non-agricultural purpose is, the land and/or buildings that would be used for this purpose, any changes to the land and buildings that the tenant proposes to make and the date on which the purpose will begin. Where the diversification is for a business purpose, the notice must also specify how the business is to be financed and managed. The notice must also address the grounds upon which the landlord can object.

How can a landlord object to diversification plans?

The landlord has an opportunity to request further information from the tenant and the tenant's refusal to provide that information is a valid ground of objection. Otherwise, the landlord can object if it reasonably considers that the intended use would:

- lessen significantly the amenity of the land or surrounding area;
- substantially prejudice the use of the land for agricultural purposes in the future;
- be detrimental to the sound management of the estate of which the land consists or forms part;
- cause the landlord to suffer undue hardship; or
- result in a business that is not viable.

As an alternative to objecting, the landlord can impose reasonable conditions on the diversified use. If the tenant considers that the conditions imposed are unreasonable, the tenant then must make an application to the Scottish Land Court for removal of those conditions. The Land Court can also impose its own conditions. However, where the landlord does make an objection, the landlord, not the tenant, must make an application to the Court to uphold the objection and must do so within 60 days of making the objection. The onus was originally on the tenant to make the application, but this was changed by the Land Reform (Scotland) Act 2016.

Esslemont v Fyffe: what we know from the Scottish Land Court

A recent case in the Scottish Land Court – Esslemont v Fyffe – established two important principles of how the diversification rules work in practice. The first is that the tenant cannot use the diversification procedures to gain retrospective approval for a diversified activity. In that particular case, the landlord objected to a long-standing diversified activity which pre-dated the 2003 Act and had demanded that the tenant stop using the farm for the diversified purpose. Mr Esslemont then served a Diversification Notice which was objected to by the landlord. The Land Court held that the statutory procedures involved service of a Diversification Notice in advance of the diversified activity starting and that it was not possible to use the 2003 Act to gain retrospective approval.

The other principle established by Esslemont v Fyffe related to the manner in which the business was financed and managed. In that case, the tenant had established a limited company to carry on the diversified business. He was the sole shareholder in the company and had the controlling interest. However, the Land Court held that a limited company is a separate legal person in its own right and that the 2003 Act had to be construed strictly so that it had to be the tenant personally who was managing and financing the business and it was not possible for them to do so via a limited company.

This is an important clarification of the law and, previously, many commentators had taken the view that conducting the business via a wholly owned limited company was permissible. In Esslemont, the landlord was able to have the limited company removed. In related proceedings, the Land Court found that the tenant had abandoned farming and that the tenancy had lost the protection of the Agricultural Holdings Acts, so leading to the eventual loss of the tenancy altogether.

An unresolved question is to what extent the tenant can use an existing family farming partnership to run and finance the diversified business. In another context, the Land Court has found it unobjectionable that such a partnership has paid for tenant's improvements when compensation is being claimed by an outgoing tenant. If the tenant makes it clear in the Diversification Notice that the partnership will be involved and the landlord doesn't object, that would probably be sufficient to see off any future complaint.

The tenant having to finance and manage the diversified business themselves can cause real problems in relation to a prospective diversified business. There may well be a positive economic opportunity on the let farm to pursue some non-agricultural business activity. However, the tenant might lack the skills or not want to expose to themselves personally to the financial risks of the business. The business might not be profitable enough to employ a manager. In such a scenario, one solution from the tenant's point of view, should they wish to conduct the business via a limited company or to involve a third party in the financing and management of the business, would be to reach an agreement with the landlord. That might, however, involve part of the farm being removed from the agricultural tenancy and let back to the tenant or the tenant's business vehicle on a commercial basis.

Diversified activity that predates the 2003 Act

It is often the case that a diversified activity, like the situation in Esslemont v Fyffe, has been conducted since long before the coming into force of the 2003 Act. Unless there is a high degree of trust and confidence between the landlord and the tenant, Esslemont demonstrates that from the tenant's point of view such arrangements can be precarious. A tenant would be well advised in those circumstances to obtain written confirmation from their landlord that the landlord has no objection to the diversified activity taking place. In a worst case scenario where a landlord declares a wish to stop diversified activity that hasn't been formally sanctioned under the 2003 Act, the tenant would have to cease operations completely, reinstate any changes that had been made to allow the diversified activity to take place so that the farm reverted to its original state and then serve a Diversification Notice. The disruption to the business that would involve might be catastrophic.

What are the rules surrounding sublets?

Some of the most common questions relating to diversification focus on the extent to which the tenant is allowed to sublet the farm to pursue a diversified activity. Subletting is permitted under the 2003 Act but only where it is ancillary to the diversified purpose itself. An example offered by the Land Court is where a tenant establishes a golf driving range as a diversified activity it might be possible to sublet part of the premises to a golf professional to operate a merchandise shop. However, the Land Court has also been very clear that subletting surplus housing on the farm on a private residential basis is not a diversified purpose. Despite this, establishing holiday chalets or a holiday letting business in surplus cottages does appear to be permitted diversification.

How does diversification affect a tenant's rent?

The next question is then the correct rental treatment of the diversified activity. Under the current rent review test as provided in Section 13 of the 1991 Act, which is a qualified open market test, the question to be asked is what rent a hypothetical tenant would offer if the farm under review was available on the open market at the next review date. The fact that the sitting tenant had gone through the diversification procedures under the 2003 Act and was conducting a viable diversified business on the let holding would undoubtedly have an impact on the rent that the hypothetical tenant was likely to offer, taking into account the fact that they would then have access to their diversified income stream. However, the improvements that the tenant had carried out to the farm to allow the diversified procedure to take place would have to be discounted. In effect, the hypothetical tenant would make or would be likely to make an offer of a higher rent because of the opportunity to pursue the diversified business.

I have sometimes come across in rent review negotiations a landlord taking the position that even where the sitting tenant is not pursuing a diversified activity, the fact that the opportunity to do so exists should in some way be taken into account for rent review purposes. In my view this is incorrect. It is right that the fact an existing sitting tenant has made use of the diversified procedures to establish a viable business is something that should be taken into account, but it is not something that should be assumed would be the case of every hypothetical tenant unless, perhaps, it could be shown that every other let farm in the district had some diversified activity or other being carried out.

However, under the new productive capacity test to be introduced by the Land Reform (Scotland) Act 2016, the rent to be paid in respect of the diversified business will be the open market rent payable for the use of fixed equipment and land provided by the landlord. It's unclear, however, when this new test will be introduced.

If you have questions about this or another related matter, please get in touch with Hamish Lean, Head of Rural Property and Business, or your usual Shepherd and Wedderburn contact.

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