



# Arbitration and appraisal:

## RENT RESET ISSUES

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### PART 1

#### Abstract

Commercial leases often contain arbitration clauses to address disputes between a landlord and tenant. One of the most common arbitration disputes centers on the determination of market rent, or rent as defined or described in the lease, when the parties are unable to reach agreement through negotiation. Often the arbitration clause in the lease will dictate that an appraiser possessing certain professional qualifications and experience is selected and mutually appointed or party-appointed if an arbitral panel is contemplated. A determination of the rent to be fixed by the

arbitrator or arbitral panel either during the term of the lease or at the end of the lease pursuant to an option to extend or renew the lease often requires evidence from real estate professionals, which typically include valuers. An appraiser appropriately qualified to act as an arbitrator, coupled with an effective appraisal strategy, should reduce the time required to complete the arbitration, and result in cost savings for both parties.

Depending on the jurisdiction in which the property is located, the complexity of the valuation issue(s), or the amount of rent in dispute, it may be appropriate for each party to have its own appraisal report

independently reviewed (*Sorenson, 2010*) by a qualified appraiser prior to arbitration. This article explores the decision to arbitrate and some of the issues encountered through the presentation of case studies, the role of an appraiser as an arbitrator, and the expectations of an appraiser acting as an expert witness.

#### Introduction

Many long-term commercial leases (*Sevelka, 2020*), whether of land or space, contain an arbitration clause as a court-alternative mechanism to resolve disputes between a landlord (lessor) and a tenant

(lessee) in a consensual, confidential, and private forum. One of the most common disputes concerns resetting of rent either at some point during the term of the lease, or at the end of the existing term by an option to extend the term of the existing lease or by exercising a renewal option. If the parties fail to negotiate a new rent within a specified timeframe as dictated by the lease, one of the parties will trigger the arbitration clause calling either for the appointment of a mutually agreed-upon arbitrator or for each party to designate a party-appointed arbitrator, the two of whom will, in turn, select ahead (neutral) arbitrator or chair, rounding out the arbitral panel. Appointing real estate appraisers with appropriate professional designations, knowledge, and skills as arbitrators to resolve rent reset disputes, and presenting them with appraisal evidence that is thorough and credible,<sup>1</sup> should reduce the time to complete arbitrations, and result in substantial cost savings to the parties of the dispute.

This article explores some of the criteria by which appraisers are selected to act as arbitrators, and the importance of appraisers in acting as expert witnesses to present evidence that is consistent with the nature of the dispute, and in compliance with recognized appraisal theory and practice. Unique situations involving space lease disputes and the potential consequences of failing to adhere to the arbitration clause or the agreement to arbitrate mutually agreed upon by the parties to the dispute are also addressed.

### Definition of arbitration

Arbitration involves resolution of disputes outside of court, wherein the parties to a dispute refer it to one or more persons, by whose decision (the 'award') they agree to be bound. Arbitration is a form of binding dispute resolution, similar to litigation, and entirely distinct from the various forms of non-binding dispute resolutions, such as negotiation and mediation, although it is possible to enter into binding mediation (Thayer and Smith, 2012).<sup>2</sup> As described by the American Bar Association,

"Arbitration is a private process where disputing parties agree that one or several individuals can make a decision about the dispute after receiving evidence and hearing arguments. The arbitration process is similar to a trial in that the parties make opening statements and present evidence to the arbitrator."

Compared to a traditional trial, arbitration allows for appointment of subject matter experts as decision makers, is less formal, and can usually be completed more quickly.

### Arbitration Award

An Arbitration Award (or Arbitral Award) resolves a matter in dispute in a private forum. At the conclusion of an arbitration hearing, the arbitrator or arbitral panel issues an *Award*, which is a determination on the merits (i.e., the decision), and is analogous to a judgment in a court of law. Depending on the jurisdiction in which the property is located or the terms of the arbitration agreement, the award is issued to the parties either in a 'conclusory'<sup>3</sup> manner or 'reasoned' (Chalk, 2019) setting out in transparent and sufficient detail (Kirchner, 2014) the bases of the decision.

### Brief literature review

In 1987, the American Arbitration Association published *Arbitration of Real Estate Valuation Disputes*,<sup>4</sup> which was funded by a grant from the American Institute of Real Estate Appraisers, a predecessor organization of the Appraisal Institute. The text includes a collection of papers authored by a number of prominent appraisers and lawyers who were engaged in the arbitration of valuation disputes of real property rights and describes the procedural steps and obligations of an arbitrator, as well as the role of an independent expert.

