



# The ABC's of Appraisals for Your Commercial Lease Extension

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**F**ive or ten years ago, the shopping center landlord and tenant carefully negotiated a commercial lease that included term, use, and many other provisions. One of the most important provisions is the rent provision. The lease will provide minimum base rent and, perhaps, percentage of sales rent. The amount of rent is explicitly agreed upon for that first term of the lease.

But, what happens when the lease has one or more lease extension options? How is the rent determined for those option periods? Some leases, of course, provide that upon the exercise by the tenant of another lease period, that the base rent increases by a certain percentage or in accordance with some other numeric formula or calculation. However, many times, the parties agree that the tenant will pay the fair market rental at the start of each option period. If the parties cannot amicably agree as to what that rental is, then they may agree that one or more third-party appraisers determine that amount.

## The Difference Among an Appraisal, Mediation, and Arbitration

People often times confuse the terms “mediation,” “arbitration,” and “appraisal.” Mediation is a non-binding settlement process through which the disputing parties meet with a neutral mediator and attempt to resolve their differences without determinations by a judge or an arbitrator. Arbitration is an alternate dispute mechanism to resolve disputes among parties. In arbitration, a neutral individual acts like a judge and makes binding decisions about the parties’ disputes. Except in very limited situations, the award of the arbitrator cannot be vacated by the losing party. Appraisal is a valuation process. Appraisers cannot make determinations except *valuations* specifically provided in the lease, such as fair market *rental*, or in a purchase option, fair market *value*. Appraisers cannot resolve disputes between the landlord and tenant as to what the lease means, whether there is a breach of that lease or any other dispute other than the valuation provided in the lease. For example, if the lease requires that rent for the first extension equals the fair market rental of similar shopping center spaces in the geographic area, an appraisal process is

often times used to make that determination in the absence of agreement by the landlord and tenant. On the other hand, if the lease calls for a determination of fair market rental, but is unclear as to the date of valuation, then, in the absence of agreement of the landlord and tenant, an arbitrator (if arbitration is provided for in the lease) must first construe the lease as to what valuation date to use, and then the valuation can be determined through the appraisal process.

## California's Statutory Scheme for Appraisals

California's arbitration enforcement statutes include, for purposes of enforcement, agreements “providing for valuations, appraisals and similar proceedings.” Therefore, there is a built-in set of rules regarding the process of appraisals. Specifically, if one of the parties will not agree to commence the appraisal process, the party seeking an appraisal may petition the court for an order compelling the parties to use the appraisal process called for in the lease. If the lease provides the method for selection of the appraiser, then the California statutes provide that that method should be followed. However, if the lease does not provide a selection method or one or both of the parties will not follow that method, then either party may seek an order from the court to select an appraiser for them. California's rules also provide, in the absence of provisions already set forth in the appraisal process, for the manner in which the process should go forward. And, once there is an appraisal award, the rules provide a method by which a court can confirm that award or correct or vacate it.

## Selection of the Appraisers

Once the landlord and tenant agree or are compelled to undertake the appraisal process, one or more appraisers must be chosen. First, how many appraisers are to participate? The terms of the lease control. The alternatives include a single, neutral appraiser or three appraisers, one chosen by each party (so-called “party appraisers”) and then a third, neutral appraiser.

The California statutes also provide that if a “neutral” appraiser is involved, that individual must disclose all matters that could

cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral appraiser would be able to be impartial. The rules provide a non-exclusive list, including personal knowledge of disputed facts, a financial interest in the dispute, or any professional or significant personal relationship with a party to the dispute. The appraiser's spouse and minor children are also considered for purposes of determining the neutrality of the appraiser.

After the decision is made as to the number of appraisers to participate, the selection process begins. What kind of expertise or experience do you want the appraisers to have? Do you want the appraisers to have an “MAI”<sup>1</sup> designation? Experience in a particular geographic area? Minimum time handling valuations of commercial property? Specific to shopping centers? Hopefully, the parties have already discussed and agreed upon the expertise needed for the appraisers, and included the appropriate clear language in the lease. If there is no minimum qualifications for the appraisers, then the parties should meet and confer to try to agree upon the minimum requirements for them.

If no agreement is reached as to the qualifications for the appraisers and/or the parties cannot agree upon the actual appraisers to handle this valuation, then the parties will need to involve third parties in the process. If the lease provides a specific methodology for selection of the appraisers, then that must be triggered. Such a mechanism might be an application to the presiding judge of the local superior court. It also might consist of each side suggesting a certain number of appraisers, and having the appraiser who overlaps be the selection. Or, the mechanism might be that each side chooses a party appraiser and that those two then select a third, neutral appraiser to make the valuation.

## Methodology of the Appraisal

The lease can provide a multitude of different methods for the appraisal to go forward once the single or multiple appraisers are selected. The lease usually designates parameters as to how the valuation should proceed, including the date of valuation, what comparison properties should be considered in determining valuation, and what geographic areas should be considered. Often times, the lease will provide

that the landlord and tenant first exchange valuation proposals, followed by meeting and conferring and, if that fails, commencement of the selection of the appraiser or appraisers.

The lease may also provide the manner in which the valuation is used by the landlord and tenant. For example, in a “baseball” type of appraisal, the appraisers determine who came closer to the value determined in the appraisal process. This method doesn’t give the appraisers the ability to “split the baby,” and also “keeps the parties honest” because if one of the parties either provides a low-ball number or one that is pie-in-the-sky, it is likely the other party, if reasonable, will be closer to the appraised amount. The lease can also provide a “floor” and “cap” to the appraisal process. For example, to protect the landlord, the lease may provide that the option rent is equal to fair market rental as of the exercise of the option but, in no event, less than the rent paid by the tenant as of the end of the now-expiring term. Conversely, the tenant may provide protection by limiting the new rent as determined by the appraisal to an amount not more than a certain percentage or quantity above the rent for the now-expiring term.

### Other Issues to Consider

Other practical matters to consider when drafting and implementing an appraisal process for a commercial lease include the timing of the process. Try to include deadlines for the various tasks so that the result, *i.e.*, the new rent, is determined before the start of the new option period. Alternatively, if that cannot be accomplished, make sure to provide ahead of time how to handle the rent that is to be paid from the end of the last term until the final decision is made with respect to the new rent amount. Does the tenant continue to pay the existing rent as of the end of the last term? Does the tenant pay, retroactively, for that gap period based upon the subsequent appraisal award?

As can be seen, the best preparation for the appraisal of future rent occurs when the landlord and tenant are still negotiating the original lease. The more that can be expressly included in the lease, the more likely the parties will have an expeditious resolution of future rent years later. Second best is cooperation of the parties near the end of the expiring lease term so that the appraiser or appraisers have clear instructions as to their role in the process. If the parties have neither, then the process can be full of pitfalls, delays, and additional expense. **CC**

<sup>1</sup> MAI means “Member of the appraisal Institute”

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