



PUT AND CALL OPTIONS

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INSURANCE

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Introduction

What is a put and call option

A put and call option is an agreement between a vendor of a property (usually called the grantor) and another person (usually the called grantee) under which:

- (a) the grantor gives the grantee a call option to buy the property from the grantor; and
- (b) the grantee gives the grantor a put option to sell the property to the grantee.

The call option is normally exercisable over a defined period and then the put option period follows. There is no reason why option periods cannot overlap.

Form

There is no particular form required for a put and call option agreement.

The concept is simple enough that the following exchange of letters has been found to be sufficient to form a put and call option for a property, with the Court implying the necessary terms not discussed in the letter¹:

"Re: Site far Sale 5 Owens Creek Road, Forest Glen

Dear Mark

As discussed our latest **unconditional** offer for the block of land located at 5 Owen Creek Road, Forest Glen, Sunshine Coast, L2 RP177389 Parish Mooloolah is our final offer to purchase and we would appreciate you putting that offer to the vendor once again on our behalf:

- Purchase price \$3,000,000.00
- \$500,000.00 non refundable deposit released when vendor signs contract
- Contract will be **unconditional** in the form of an Put & Call
- Settlement **12 Months** from date of contract
- The vendor to remain responsible for the insurance of the properly until settlement

We do require a security over the land to ensure that our deposit is secured in the form of a caveat, or mortgage. If the vender accepts this offer, please have him sign off the letter of offer as accepted and we will instruct our Lawyer to prepare the contract documentation.

Regards

[Signature]

Myles Prebble

Ph 0405572100

I Kim Maree Edwards of Hebron Park Pty Ltd acknowledge acceptance of the above offer for the land located at 5 [O]wen Creek Road, Forest Glen, Sunshine Coast being L2 RP177389 Parish Mooloolah." (emphasis in original)

¹ Moffatt Property Development Group P/L v Hebron Park P/L [2009] QCA 60

The use of put and call options

Put and call options are usually used to create the effect of a contract for sale while delaying the formation of the final contract. There is any number of reasons for this:

- (a) the deferment of transfer duty on the sale price;
- (b) the vendor may want to defer the disposal of a capital asset until a later tax year;
- (c) the buyer may want to defer the final decisions about, or creation of, the ultimate purchasing entity;
- (d) an expectation of on-selling.

Put and call options are also used to allocate risk and tidy up residual rights in other situations, such as under development agreements or joint ventures. An example of this is provided in *Ross Nielson Properties Pty Ltd v Orchard Capital Investments Ltd*².

Marketing arrangements

A common use of put and call options for residential property is as marketing instruments. For example:

- (a) marketeers and speculative investors may take an option over residential lots with a view to “on-selling” using a nomination provision (discussed later) with the marketeers reward being the price uplift achieved through the nomination;
- (b) home builders commonly secure lots under put and call option so that they have control of land for home building packages.

The benefit to the vendor is that the put option is supposedly securing the ultimate sale of the property.

It is not unheard of for options to be used by marketeers as part of a sham arrangement under which the effective payment of a sales commission is hidden from the ultimate buyer of the property (discussed later).

Some duty issues

Call option is a dutiable transaction

A put and call option agreement is a dutiable transaction as the call option is the acquisition of a new right³. Incidentally, the put option is not the acquisition of a new right and so a put option agreement is not a dutiable transaction.

The dutiable value of the call option is the higher of the call option fee and the market value of the right that is granted⁴.

² [2011] QCA 49

³ Duties Act 2001, section 9 and Schedule 6

⁴ Duties Act 2001, section 11(7)

Credit for duty on call option fees

Under section 23 of the *Duties Act 2001*, a credit for the duty paid on a call option fee will apply where:

- (a) the call option is exercised; and
- (b) the call option fee is credited to the price.

Note that the credit should not apply where the put option is exercised.

Dutiable value of the resulting contract

One effect of using an option to delay formation of a contract is the potential impact on the duty for the contract. The dutiable value of a contract is the higher of the price and the unencumbered value of the property sold at the time that the contract is entered into⁵. This means that any value increase during the option period, such as because of a development approval obtained during that time, could raise the dutiable value of the resulting contract substantially above the purchase price.

