

Hewitsons LLP

## **Whitepaper**

An option is not the only option

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## Introduction

Our previous Whitepaper “What to do when the developer calls” focused on the various considerations landowners may need to take into account when they are approached about the development potential of their land.

The previous Whitepaper noted that there is an intent to build more houses nationally. In particular and more locally, the Oxford – Milton Keynes – Cambridge Growth Region is expected to see a significant increase in development in the area with the National Infrastructure Commission estimating that 1 million new homes will be required. We focused on the initial considerations for a landowner approached by a developer. The previous Whitepaper can be found by clicking this [link](#).

Once those initial factors have been considered it will then be for the landowner to consider the various possibilities for taking the land forward under a development agreement. This whitepaper sets out the differences, advantages and disadvantages of the two main types of development agreement being option agreements and promotions agreements. It also touches on various alternatives.

## Option Agreements:

An option agreement is a form of contract for the sale of land entered into by the landowner and a developer. The purpose of the option agreement is to grant the developer the right to purchase the land within a given time period. The exercise of the right to purchase the land is usually subject to conditions being met. The most common condition is the grant of planning permission. The developer will be obliged to apply for planning permission at its own cost.

Therefore a key feature of an option is the planning obligation. The option will usually oblige the developer to seek the most valuable planning permission it can within a reasonable time frame. A well drafted option will give the landowner the right to monitor and comment throughout the planning process and to approve the planning permission that is granted, however the developer has control of the planning process. Therefore, it is important to choose a developer with a track record of securing good quality planning permissions. Also the landowner would be well advised to have his own agent monitoring the developer’s performance. Frequently the developer will meet the upfront costs of a monitoring agent, which will commonly be a deduction from the purchase price paid by the developer.

Once the developer has secured a satisfactory planning permission it has the right to buy the property with the planning permission.

It should be noted that the right for the developer to purchase the land is usually just that, a right to opt to purchase the land if the developer wishes to do so. Unless the option agreement specifically provides so, the developer is not obliged to purchase the land even if

the conditions of the agreement are met and planning permission has been granted. This can mean that the disadvantage is that the land is tied up with the developer under the option agreement for the term of the agreement but may not be sold if the developer chooses not to exercise the option. Therefore there should be a right to end the option if the developer does not buy the land within a reasonable period of time after obtaining a planning permission. The developer will not be entitled to their costs back if they do not exercise the option and the landowner should (hopefully) have the benefit of a more valuable site. Although the developer is not obliged to exercise the option, it takes on the risk and the costs of obtaining the planning permission which may not be satisfactory to them once granted.

If the developer does exercise the option to purchase the land the landowner is obliged to sell the land.

The purchase price is not commonly fixed at the time of the option agreement. Instead it is determined after the grant of planning permission on the basis of the market value of the land with the benefit of the planning permission for development. Often, the developer will pay an agreed percentage of the actual market value of the land (say 85%), such reduction being relevant to the initial risk the developer has taken in applying for planning permission at their cost. The developer may also seek to claw back its planning costs (if this has not been factored into the agreed discount.) The valuation is typically based on the RICS Valuation - Global Standards 2017 ("the Red Book"). Tension between the parties can arise at this point as their interests are misaligned as a landowner will be seeking the maximum value for the land whereas a developer will be seeking to purchase the land at the lowest price possible. This can cause resistance between the parties as the valuation of development land is not a simple exercise, particularly as the actual value of the land is not tested on the open market.

If the parties fail to agree the value then an expert is appointed to determine the market value.

### Promotion Agreements:

Instead of an option the landowner could enter into a promotion agreement with a promoter. The promoter is obliged to obtain planning permission for the land on behalf of the landowner in a very similar way to an option agreement. However, under a promotion agreement, once the planning permission is granted, the land is then placed on the open market for sale with the benefit of the planning permission. The landowner is then obliged to sell the land to the chosen third party buyer in accordance with the terms of the agreement.

The proceeds of the sale are then split in agreed percentages between the landowner and the promoter. The promoter takes their share (sometimes together with the repayment of their costs) as a success fee for using their expertise to obtain the planning permission.

The advantage of promotion agreements is that once a planning permission is obtained the interests of the landowner and promoter are more closely aligned. Under an option, once planning permission is granted, the interests of the landowner and developer are opposed as the landowner wants the highest price, the developer the lowest. Under a promotion agreement both parties are working together to achieve the common goal of achieving the highest sale price as both parties shall take a percentage of the increase in value of the land. The benefit of the promotion agreement is also that the value of the land is tested in the real market and is subject to real bids as opposed to a hypothetical valuation under an option agreement.

### Points to consider in respect of both:

Currently promotion agreements are more popular with landowners than option agreements. The advantage for the landowner is under a promotion agreement the property is exposed to the market. The valuation of the development land is complex and so it is not uncommon to see a range of bids with a substantial difference between the top and bottom bids. Under a promotion agreement the landowner and promoter can choose the highest credible bid. With a theoretical valuation under an option where there is a range an expert is more likely to choose a middle value.

