Procurement Blog – Development Agreements

The forecast for Development Agreements not tendered under OJEU – Sunny spells but still foggy in parts.

On 26 August 2016 the Hon. Mr Justice Holgate provided his emphatic judgment on the matter of Faraday Development Limited vs West Berkshire Council and St Modwen Developments Limited and refused leave to appeal. For procurement lawyers who regularly advise public and private bodies on the applicability of the Public Contracts Regulations ("PCRs") to Development Agreements and similar "sale of land" contracts, there is useful guidance here on identifying the main object of a contract and the role of indirect obligations regarding the definition of a Public Works Contract. There are also clear principles set out in respect of the assessment of achieving best consideration for land pursuant to s123 of the Local Government Act 1972.

In summary, the Council ran what could be considered a "model" process for a development agreement which the Council intended to be outside of the PCRs. It concerned the regeneration of land at the London Road Industrial Estate (LRIE), about 0.25 miles east of Newbury, of which the Council was the majority freehold owner, other than a small plot to the north west.

By all accounts, it is a difficult site which will require a phased yet coherent approach to development and for which there was no easy way to establish "market price" without some type of market testing. There are 26 plots including vacated Council offices and a series of long leases to businesses, not due to expire until 2044 to 2110. Investment has not been made in the estate for over 40 years.

Faraday was a special purpose vehicle and an existing lease holder. It was established in order to assemble land for redevelopment in the LRIE and also entered into a joint venture with Wilson Bowden Developments Limited (WBD) (a subsidiary of Barratt Developments Plc) to that end. Faraday had secured planning permission for a mixed use development on part of the site and had negotiated with the Council for a consolidated ground lease. The Council ceased negotiations, however, in 2011. Subsequently the Council decided to tender for a partner for the whole development.

WBD and David Wilson Homes (DWH) (another subsidiary of Barratt) submitted a tender including Faraday's land in consortium with Faraday, which would develop the flats proposed on its land. On 27th March 2014, the Council chose a bit submitted by St Modwen Developments Limited in preference to WBDs.

The Council appears to have been well advised on both s123/State aid law regarding "best consideration" and also the definition of a "Public Works Contract" from the outset of its tender process and Mr Holgate supported them on each ground. It is a wonder Faraday were minded to challenge, it but very helpful for us they did.

The Council took the following steps in respect of s123 (best consideration):

- They advertised the opportunity and ran a tender process (albeit not in OJEU);
- Their audit trail was emphatic from the outset (from cabinet reports to tender documents) that the aim of the deal was to secure the best financial return from their asset taking all relevant matters into consideration as well as the regeneration of the site. They did not want to simply sell the asset but maximise long term receipts;
- They appointed third party advisers from the outset to produce a Strategic Feasibility Study and advise on the market and the offers received.

With regard to the PCRs:

- They made it clear the Development Agreement would not include any direct obligations upon the developer to undertake the works or indirect obligation to procure the undertaking of the works;
- It was clear from the Development Agreement that

the designs and specifications would be solely for the control of the developer, albeit subject to overarching and general "master plans" upon which the Council would have approval;

- Influence and rights of approval over master planning and other key matters were to be exercised through a mutual steering group in which the Council and developer would have a 50/50 say.

It is to be noted, however, that the draft leases appended to the Development Agreement did include enforceable obligations to develop the land once the option of taking the lease was exercised by the developer.

The Claimant was the second-place bidder who claimed that the Council did not have due regard to its duty under s123 LGA 72 in awarding the contract to the winner; and in any event the contract is a Public Works Contract under the PCRs and should have been tendered on that basis.

The Council, naturally, countered that it certainly had complied with its s123 and State aid duties and the Development Agreement is not a Public Works Contract because there was no enforceable obligation on the developer to undertake any works – directly or indirectly. It was not sufficient that there were obligations to deliver services relating to works as it was obvious the services were not the main object.