Is a put and call option the same as a contract for sale?

The various cases in which put and call options are treated as relevant contracts (discussed later) include statements like the following:

*"The Deed, being a contract for the sale of residential property in Queensland, and not being a contract formed on a sale by auction, was a "relevant contract".*⁶

The relevant definition in section 9 of the *Duties Act 2001* is:

"(b) an agreement for the transfer of dutiable property, whether conditional or not".

Perhaps the Commissioner will start to take the view that put and call options should be assessed in the same manner as contracts for sale? The arguments for the status quo are:

- (a) a call option is already a dutiable transaction as the grant of a new right and a put option is not dutiable at all;
- (b) put and call options are not new concepts;
- (c) this is a difference between an agreement to transfer dutiable property and an agreement to accept a future obligation to transfer dutiable property where that future obligation may never arise.

Option fees and deposits

Option fees

An option fee is a payment in consideration for the grant of the option. That payment may or may not be credited to the purchase price that is payable if the option is exercised.

It is normal practice to include put and call option fees in the agreement, even if only nominal and therefore effectively cancelled out.

⁵ *Duties Act 2001*, sections 16 and 22(2) and Schedule 2.

⁶ See the discussion from paras 33 to 85 in *Vale 1 P/L as Trustee for the Vale 1 Trust v Delorain P/L as Trustee for the Delorain Trust* [2010] QCA 259

As a practical matter there is no need to include nominal option fees as the grant of each option is consideration for the other.⁷ For reasons that will be discussed later, it is probably not a good idea.

Deposits

Even if an option fee is not payable, it is common for the grantee to be obliged to provide a deposit. If an option is exercised then the deposit under the option agreement becomes the deposit under the resulting contract. The disposition of the deposit if neither option is exercised ought to be clearly stated. A deposit will be refundable to the grantee in at least some circumstances in which the sale does not proceed.

Some drafting issues

Sometimes a put and call option agreement will require the payment of a deposit that is stated to be not refundable in any circumstances (though it would be relevant to the calculation of damages for the grantor's repudiation of the sale). The problem here is that the duty and GST obligations might not be properly recognised.

A payment that is not refundable in any circumstances is arguably consideration and so ought to be used to calculate the GST on a taxable supply and the duty on the option. The characterisation of the payment as a deposit could lead to a mistaken assessment of revenue obligations.

Another reasonably common provision is that the option fee is credited to the deposit under the contract formed on the exercise of the option. This might occur where the drafter wants to include a substantial deposit under the contract, while minimising the additional amount that the grantee has to pay before completion.

The effects of such a provision need to be considered. The option fee is the consideration for the grant and becomes the property of the grantor. However, a deposit is potentially refundable to the buyer and so the exercise of the option and the subsequent valid termination of the contract may result in the refund of the deposit and effective loss of the option fee. As discussed below, the inclusion of the option fee in the contract deposit may be relevant to whether the option agreement is an instalment contract.

Options and instalment contracts

Risk issue

An option under which a call option fee is payable may be an instalment contract. In that event, the obligations and rights under section 73 and 76 of the Property Law Act 1974 would apply. This was one of the issues in *APM Property 3 Pty Ltd v Blondeau & Ors*⁸, in which the grantee claimed an entitlement to terminate the option agreement under section 73 because the grantor had given a mortgage over the property.

APM Property involved a put and call option under which put and call option fees of \$100 each had been paid and the grantee was also required to pay a deposit. After entering into the option, the grantor mortgaged the property and the grantee claimed a right to terminate the agreement under section 73.

Before reviewing the *APM Property* decision it is worth considering the relevant provisions of the Act.

⁷ *Moffatt Property Development Group P/L v Hebron Park P/L* [2009] QCA 60

⁸ [2009] QSC 326

What is an instalment contract

An “instalment contract means an executory contract for the sale of [or option to purchase] land in terms of which the purchaser is bound to make a payment or payments (**other than a deposit**) without becoming entitled to receive a conveyance in exchange for the payment or payments.”

A “deposit means a sum--

- (a) not exceeding 10% of the purchase price payable under an instalment contract; and
- (b) paid or payable in 1 or more amounts; and
- (c) liable to be forfeited and retained by the vendor in the event of a breach of contract by the purchaser.”⁹

It has been well established that any obligation on the buyer to pay money to the seller (other than a deposit) prior to completion will give rise to an instalment contract¹⁰.