While the appraisal profession in North America has a long history of involvement in resolving real estate disputes, the topic of arbitration appears for the first time in the 11th edition of the Appraisal Institute's *The Appraisal of Real Estate*

published in 1999 in which the word "arbitration" appeared only once. In November 2016 (later revised in 2020), the Appraisal Institute published Guide Note 16 *Arbitration*,<sup>5</sup> accompanied by a press release referencing Advisory Opinion 21 of the *Uniform Standards of Professional Appraisal Practice (USPAP)*,<sup>6</sup> which explains the purpose of arbitration, as well as the role and professional obligations of a Member of the Appraisal Institute acting either as an expert witness or as an arbitrator, usually to resolve a dispute involving market value, market rent, value, or rent as defined and described in the lease.

The Appraisal Institute, in broadening an understanding of arbitration as a means of resolving valuation disputes, undertook several initiatives to raise awareness and understanding of arbitration as an area of expertise within the valuation profession. These include:

- Publication of *Appraisers in Arbitration* (Konikoff, 2022);
- Inclusion of a brief reference to arbitration in the 15th edition (2020) of *The Appraisal of Real Estate* as a subcategory of consulting (p. 648);
- Development of a course entitled, 'Expand Your Practice: Arbitration Do's and Don'ts.'

The text, *Appraisers in Arbitration*, delves into areas of appraisal practice beyond those typically associated with valuation practice. Alternative dispute resolution (ADR), which includes negotiation, mediation, and arbitration (Celik, 2013), presents a growing area of need for the skills of valuation professionals.

*The Appraisers in Arbitration*, second edition, provides detailed information to help valuation professionals participate in arbitration and understand the roles they will play. The text provides specific advice on how to perform each task required of an arbitrator, expert witness, or consultant and the standards that apply to each service. Every step in the arbitration process, from the preliminary hearing to the final award, is explained and common arbitration scenarios and real-world examples are discussed.

### Appraiser as arbitrator

The qualifications for selecting an arbitrator in a rent reset dispute are dictated by the language of the lease or as agreed upon by the parties to the dispute. If an appraiser is appointed to act as an arbitrator in a rental dispute, that individual is typically expected to possess a requisite professional designation, as well as the skills and experience to understand and resolve the dispute. Complex rent resets involving ground leases (*Sevelka, 2011*) demand a higher level of knowledge and expertise than is necessary to address a rent reset of a single tenancy in a small storefront. However, in all rent reset disputes the real estate appraiser appointed as an arbitrator should possess experience with the property type and have experience reading commercial leases and understanding relevant lease clauses. A lease is a contract, and the interpretation of the rent reset clause is of critical importance to the parties in a rent reset dispute.<sup>7</sup> Appraisers may possess the same professional designations, but can have vastly different skills and experiences. An appraiser's suitability to act as an arbitrator depends on the language of the arbitration clause or as agreed upon by the parties, and may speak to some of the following:

- Professional Appraiser or Appraisal Review Qualifications (e.g., MAI, AACI, FRICS, AI-GRS<sup>8</sup>)
- Continuing Professional Development (ongoing professional education)
- Professional Contributions (e.g., relevant articles published in recognized journals or trade publications)
- Appraisal Experience
- Ethical Requirements (whether the appraiser has been disciplined by any governing appraisal body for ethical breaches)
- Reputation within the Appraisal Community
- Geographic knowledge of the area where the property (demised premises) is located (*Carneghi, 1999*).

In virtually all jurisdictions, the decision of an arbitrator or arbitral panel is final and binding, so it is extremely important

for a real estate appraiser when acting as an arbitrator to understand their legal duties to the parties. Short of fraud, evident partiality,<sup>9</sup> or a failure on the part of the arbitrator to adhere to the parties' arbitration agreement or to the provisions of the relevant arbitration act in conducting the arbitration, it is virtually impossible to vacate an arbitration award.<sup>10</sup> Public policy supports minimal judicial intervention in an arbitration award, and the parties do not get to appeal an adverse decision<sup>11</sup> unless the arbitrator or arbitration panel has exceeded its jurisdiction<sup>12</sup> or authority.<sup>13</sup> Parties who opt for arbitration to settle their disputes accept up-front the risk of errors in *law* or *fact* committed by the arbitrator or arbitration panel.<sup>14,15</sup>

