Legal trade secrets

Tim Lee sheds some light on the subject of option agreements and rights of pre-emption when it comes to selling and buying a practice

We have recently acted on several practice sales/purchases where the recent crash in property values has significantly affected the structures of the transactions.

This is not so much to do with lenders’ requirements tightening up (less of a problem with dentist practice purchases than in many other markets), instead it arises from the increasing reluctance of some dentists, who own the freeholds of their premises, to sell outright, in the current depressed property market.

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Some sellers are looking to retain the freeholds of their premises, (either personally, or in their pension funds) and grant 15 or more year leases to the buyers.

Some buyers – often associates with the practice – may be reluctant to proceed, if they might only be able to acquire the freehold at some time in the future and at the whim of the seller. Buyers may also be concerned at the possibility of the seller asking them for a premium price down the line.

Bridging the gap

Two possible approaches to ‘bridge’ this gap between seller and buyer are:

1. The seller grants the buyer a ‘right of pre-emption’; or
2. The buyer is granted a ‘call’ option.

A right of pre-emption is the right granted to the buyer, of first refusal! if and when the seller wishes to sell. The buyer’s rights are protected by registration at the Land Registry. From the seller’s point of view, the choice to sell is his/hers.

If the seller chooses a time to sell which is inconvenient to the buyer, (whether financially or otherwise), then the buyer may find that they are unable to exercise their pre-emption rights, and the seller may then go on to sell to a third party.

If the buyer has the benefit of a ‘call option’ (also registrable at the Land Registry), this means that the buyer, by exercising the option, can require the seller to sell, upon the terms of the option.

Rights of pre-emption and call options usually have conditions attached. Typically, there may be time limits on the exercise of a call option, providing a ‘window’ within which the option is exercisable.

Fixing a value

One mechanism to avoid this problem might be to fix a minimum ‘threshold’ value, so that the buyer can only exercise the option on condition that not only has the option window been reached, but also that the property price has reached or exceeded the agreed threshold. Agreeing such a threshold may be difficult, particularly when future property prices are so uncertain.

The ‘threshold’ issue is less of a problem with pre-emption options. If the seller considers that they would not achieve the right price, then they have the choice of not selling. A further problem in considering valuation formulae, whether for call options or pre-emption agreements, is whether the formula should explicitly exclude, from such valuation, any value relating to inherent goodwill in the property. Dental surgery premises may have an inherent goodwill value element attributable to the location and public knowledge thereof.

This raises the question of whether, in the case of the exercise of a call option or a right of pre-emption, the valuation formula ought to specifically exclude any value element relating to inherent goodwill. This is to avoid the danger of the seller, having being paid goodwill in respect of the original sale of the practice, then having a second ‘indirect’ bite of the goodwill cherry.

While there are arguments that the seller should not be able to argue that inherent goodwill should be included in a later sale of the freehold, it may be worth while including an explicit exclusion in the valuation formula just to avoid any ambiguity.

Points to consider

Several important points need to be considered by prospective parties to rights of pre-emption/call options. The formula by which the property is to be valued at the relevant time is of major importance.

Often the valuation is to be at open market value at the relevant time, either to be agreed between the parties or, if not agreed, to be independently assessed. Independent assessment may be achieved by nominating a particular firm of valuers who then carry out an open market valuation, which ‘binds’ both parties. There are more sophisticated mechanisms for fixing valuations available.

A problem faced by a seller where there is a call option in place is that, with the current uncertainty in the market, the option may be exercised by the buyer at a time when the seller feels that property prices are still too low.

About the author

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