It would also appear to be clear from the relevant definitions that the significance of the 10% limit is that it is part of the definition of “deposit”. So, an obligation to pay a 5% deposit and to pay other sums to the vendor would give rise to an instalment contract even if the total amount paid prior to completion is less than 10% of the price.

APM Property decision

The purchase price in the APM Property case was \$2,140,000.

One drafting difficulty in the case was that the form of contract stated that the deposit was not more than 10% of the price, while the option agreement:

- (a) required the payment of a call option fee of \$100 and a deposit of \$214,000;
- (b) included a clause providing that the call option fee was to be credited to the deposit under the contract if the option was exercised.

The Court determined that that true intention of the parties was that the grantee had an obligation to pay a call option fee of \$100 and a deposit of only \$213,900, giving a total payable that was 10% of the price.

His honour held that the option was not an instalment contract, saying:

“The applicant argued that the option agreement was not an instalment contract, because the option fee did not form part of the deposit as it was a payment made to bring the option agreement into existence and was not a payment under the option agreement. The difficulty with this argument is that the option fee is paid under the option agreement as the consideration for the grant of the call option and is therefore properly characterised as a payment under the option agreement. The alternative argument of the applicant was that the amount of the performance bond required to be paid under the option agreement was 10 per cent of the purchase price, less the option fee of \$100, so that the whole of the deposit did not exceed 10 per cent of the purchase price.”

And:

⁹ Property Law Act 1974, section 71

¹⁰ Wacal Developments Pty Ltd v Realty Developments Pty Ltd (1978) 140 CLR 503 and

“If either option were exercised, clause 6 of the option agreement provides that the option fee forms part of the performance bond under the terms of the contract. This means that the option fee must be credited towards the deposit of \$214,000, leaving a balance of \$213,900 to be paid by the first respondent.”

And further:

“As the total of the amounts that the first respondent was bound to pay under the option agreement did not exceed 10 per cent of the purchase price, the option agreement is not an instalment contract for the purpose of s71 of the PLA.” (Emphasis added)

With respect, this decision seems wrong. The requirement under section 71 is that the buyer not be obliged to pay any amount that is not a qualifying deposit. The option fee was such an amount and so the option agreement would seem to have been an instalment contract. The contrary interpretation, which has to be implied into the decision, is that the option fee is treated as part of the deposit for the purposes of section 71 because it would become part of the deposit under the contract formed on exercise of the option.

Nomination provisions

What are nominations

Call options commonly include nomination provisions under which the grantee is entitled to nominate one or more additional people who will be entitled to exercise the option.

It is not uncommon for the grantee to be able to nominate a purchaser at a higher price, with an obligation on the grantor to pay the amount of the increase to the grantee. Usually the purchaser will not know that an option over the property had been granted at a lower price. Depending on the nomination provisions in the option, the ultimate purchaser may not even know that the option existed.

The nature of the legal rights created by a nomination will depend on the drafting of the agreement, and a variety of provisions can be seen in practice. The following are examples:

- (a) the option allows the grantee to nominate one or more persons by delivering completed nomination forms to the grantor, the nominees effectively become offerees under the terms in the option agreement, but a new offeree may gain no enforceable rights unless he or she accepts the offer;
- (b) the nominee enters into a deed with the grantor that gives the nominee rights and obligations under option agreement;
- (c) the nomination provision simply obliges the grantor to enter into a sale contract with a nominee if the contract is presented by the grantee and certain preconditions and minimum requirements have been satisfied (such as delivery of disclosure statements and compliance with the PAMDA).

Is a nomination arrangement dutiable?

An exchanged call option agreement for land is an “existing right” as defined in the *Duties Act 2001* and so is also “dutiable property”¹¹. Any transfer or agreement to transfer the call option is therefore a dutiable transaction.

¹¹ Section 10(1)(c)

If a nomination is, in substance, an assignment of the call option then duty will apply.

There could also be an argument that the actual nomination (depending on the form taken) is the grant of a new option and so is dutiable as the creation of a new right.