Also under a promotion agreement the process is more transparent. The land is marketed, third party bids are opened and highest is chosen. With an option the land is never exposed to the market.

That said, options do have their place. A developer who wants to build houses or commercial units is unlikely to want to sign a promotion agreement. If they obtain planning they will want to buy and develop the land. They may argue as they are the ultimate developer, as opposed to a "middle man" promoter, they are best placed to design quality schemes and obtain the best and most valuable planning permission. Also they will argue that they have more credibility with the local planning authority, particularly in terms of delivery, as the local planning authority know once a developer has planning permission it is likely to want to develop the land.

Landowners can usually expect their upfront legal costs and agents fees in respect of either a promotion agreement or an option agreement to be paid to the by the developer or promoter. This is typically reimbursed to the developer or promoter when the land is sold.

A landowner commonly also receives a fee under either agreement for entering into the agreement. The level of the fee is open to negotiation and can range from a nominal amount to tens of thousands of pounds. The fee may or may not be deductible and / or repayable if the land is sold, and again this is a point of negotiation. However, if planning permission is not granted or the land is not sold the fee will not be refundable by the landowner.

It is also advisable in either type of agreement to include a “minimum price” below which the land may not be sold so as to guarantee that the return to the landowner will not be below a certain amount. The minimum can be expressed as a minimum price payable for the land by the developer under an option agreement or by a third party buyer on the open market under a promotion agreement. Or perhaps a more advantageous method of dealing with the minimum is to express a “minimum receipt.” This would be the minimum receipt to the landowner once any costs or fees are deducted, this will give the landowner certainty as to the amount they will actually receive. If the minimum is not reached either when negotiating the price under an option agreement or via third party sales under a promotion agreement, then there may be a freezer clause. A freezer clause will suspend the option period or promotion agreement period for a period of time during which it is hoped that the market conditions will improve and the minimum will be reached rather than allowing the agreements to expire without a sale.

With the current political uncertainty landowners are also considering tax freezer clauses. These provide that if the tax payable by a landowner exceeds a certain threshold then the landowner can delay the sale for a period. However, the concern here is how long do you wait? A planning permission may lapse if not implemented and whilst you are waiting for a change of government to reduce the tax rates the planning permission may lapse. The permission could be implemented to preserve it but that could trigger other costs, therefore careful thought needs to be given.

### Other Arrangements:

#### **A hybrid agreement**

A hybrid agreement is a cross between an option agreement and a promotion agreement. Hybrid agreements are commonly used in relation to large developments where a developer may wish to develop part of the site (and so will have the option to purchase part) but will also promote the rest of the land for sale to third parties with the benefit of the planning permission in return for an agreed share of the sale proceeds. If the developer in this scenario does not exercise the option to purchase any part of the land it can then instead be placed on the open market for sale to third parties with the remainder of the land.

The rationale here is with a larger site, there may be too much for one developer to build out. So the developer who signs the option builds all of say the first phase and puts in the infrastructure. The later phases can be sold on the open market with the benefit of the infrastructure. This way you have one master builder laying out the whole site, but elements of the site are sold on the open market. This will produce greater price transparency, and help if the developer who signed the option acquires a later phase as the purchase price for the phase will have been marked tested.

Hybrid agreements can have additional complexities because you are expecting more than one developer to build out the development you need to consider who will provide the

infrastructure to site, such as roads, mains water and sewers. Also you will need to consider how obligations under planning agreements with the local authority will be shared.

### **Building Licence/Lease**

Under a building licence or lease either the landowner or the developer may obtain the planning permission. If it is the developer then you will need the same planning obligations as seen in an option or promotion agreement. The difference with a building lease or licence is the land is not sold to the developer. Instead the developer takes occupation under the licence or lease and builds the houses. When the house is sold the landowner transfers the land and the proceeds of sale for each house are split between the landowner and developer. The structure means the developer does not need to buy the land upfront, a number of years before it starts building houses. As the developer does not have a gap between when it spends the money buying the land and when it starts building houses it can afford to pay the landowner more. Also the landowner can take advantage of a rising property market. The tax position of the landowner would need careful consideration in such an agreement.

### **Joint Venture Agreement**

Under this arrangement the landowner may transfer the land into a company jointly owned with the developer and that company develops and sells the land. The proceeds of sale would be split between the landowner and developer as shareholders. This can give the landowner greater control over the development process as it is a shareholder in the developer, and potentially a greater return. However the landowner's risk profile is likely to be greater as it will be sharing in the development risk. As ever the tax treatment would need to be carefully considered.

### **Conclusion:**

As you will have seen there are various elements of the different types of development agreement that need to be considered. There may not be a clear cut preferred choice for a landowner as each has its pros and cons. However, with the correct negotiation of the key terms under each type of agreement, a landowner can ensure that their interests are protected and they are able to achieve the full potential from their land. We have specific expertise in dealing with all types of development agreement, acting for landowners and developers and promoters. We can often use our experience from acting for either side of the deal to assist when negotiating the terms of such agreements for a landowner.

This paper is written as an outline guide only and any action should not be based solely on the information given here. Appropriate professional advice should always be taken in specific instances.

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