S123, State aid and "best consideration"

Looking at the s123 issue first, Justice Holgate helpfully reiterated the following principles which have not been seen so concisely set out for a long while:

1. a Court is only likely to find a breach of s123 if the authority has failed to take proper advice, or followed advice which was so plainly erroneous the authority must have known it couldn't rely on it;
2. s123 does not mandate that the Council has to have regard to any particular factors;
3. there is no need for the Council's decision-making process to even refer to s123 explicitly provided that the Court can see that the duty has in substance been performed;
4. s123 is not an obligation to conduct a particular process but to achieve an outcome – though process has a strong evidential role to play;
5. consideration is confined to elements which are commercial or have monetary value. It doesn't have to be "cash" but it can't be a social or environmental consideration e.g. job creation;
6. deliverability or credibility of a bid are commercial factors which an authority can take account of when evaluating whether consideration is the best reasonably obtainable. They do not have to take the highest price on paper for the land and can take the view "a bird in the hand is worth two in the bush"; and unlike for State aid purposes
7. there is no absolute requirement to market the land being disposed of OR to obtain an independent valuation.

In short, the Council had an extensive audit trail evidencing in had in fact complied with the duty. So what was of interest in the judgement in respect of s123? All bids were submitted on the basis of a "residual land valuation". Crudely put, it is an estimated figure which deducts the cost of the build and developer's desired profit from the estimated final sale/rental value and what's left equals the "value" of the land which can be paid to the Council. The actual final price offered in a bid based on a residual land valuation is never be guaranteed – although the winner did offer a minimum payment matching the Council's existing rental income. We are often asked to advise as to whether this type of residual land price is acceptable to establish best consideration, being uncertain as to final quantum and depending as it does on the developer's specific plans for the site and ability to deliver.

The Court found that due to the comprehensive process followed by the Council it was clear that the s123 duty had nevertheless been observed and this reflected the very difficult nature of the site and the huge amount of commercial risk that the developer was taking on to make the scheme work. The fact that all bidder's had put forward a similar formula to calculate land value reflected the fact that for that site, an estimated residual land valuation only was the best the Council would get and simply the way, commercially, any buyer would approach costing the site.

However, we cannot interpret this to mean a residual land valuation is permissible in all situations and we should not take this judgement as a blanket approval for this type of valuation method per se. Unlike point 7 above re s123, under the "Commission Communication on State aid elements in sales of land and buildings by public authorities", public bodies must either run an "unconditional" market process or obtain an independent valuation for the land which is also on the basis of conditions that all bidders would need to fulfil in order to demonstrate they have obtained market price.

The Council did run a tender process here and the claimant appears to have accepted, without argument, that if the s123 duty had been met then the State aid one also would be - so the Court was not troubled to explore it (para 2). However, if it had been contested, it could be queried whether the residual land valuation based on a development agreement which is full of developer specific conditions and with no guaranteed price would count as an "unconditional" bidding process; without the Council also still having established an idea of what the land would be worth on a standard unconditional sale basis. Certainly where a local authority wishes to rely solely on an independent valuation to justify making a direct award then its "bottom line" for comparison against the developer's financial model must still be an arms-length "market" valuation arrived at using standard valuation assumptions. This also perhaps points to a need for developers to assist a Council by offering a minimum guaranteed price if their bid is going to be based on a residual land valuation (as the winning bidder actually did here and

ironically the claimant did not) and not a floating unconditional figure. The latter may give rise to state aid issue; if not necessarily s123 ones.

Public Contracts Regulations 2015

Procurement lawyers have long advised clients to keep direct obligations to undertake works out of their development agreements if they wish them to stay outside of the Regulations, however what was less clear was how far a raft of indirect obligations could be evidence that works is still the "main object" of the contract. Indirect obligations in this context refer not just to an obligation to procurement someone else to do the work, but rather obligations to provide a litany of "services" such as consultation and design which arguably point very clearly at the Council's intentions.