If a nomination results in the creation of a new right then the dutiable value of that transaction may include any price uplift payment to the original grantee and the grantor of the option may be one of the parties liable to payment of the duty.

Any nomination arrangement needs to be carefully considered to ensure that the liability to duty is properly assessed.

GST and nominations with price uplifts

The impact of GST needs also to be taken into account where the sale of the land, or the nomination arrangement, is a taxable supply.

For the vendor, where the sale is a taxable supply, GST will apply to the increased price and so the vendor's obligation to pay the price uplift to the grantee will need to be nett of the additional GST.

The nomination by the grantee may also be a taxable supply. Depending on the drafting of the original option, this may depend on a greater or less stretching of the definition of supply in the *A New Tax System (Goods and Services Tax) Act 1999*. For example, the introduction of the ultimate buyer to the grantor might be the grantee's supply.

Marketeering and disclosure risks with price uplifts

If a vendor is required to pay a price-uplift to an option grantee with respect to the nominee's contract then that payment ought to be disclosed on any form 27c provided to the buyer.

Sections 138 and 268 of the PAMDA oblige real estate agents and property developers to disclose:

“(c) the amount, value or nature of any benefit any person has received, receives, or expects to receive in connection with the sale, or for promoting the sale, or for providing a service in connection with the sale, of the property.

Examples for paragraph (c) of persons who may receive a benefit--

finance broker

financial adviser

financier

property valuer

residential property agent

seller

solicitor “

It is difficult to see how a price uplift payment to an option grantee is not received “in connection with the sale” to the nominee.

Risk to the grantor

To the nominee purchaser, the option grantee may be the ostensible agent of the vendor. Given the option grantee's substantial financial interest in the transaction, the prudent vendor will want to minimise the risk of misrepresentation and fraud by the grantee.

Where the grantee is a marketeer or a builder, it would be especially prudent to warn the grantor of this risk.

Risk to the grantee

A grantee who is entering into options as part of a property marketing arrangement is at risk of committing an offence under section 160 of the PAMDA by acting as a real estate agent while unlicensed. And if they are licensed then the offence is under section 144.

Put and call options and residential property

General position

Chapter 11 of the *Property Agents and Motor Dealers Act 2000* applies to "residential property" sales. In particular, the Chapter imposes obligations and creates rights with respect to "relevant contracts".

A relevant contract is a contract for the sale of residential property in Queensland, other than a contract formed at auction¹². Residential property is defined in section 17.

In a number of cases it has been decided that a put and call option for residential property is a relevant contract¹³. As a consequence, the obligations and rights under Chapter 11 attach to the option agreement and not to the contract between the grantor and grantee.

Agreements for multiple lots

In *Cheree-Ann Property Developers Pty Ltd & Anor v. East West International Development Pty Ltd*¹⁴, Mullins J held that two put and call option agreements relating to 12 and 13 residential lots respectively were not relevant contracts. The grantees of the options were property marketers who intended to on-sell under the nomination provisions. The put options meant that the marketers were underwriting the sale of the lots.

There were two grounds for this decision:

- (a) the first is that the purpose of the agreement as a supply of stock for property marketing means that it is not a relevant contract:

"it would unduly strain the definition of "relevant contract" in s364 of the Act to conclude that an agreement that facilitates the marketing of lots to third party purchasers whilst the subdivision is being developed can be characterised as a contract for the sale of those lots to the marketer, because the agreement also incorporates a put option able to be exercised by the vendor against the marketer. The substance of each agreement was to provide stock for the applicants as property marketers and the agreements cannot be characterised as contracts for the sale of property"¹⁵; and

¹² Section 364.

¹³ *Devine Ltd v. Timbs* [2004] QSC 24; *Mark Bain Constructions Pty Ltd v. Barling & Ors* [2006] QSC 48;

¹⁴ [2006] QSC 182

¹⁵ para 51

(b) the second ground is that a relevant contract can only be a contract for a single parcel of land:

“It is clearly the Parliament’s intention to confine the application of chapter 11 of the Act to a contract for the sale of residential property that is limited to a single parcel of relevant land. I am therefore satisfied that the use of the word “single” in s 17(1) of the Act amounts to a contrary intention that displaces the presumption of plurality created by s 32C of the [*Acts Interpretation Act 1954*]¹⁶.”

