

Heads You Win : The Art of Negotiating Heads of Terms

Heads of Terms (“HoTs”) are frequently used in commercial transactions to set out the key points of the deal such as the identities of the parties, the price, the property/land for sale and the conditions of the proposed sale/purchase.

Whilst HoTs do not contain every detail of a transaction and are not intended to be legally binding they do serve a useful purpose in highlighting the parties’ general intentions, help limit misunderstandings and save the time and cost of extensive negotiation on fundamental points. They will also give the legal draftsman a good starting point for drafting the contract.

This article will set out some of the commercial considerations the parties should be aware of when negotiating and agreeing HoTs.

HoT’s are often morally binding

HoTs are frequently labelled with statements such as “subject to contract” to make clear to all parties concerned that the terms are not legally binding until contracts have been exchanged.

This does not mean however that the parties can simply disregard the provisions set out in the HoTs when negotiating the fine detail of the commercial transaction. The contracting parties may well consider that they have a moral commitment to be bound by the commercial terms agreed in the HoTs and any divergence from the commercial terms set out in the HoTs is likely to be resisted on the grounds that they are not included in the HoTs.

It is therefore important to allow some flexibility in the provisions set out in the HoTs to enable the parties’ solicitors to negotiate the final contract and to allow for unknowns, such as adverse soil reports. In fact contracting parties should always consider involving their legal advisers at an early stage of negotiations prior to the agreement of HoTs to ensure that they accurately reflect each party’s intentions.

What should be included in the HoTs?

These can usually be split into 4 sections: -

1) Terms of the Purchase

These are the key details of the transaction including: -

Parties

Obviously the identities of the contracting parties and their legal representatives should be included in full. If there are any third parties involved such as guarantors, agents who will certify the satisfaction of conditions or contractors who will be giving collateral warranties then details of these parties should also be included at the outset.

If there are any occupiers or tenants on the site then these should be disclosed at this stage.

Property

The extent of the land or property that is being purchased must be described in full. A plan of the land or property is recommended. Whether the seller has a freehold or leasehold interest in the land and/or property should also be revealed.

Conditions

Where the parties are agreeing a conditional contract it is advisable to include the conditions in the HoTs. Common conditions include obtaining a satisfactory planning permission, expiry of the judiciary review period without judicial challenge following issue of a planning permission and obtaining consents from third parties such as Network Rail where its consent is required to develop within close proximity to rail lines.

Contracts for the disposal of affordable housing are often conditional on the developer acquiring the site and constructing up to “golden brick” level.

2) Financial terms

Price and VAT

The HoTs should state the price, if fixed, or the mechanism for fixing it, and whether VAT is intended to be charged, bearing in mind that SDLT is payable on the price plus VAT.

Deposit

Where a deposit is to be paid it is appropriate for the parties to agree whether the deposit is released unconditionally to the seller on exchange of contracts or held as stakeholder by the seller’s solicitor pending completion. In conditional contracts it is usual for the deposit to be held by the seller’s solicitor pending satisfaction of the conditions. It is also important to agree the amount payable on exchange of contracts. Sometimes, a deposit may be non refundable but this is unusual.

Overage/Underage

It is rare for complex land transactions nowadays to have a fixed price and deals in addition to a base price often include one or all of the following. There are myriad types of overage the parties may want to incorporate in their transaction including planning overage (based on the number of units or habitable rooms the developer obtains over and above an agreed base figure), sales overage (sharing in the returns made once the units are sold less any incentives or costs) and housing grant overage (sharing in any grant the scheme receives from the Homes and Communities Agency).

Underage allows a developer to reduce the consideration payable where the developer has been unable to meet an agreed base figure. If the local planning authority grants a planning permission for fewer units than the base figure or the developer’s proceeds from the sale of the units do not reach an agreed target then the purchase price can be adjusted to reflect this.

Deductions

Where there are planning costs (pursuant to Section 106 of the Town and Country Planning Act 1990) the parties’ may agree that these are deductible from the purchase price (subject to an agreed cap).

A recent development is the creation of the Community Infrastructure Levy (a charge or contribution which is levied as a result of a planning permission) and the parties may agree that the levy (or part thereof) can be deducted from the purchase price.

The seller may want the developer to undertake works on the seller’s retained land as part of the transaction and again the parties may consider deducting the costs of these works from the purchase price. Works may include constructing a new community facility

or the provision of replacement services which were supplied on the land which is the subject of the sale. SDLT implications should be borne in mind.

Parties may agree the cost of professional services, such as obtaining satisfactory environmental reports, reports pursuant to the Charity Act where land is being sold by a charitable entity, and legal fees are borne by one party in order to facilitate an agreement.

Early Payments

Sometimes when the seller is a government agency the buyer pays the price upfront and carries out the works under licence with completion taking place following construction of the works. It should be borne in mind that SDLT will be triggered by "substantial performance" (payment of a substantial part of the price or the buyer taking possession of a substantial part of the site).

Deferred Payments

The archetypal transaction where there is a ten percent deposit followed by the balance payable on completion is largely replaced (particularly in the current climate) with deferred payments made at agreed intervals after completion of the land acquisition. Parties should consider whether the intervals should be fixed in time, e.g., twelve months after completion, or contingent on a particular event e.g., the developer obtaining a satisfactory planning permission. As mentioned below the seller may require some form of security where title passes to the buyer before the entire price is paid.

Staged Payments

Where the site is large or construction will be undertaken in phases the parties may consider staged payments.

3) Timetable

Longstop Dates

Parties will want to agree trigger dates and longstop dates within the contract by which a planning application is submitted to the local planning authority, planning permission is obtained by the developer, payments are made or works are started and/or completed.

Extensions

Where completion is conditional on planning the developer should negotiate when longstop dates are extendable. Such circumstances include where a planning application has been rejected and the developer wants to resubmit a fresh application, where the developer is minded to appeal a planning refusal and where the planning consent is subject to judicial challenge.

4) Terms specific to the deal

Access

A developer may want to gain access to the site either to undertake ground surveys or commence works prior to legal completion of the land purchase. Care should be taken to avoid SDLT becoming payable prior to completion by "substantial performance" as mentioned above.

Security

Where payments are made in advance of legal completion or in advance of works a party may want to negotiate security to protect these payments. Security may take a number of forms. A bank bond, legal charge or parent company guarantee can be offered as part of the deal.

Warranties and licences

Where new properties are to be built on the land the contractor, sub contractor or professional team maybe required to provide warranties. The buyer may also require licences from third parties to use drawings and warranties from the seller's consultants where the seller has obtained any planning permission or commissioned any reports or carried out works on which the buyer wishes to rely. The seller may require these from the buyer's consultants if a conditional contract is terminated because the conditions are not satisfied.

Works

If works will be undertaken as part of the transaction the parties should agree a specification for the works which includes the type of materials used in the construction, the standard to which the works must be constructed, any service media that will be supplied/connected (if any) and a timetable for the completion of the works. Again, SDLT implications should be borne in mind; the works may comprise chargeable consideration.

Lease back

Sometimes the buyer agrees to lease back part of the site to the seller following construction of works. SDLT implications should be borne in mind: the SDLT exchange rules will apply which means that SDLT will be payable on market value and not on the price, VAT and overage.

Concluding Remarks

Comprehensive and well defined HoTs will set out the commercial points of the transaction providing the legal adviser with a good starting point in drafting the contract. The HoTs should not include the minutia of the transaction. This should be left to the legal advisers to negotiate.