Firstly, the Court cautioned against deciding upon a contracts main object solely by looking at the obligations in it; one must look at the transaction as a whole. Works may indeed be the main object, but if the contractor is not under an enforceable legal obligation to carry out the main object then the contract still falls outside of the Regulations (cited Helmut Muller and Midlands Co-operative). One must ask:

- What is the main object?
- Does it correspond to one of the three limbs of the definition of public works contract? If no then it is outside of the Regulations;
- If yes, then is a legally enforceable obligation on the developer to carry out the works? If no, again the contract will fall outside of the Regulations.

While an indirect obligation to procure somebody else to carry out the works is caught (because it is still an obligation to "carry out"), other indirect obligations e.g. master planning, obtaining planning approvals and negotiating for land interests are not sufficient.

The claimant's lawyers argued that, while there is no case law to justify why they should be given the same weight as direct obligations, the approach is justified because they represent an "artificial avoidance mechanism" intended to avoid the public procurement legislation. They also cited the obligations in the draft leases which would be taken up should the developer choose to so develop as an artificial way of getting works obligations in by the back door. Happily this was firmly rejected by the Court which cited the recitals from the Directive which enforces the need for "a direct or indirect obligation that is legally enforceable to ensure the works will be realised". The Directive contains no explicit anti-avoidance mechanisms. As per Midlands Co-Operative, it is not illegal for a public body to actively choose to enter into a contract which avoids the requirements of procurement legislation and there is no need to be sheepish about it.

The claimant further tried to argue that if there are no enforceable obligations to deliver works then works cannot be the main object at all – the main object must be the services to which there were enforceable obligations - making it a Public Services Contract which also needed to be tendered. This was rejected by Justice Holgate in dealing with the point above – the main object can still be works but fall outside of the Regulations for lack of enforceable legal obligations relating to it. The Directive recitals appears to explicitly condone Authorities organising their procurement of works or services "by means other than public contracts within the scope of this Directive".

Finally, the claimant argued that the second limb of the definition of "Public Works Contract" applies where the object of a contract with "both the design and execution of works" and it is enough that the enforceable obligations are for the design part only for it to be a Public Works Contract. This also received short shrift. If you establish at the outset the services are merely ancillary and not the main object – you cannot retrospectively make them so in lieu of obligations re the works themselves.

Conclusion

This is a great judgment for local authorities and developers alike but there are a couple of areas where the details become "foggy" and after reading the judgment one wishes it could have gone further:

The first question is whether this Development Agreement only escaped unscathed because there were no direct works obligations in it at all? In many of the scenarios we deal with, public authorities often still require relatively low value obligations in respect of public infrastructure. Would the presence of *any* works obligations have given us a different judgment? Possibly and this would lead us to look for an alternative "main object" – step forward Regulation 10(1)(a), 'sale of land' exemption. Unfortunately, this was not explored – it become superfluous once the court had decided works were indeed the main object here.

A second question arises in respect of the draft leases in the case, which the developer will be bound by if it decides to exercise its option over the land. As explained above, it appears that these draft lease do indeed contain works obligations - which will become legally enforceable once the option is taken up. The Court considered that they were still not directly legally enforceable because the developer did not have to exercise the right. This does come as a surprise as we'd usually advise our clients to exercise caution in how they draft leases too because at the *point at which those leases are taken up* they may well have all the characteristics of a Public Works Contract applying the rationale set out in the judgement. Will they be challengeable in the future?

Possibly Justice Holgate considered that the leases, being in draft, are ancillary to the main agreement and cannot be

looked at in isolation - but it is unlikely that we have seen the last of that point. It is certainly true that the likely defence to a challenge to the *leases* would be that it is an exempt agreement for the sale of an interest in land under Regulation 10(1)(a) and again, it would have been helpful to have seen more on that.

But this is perhaps nit picking - a very satisfactory judgement all round and one can't have it all!

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