The decision in *Cheree–Ann* was reviewed by the Court of Appeal in *Vale 1 P/L as Trustee for the Vale 1 Trust v Delorain P/L as Trustee for the Delorain Trust*¹⁷. Applegarth J, with who the others agreed, took the view that the purposive test in *Cheree–Ann* ought not to be upheld. However, the second limb of the *Cheree–Ann* decision would appear to be sound¹⁸.

Drafting put and call options

Keep it simple

The various reasons that put and call options are used instead of contracts for sale can have an impact on the long-run risk to the client. For example:

- (a) the failure of a grantee intending on-sell the property may have them looking for an opportunity to terminate;
- (b) any contract with a long time between exchange and settlement is at the risk of changed circumstances.

One of the concerns with put and call options is that the ultimate goal, being the concluded sale or purchase of the property, is subject to more detailed requirements than an equivalent contract. One must properly exercise the option within the required time, or properly appoint a nominee. The more there is to do, the more there is to go wrong.

For example, in *JV Property Syndicates Pty Ltd v Croakybill Ltd*¹⁹, the assignee of a call option failed in an application for specific performance of the agreement it claimed was formed on the exercise of the option. The grantor of the option successfully claimed that the grantee and assignee had not complied with the assignment provision in the option agreement because they had failed to deliver a deed of covenant with notice of the assignment. The property having increased in value during the option period, the grantor declined to exercise the put option.

When drafting an option agreement:

- Keep the notice provisions simple, complicated forms are not necessary.
- How and where will the option be exercised? Is there is risk of the notice being lost or missed? Should ordinary mail be used? What about email?

Nominations are dangerous

A nominee will be a new purchaser under a new agreement. Therefore:

¹⁶ para 59
¹⁷ [2010] QCA 259
¹⁸ At para 69
¹⁹ [2005] QCA 479

- (a) all relevant disclosure and other procedural and formal obligations ought to be satisfied before the nominee has a right to exercise the call option;
- (b) is the nominee providing a new deposit and what is happening to the deposit given by the grantee;
- (c) consider whether the grantor needs to be protected from being the ostensible principal to a marketeer/ostensible agent on-selling the property;
- (d) should the put option be preserved in case a nominee contract is not settled?

An example nomination clause is attached.

How much risk?

For reasons previously discussed, there is often a low expectation that the grantee will be the actual purchaser of the property. Instead, the grantee is looking to profit from the transaction through a price uplift or through securing a site for a house building package sale.

Where the ultimate buyer is a nominee, a defaulting grantor will potentially be exposed to damages claims from both the grantee and the nominee. The grantor will need to clearly understand whether the grantee also has rights if there is a breach of the contract with the grantor.

It is also sensible to clearly state the rights of the grantor and grantee with respect to the decisions that might be made with respect to the performance of the nominee contract. For example, whether settlement extensions ought to be granted.

Caveatable interest

A put and call option will usually give the grantee a caveatable interest in the property. Grantees need to be advised about the prudence of lodging a caveat to secure the option and a long term option will require consent from the grantor unless the option is an instalment contract.

A Grantor giving consent to a caveat ought to consider having a withdrawal of the caveat held in escrow on appropriate undertakings. The following example clause could be used:

“The Seller must immediately give the Buyer a consent in registrable form for a caveat to be lodged on the Land by the Buyer. In exchange for the consent, the Buyer must give the Seller’s Solicitor a duly executed withdrawal of the Caveat on the Solicitors undertaking to hold the withdrawal in escrow until:

- (a) the Buyer terminates this option deed or the Sale Contract; or
- (b) seven days have elapsed after the Seller terminates this option deed or the Sale Contract and the Buyer has not lodged a claim in Court as to the validity of the Seller's termination.”

The seven days in the undertaking is to allow the aggrieved buyer to commence proceedings to protect its rights under the option.

Example nomination clause

Nomination

Right to nominate

The Buyer will be seeking to procure people (Nominees) to purchase Lots from the Seller as part of a house and land package offer by the Buyer.

If the Buyer complies with this clause 4 then the Seller must enter into a Nominee Contract with a Nominee.

Buyer is not the Seller's agent or partner

The rights and obligations of the parties in this clause 4 in this agreement do not make the Buyer the agent or partner of the Seller.