No matter how harsh,<sup>16</sup> unfair, or unreasonable the terms and conditions of a lease are to either party, absent any ambiguity,<sup>17</sup> courts will not intervene and rewrite a lease to which the lessor and lessee voluntarily and mutually agreed on terms and conditions drafted by experienced legal counsel. Rent reset clauses are the product of negotiation either directly by the parties to the lease (contract) or indirectly through legal counsel, and each rent reset clause is uniquely tailored to meet the specific business interests of each party, and the way in which parties contract to have rent reset is entirely within their discretion. The fact that a contract term is imprudent for one party to have agreed upon or that it worked out badly or even disastrously is no reason to deviate from the clear language of a rent reset clause. Whether a rent reset clause favours the landlord or the tenant is an irrelevant factor in fixing the new rent.

Arbitration, unlike mediation,<sup>18</sup> is not intended to produce a 'win-win' outcome for both parties, which can sometimes lead a disgruntled party confronted by an unfavourable award to sue its own valuation expert in those jurisdictions that do not recognize witness immunity.<sup>19</sup> However, an appraiser acting as an arbitrator is entitled to arbitral immunity, which is defined and explained as follows:

"Arbitral immunity refers to the immunity that is extended to arbitrators for acts arising out of the scope of their arbitral functions. Arbitrators are judges chosen by the parties to decide the matters submitted to them. The independence necessary for principled and fearless decision making can best be preserved by protecting these persons from bias or intimidation caused by the fear of a lawsuit arising out of the exercise of official functions within their jurisdiction. Arbitral immunity is the keystone of the arbitral system and should not be overturned. Arbitral immunity is necessary for finality of arbitrators' decisions."<sup>20</sup>

### Conducting an arbitration

Once appointed, an arbitrator or arbitral panel performs several duties, and arbitral decisions on issues that are within the arbitrator's jurisdiction are given substantial deference by the courts. In a rent reset arbitration proceeding, the arbitrator or arbitral panel should:

- Obtain a copy of the executed lease, including amendments to the lease, and a statement of the issue(s) in dispute (e.g., property value, rental value) from each party.
- Read the lease thoroughly, including schedules and any amendments to the lease, well in advance of the actual arbitration.
- Request a mutually agreed-upon Statement of Facts from the parties to narrow the scope of the dispute and minimize the duration and cost of the arbitration.
- Not engage in *ex parte* communications, as this conduct is a ground supporting vacatur of an arbitral award.<sup>21</sup>
- Arrange a preliminary conference call, remote hearing, or in-person hearing with the parties to discuss pre-arbitral issues, arbitral procedural issues, and rules set forth by the arbitrator for the hearing. The arbitrator and the parties should agree on basic procedural issues, such as the schedule, length, and location of hearing(s), the number of expert witnesses, and the amount of time each party will have to present its case.

- Conduct the arbitration on the basis of a formal hearing, written submissions, teleconference or video conference (visual and audio), or a combination thereof. Consider the complexity of the issue(s) in dispute, while adhering to the principles of a fair arbitration process.<sup>22</sup> The COVID-19 global pandemic, announced March 11, 2020, which restricted public gatherings, has resulted in a paradigm shift reducing or eliminating the need for in-person hearings, and now post-pandemic, most arbitrations are conducted online resulting in substantial cost savings to the parties.
- Issue, if necessary, a subpoena requiring a non-party to produce documents and/or attend and give evidence at an arbitration hearing. However, seeking documents and/or testimony from non-party witnesses is a complicated legal process in some jurisdictions, and if the subpoena is resisted, it may cause unnecessary delay of the arbitration. In some rental disputes, before the actual hearing commences, it may be appropriate for the arbitrator to order the appraisers retained by the parties to meet in private (without prejudice) to seek consensus on issues bearing on the determination of rent and submit a joint statement to that effect, which should be of assistance to the arbitrator and possibly lead to settlement between the parties.
- Exercise discretion over the admissibility of evidence as to its relevance and necessity, and guard against tactics that are inconsistent with the principle of fundamental fairness (*Blankley, 2014*).<sup>23</sup>
- Inspect the subject premises, when it is appropriate and practical to do so or when authorized by the parties.
- Inspect the comparables, when it is appropriate and practical to do so or when authorized by the parties.<sup>24</sup>
- Rule on *motions* submitted by the parties during the arbitration.
- Enter an *award* upon agreed terms at the request of the parties if a settlement is reached during the

arbitration. Conversely, the parties may agree to discontinue the arbitration and enter into a private contract spelling out the terms and conditions of the settlement.