The Buyer is not authorised by the Seller to:

- (a) make any representations about the Lots to a proposed Nominee other than the provision of a Disclosure Statement; or
- (b) bind the Seller to any agreement with a proposed Nominee or any other person.

Marketing activities of the Buyer

The Buyer must:

- (a) fully inform the Seller as to the methods by which the Buyer will market the Lots to proposed nominees and provide copies of all promotional and marketing material, including with respect to the availability of finance and building services for buyers; and
- (b) not make any material change to the Buyer's marketing activities, including changes in marketing and promotional materials, without giving the Seller 7 days notice of the change including copies of all changed promotional and marketing material, including with respect to the availability of finance and building services for buyers; and
- (c) not use any marketing material or promotional method that is not approved by the Seller; and
- (d) ensure that all proposed Nominees are introduced to the Seller by the Seller's Agent and the Seller's Agent is the effective cause of the sale.

The Seller will negotiate the terms of a proposed Nominee Contract with a proposed Nominee, but the Seller may accept or reject proposed amendments in its absolute discretion.

Termination

The Seller may immediately terminate this agreement by giving the Buyer a notice if the Buyer or an agent of the Buyer at any time breaches any law or is commits any fraud or other misconduct in the promotion of the Lots to potential nominees.

Disclosure statement to be given

The Buyer must ensure any proposed Nominee is given a Disclosure Statement relating to the Lot that is provided by the Seller and that complies with the Land Sales Act 1984.

The Seller must promptly provide a Disclosure Statement and proposed Nominee Contract at the Buyer's request. The Buyer acknowledges that the Seller is not obliged to provide a Disclosure Statement until it is lawful for the Seller to enter into a Nominee Contract.

Right and process to nominate

- (a) The Buyer may appoint a Nominee for a Lot:
 - (i) only during the Call Option Period; and
 - (ii) provided that the Lot has not already been sold.
- (b) The form of Nominee Contract will be generally the same as the Sale Contract except that the Settlement Date may be the later of:
 - (i) 14 days from the date the buyer is notified that the Subdivision Plan is registered; and
 - (ii) 35 days after the Contract Date for the contract.
- (c) To appoint a Nominee for the sale of a Lot, the Buyer must give the Seller all of the following at the one time:
 - (i) copies of:
 - A. the form 27c provided by the Seller's Agent correctly completed and signed by the Seller's Agent and the proposed Nominee; and
 - B. the Disclosure Statement for the relevant Lot that was provided to the Nominee and that has been signed by the Nominee; and
 - (ii) two copies of the form of Nominee Contract properly completed for the relevant Lot and signed by the Nominee, including:
 - A. a Form 30c Warning Statement and any other forms that must be attached to the Nominee Contract under any laws; and
 - B. a price that is at least the Price for that Lot identified in Schedule A plus the amount of any commission and other charges the Seller will be obliged to pay the Seller's Agent with respect to the proposed contract; and
 - C. a deposit that is at least \$#; and
 - (iii) evidence satisfactory to the Seller of compliance with the relevant requirements of Chapter 11, Part 2, of the Property Agents and Motor Dealers Act 2000; and
 - (iv) a cheque for payment of the deposit under the Nominee Contract.

Payment of price uplift to Buyer

If a Nominee completes a Nominee Contract and the price payable under the Nominee Contract is greater than the Price for that Lot identified in Schedule A then:

- (a) the Seller must pay the Buyer the amount, if any, by which the price under the Nominee Contract exceeds the amount calculated with the following formula

$$P + AC + AGST$$



where:

P is the Price for the relevant Lot identified in Schedule A;

AC is the commission and any other amounts the Seller must pay to the Seller's Agent with respect to the Nominee Contract;

AGST is the amount of GST the Seller must pay on the difference between the Price and the sale price under the Nominee Contract; and

(b) the payment to the Buyer must be made within 7 days after completion of the sale to the Nominee.

No obligation to complete Nominee Contract

This agreement does not oblige the Seller to complete a contract with a Nominee, or to grant a Nominee any extension of a settlement date.

The Nominee is not entitled to any damages or compensation because the Seller does not comply with its obligations under a Nominee Contract.

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