- Issue a written, dated, and signed decision (Arbitration Award),<sup>25</sup> including the legal place of the arbitration, and refrain from attaching any professional designations to the signature.<sup>26</sup>
- Issue a written and signed Cost Award in favour of the prevailing party, if mandated, following the completion of the arbitration.

#### End notes

<sup>1</sup> *Uniform Standards of Professional Appraisal Practice* (USPAP) define "credible" as "worthy of belief." Appraisal Institute's *Standards of Valuation Practice* (SVP), effective November 12, 2021, define "credible" as "worthy of belief, supported by analysis of relevant information. Credibility is always measured in the context of intended use.

<sup>2</sup> See *Bowers v. Raymond J. Lucia Companies, Inc.*, 206 Cal. App. 4th 724 (2012) 142 Cal. Rptr. 3d 64. <https://casetext.com/case/bowers-v-raymond-j-lucia-cos>

<sup>3</sup> Consisting of or relating to a conclusion or assertion for which no supporting evidence is offered. <https://dictionary.findlaw.com/definition/conclusory.html>

<sup>4</sup> *Arbitration of Real Estate Valuation Disputes*, American Arbitration Association, New York, 1987.

<sup>5</sup> Guide Note 16, *Arbitration*, revised November 2020, <https://www.appraisalinstitute.org/assets/1/7/guide-note-16.pdf>.

<sup>6</sup> Appraisal Institute's New Guidance Outlines Appraiser's Role in Arbitration, *Real Estate Rama*, January 27, 2017. <https://www.realestaterama.com/appraisal-institutes-new-guidance-outlines-appraisers-role-in-arbitration-ID040185.html> [retrieved on 4 December 2023].

<sup>7</sup> Contract interpretation might require the assistance of legal counsel.

<sup>8</sup> The AACI designation is awarded by the Appraisal Institute of Canada, and

the FRICS designation is awarded by the Royal Institution of Chartered Surveyors in United Kingdom, both with similar designation requirements to the MAI granted by the Appraisal Institute in United States. The AI-GRS is a 'General Review Specialist' designation awarded by the Appraisal Institute to professionals who provide reviews of appraisals of a wide range of property types, including commercial, industrial, agricultural, residential, and vacant land. For designation requirements, see the link <https://www.appraisalinstitute.org/assets/1/7/ai-grs-path-chart.pdf>.

<sup>9</sup> On December 30, 2019, the Ninth Circuit Court of Appeals denied petitions for panel rehearing and rehearing en banc in *Monster Energy Co. v. City Beverages, LLC*, No. 17-55813, and confirmed its decision to vacate an arbitration award for failure to disclose that (1) the arbitrator was a co-owner of JAMS (Judicial Arbitration and Mediation Services, Inc.); and (2) the prevailing party (Monster Energy Co.) had several prior cases with JAMS. The Ninth Circuit reversed and vacated the arbitration award for 'evident partiality' resulting from the arbitrator's failure to disclose an ownership interest in JAMS, even though he stated to the parties that he "has an economic interest in the overall financial success of JAMS."

<sup>10</sup> In the United States, grounds for setting aside an award are set out in the *Federal Arbitration Act (FAA)*: "(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made (9 U.S. Code § 10 (a))."

<sup>11</sup> "Courts have repeatedly instructed litigants that challenges to the arbitrator's rulings on discovery, admission of evidence, reasoning, and conduct of the proceedings do not lie." *Evans v. Cornerstone Development Co.*, 35 Cal. Rptr. 3d 745 (2005) 134 Cal.App.4th 151.

<sup>12</sup> In *Westnav Container Services v. Freeport Properties Ltd.*, 2010 BCCA 33, the arbitrator's award made an error in describing the rental rate for a comparable property and, in supplementary reasons, the arbitrator eliminated reference to that comparable and added reference to other comparables, leaving the result unchanged. The Court of Appeal, at para. 47, found that the arbitrator had exceeded his jurisdiction and committed arbitral error.

<sup>13</sup> In *Bankers Life & Casualty Insurance Co. v. CBRE, Inc.*, 830 F.3d 729, (2016), the Court of Appeals, 7th Circuit, held that the arbitration panel exceeded its authority by basing its award on documents outside the parties' agreement, unilaterally inserted by CBRE.

<sup>14</sup> As established by the US Supreme Court in *Oxford Health Plans v. Sutter*, 133 S. Ct. 2064, 569 U.S. 564, 186 L. Ed. 2d 113, "[t]he potential for...mistakes is the price of agreeing to arbitration."

<sup>15</sup> In Canada, in *Sattva Capital Corp. v. Creston Moly Corp.* 2014, SCC 53, the Supreme Court of Canada limited the availability of appeals from commercial arbitration awards on questions of law to those "rare" cases where the arbitral tribunal has made an "extricable error of law." *Pre-publication Article: Arbitration Appeals on Questions of Law in Canada: Stop Extricating the Extricable!*, <https://arbitrationmatters.com/news/pre-publication-article-arbitration-appeals-on-questions-of-law-in-canada-stop-extricating-the-inextricable/> retrieved on 4 December 2023.

<sup>16</sup> *Heller & Henretig v. 3620-168th St., Inc.*, 302 N.Y. 326; *Hartigan v. Casualty Co. of America*, 227 N.Y. 175.

<sup>17</sup> *Ruth v. A.Z.B. Corp.*, 2 Misc.2d 631, 636 [NY County], *affd* 2A.D/2d 970 [1st Dept 1956]. Case cited in *The Manufacturers Life Insurance Company v. Parc-IX Limited*, 2018 ONSC 3625.

<sup>18</sup> *Black's Law Dictionary*, 11th edition, defines "mediation" as "[a] method of nonbinding dispute resolution involving a neutral third party who tries to help the disputing parties reach a mutually agreeable solution."

<sup>19</sup> In *Marrogi v. Howard*, 805 So. 2d 1118 – La: Supreme Court 2002, para. 1129, and corresponding footnote 16. In *Estate of Voutsaras v. Bender*, Mich: Court of Appeals 2019, the court ruled that "[l]icensed professionals owe the same duty to the party for whom they testify as they would to any client, and witness immunity is not a defense against professional malpractice."

<sup>20</sup> USLegal, <https://definitions.uslegal.com/a/arbitral-immunity/>

<sup>21</sup> The United States Court of Appeals for the Sixth Circuit held that ex parte communications void an award if they violate the parties' arbitration agreement. In *Star Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, No. 15- 1403, 2016 BL 267734 (6th Cir. Aug. 18, 2016),

<sup>22</sup> In *1414 Holdings, LLC v. BMS-PSO, LLC*, 2017 NY Slip Op 32551(U), the New York Supreme Court upheld a neutral arbitrator's decision to not undertake a formal hearing, and confin[e] "the scope of the assignment...[to] meeting with [the parties'] arbitrators, reviewing all submitted documents and evidence, inspecting the subject premises, confirming the appropriateness of the

data assumption and analyses presented by the arbitrators, and reaching a decision as to the value of the 19th Floor Space [at 1414 Avenue of the Americas in New York]." There is no express requirement in the lease for a formal hearing.

<sup>23</sup> In *1552 Broadway Retail Owner LLC v. McDonald's*, 2017 NY Slip Op 50011(U) [Jan 9, 2017], the New York Supreme Court upheld the Arbitration Award, while "find[ing] the behavior of Tenant's counsel and expert reprehensible, especially in light of the Tenant's previous protestations that the parties having different understandings of FMV would cause the arbitration to be 'fatally flawed.'" [Footnote 9]

<sup>24</sup> In *California Union Square LP v. Saks & Co., LLC*, 50 Cal.App.5th 340 (2020), the arbitration agreement gave the arbitrator discretion to inspect "the subject property" and "the party experts' lease comparables," but the trial court determined that the arbitrator exceeded his powers by visiting properties outside the scope of his authority as arbitrator.

<sup>25</sup> In most jurisdictions in the United States, reasons for an arbitration Award are not required, but the parties may still request a reasoned Award.

<sup>26</sup> A state-licensed appraiser acting as an arbitrator in Hawaii is subject to Hawaii Revised Statutes Section 466K-6, and "the record of an award shall include, but not be limited to findings of fact, the...rationale for the award...certification of compliance with the most current *Uniform Standards of Professional Appraisal Practice*...; and information regarding the evidence, including the data, methodologies, and analysis that provided the basis for the award." This requirement is unique to the state of Hawaii. ■

**NOTE:** Part two of this article deals with the arbitration-specific information and examples regarding lease renewals and extensions, determining rent, existing use or (unrestricted) highest and best use, appraisal suggestions, a case study, non-compliant appraisal reports, and the conclusion. The next installment will be published in *Canadian Property Valuation* Volume 68, Book 2.