Part I of II

Rental dispute arbitration

Note: Part II of this feature will be published in the Fall 1998 issue of *The Canadian Appraiser*.

Tony Sevelka

Arbitration is a quasi-judicial process that has been promoted as an effective alternative to civil proceedings between landlords and tenants in resolving disputes over the fixing of rent in connection with rent review and rent renewal.

Proponents of arbitration claim that the process is more efficient, less costly, less time-consuming and less cumbersome (formal) than civil court proceedings, and eliminates harassing litigation. Further, it is claimed that an individual selected as an arbitrator is likely to possess specialized issue-specific knowledge, consistent with the issue in dispute, not necessarily possessed by a judge educated and versed in law. *Black's Law Dictionary (Centennial Edition 1891 - 1991)* defines arbitration as:

1. A process of dispute resolution in which a neutral third party (arbitrator) renders a decision after a hearing at which both parties have an opportunity to be heard. Where arbitration is voluntary, the disputing parties select the arbitrator who has the power to render a binding decision.
2. An arrangement for taking and abiding by the judgement of selected persons in some disputed matter, instead of carrying it to established tribunals of justice [the courts], and is intended to avoid the formalities, the delays, the expense and vexation of ordinary [civil] litigation.

Arbitration framework

The provinces of Prince Edward Island, New Brunswick, Ontario, Saskatchewan, Alberta and British Columbia, as well as the Northwest Territories have an *Arbitration Act*, which allows for the voluntary resolution of commercial disputes by means of arbitration rather than civil litigation. Appraisers should familiarize themselves with the *Arbitration Act* which has jurisdiction in the geographic area of their practice in the event of being appointed as an arbitrator or retained as an expert witness in a rental dispute arbitration.

Arbitration decisions (awards) are usually final and binding upon the parties, unless the parties stipulate otherwise, or the arbitrator has made an error in law. Any residual discretion of the courts to grant leave to appeal of an arbitral award will not be treated lightly, as the courts are reluctant to intervene in a process commissioned, co-ordinated and undertaken by mutual and voluntary consent.

Arbitration is usually triggered by an arbitration clause forming part of a lease (contract) between landlord (lessor) and tenant (lessee), which, in the case of dispute over the rent to be paid at the time the rent is to be reviewed or renewed, and failing agree-

ment, provides for compulsory arbitration in compliance with the *Arbitration Act* having jurisdiction.

The purpose of the arbitration clause is to avoid contesting the rental dispute in court. In theory, the arbitral system is to be parallel, but unconnected, to the judicial system, except on those few grounds where the court has the power to intervene in an arbitral process.

Should a landlord and tenant fail to agree on the quantum of rent at the time of rent review (during the term of a lease) or rent renewal (when an option to renew a lease has been exercised), and the arbitration clause is triggered, the parties should set the ground rules for the arbitration proceeding and reduce the number and magnitude of issues surrounding the rental dispute to be contested, to avoid unnecessary expenditures of time and money. This can be accomplished by compiling a mutually agreed-upon *Statement of Facts* detailing all facts not in dispute prior to commencement of the arbitration hearing. Agreement of the parties should include such items as:

- name of arbitrator(s);
- names of the parties (i.e., landlord and tenant) to the dispute;
- address and legal description of the property;
- site dimensions and area, if applicable;
- building area(s) or area of the demised premises, if applicable;
- land use controls (i.e., zoning, official plan, secondary plan, etc.);
- permitted uses, if detailed, under the use clause or the use of premises clause;
- highest and best use of the property or demised premises, if applicable;
- date and term for which the rent is to be fixed;
- acceptance of all subsisting clauses in the existing lease (save and except the quantum of rent);
- application of 'subjective' or 'objective' approach in determining the rent;
- procedural and evidentiary protocols; and
- date, time and location of the arbitration hearing.

Selection of appraiser as arbitrator

Only professionally-designated appraisers conversant with the requirements of the *Uniform Standards of Professional Appraisal Practice (USPAP)*[1] and with extensive experience conducting and reviewing appraisals should be considered for appointment to an arbitral tribunal involving a rental dispute. Professional background checks, review of any published materials and scouring of public records for cases/disputes in which the potential arbitrator(s) may have participated should always be conducted before deciding on an arbitrator.

Ethical considerations are paramount, and demand that any actual or perceived conflict of interest be disclosed by the potential arbitrator. The potential arbitrator should be held in high esteem by his peers; be able to conduct himself in a fair and unbiased manner; and not favour either party to the dispute. An appraiser appointed as sole or chief arbitrator should be allowed to retain independent legal counsel, with the expense borne by the parties, to assist strictly with questions of law, and procedural and evidentiary issues prior to, during, and after the hearing until the arbitrator's written final award is issued and any leave to appeal exhausted.

Composition of arbitral tribunal

In a private commercial dispute, the number of arbitrators to be appointed to an arbitral tribunal is by mutual agreement of the parties and usually dictated by the terms of the arbitration clause in the lease. In rental disputes, depending on the complexity of the issue(s) involved, the arbitral tribunal is generally either composed of a sole arbitrator or of three arbitrators, one of whom is appointed as the chief arbitrator, usually by consensus of two other party-nominated arbitrators. If an arbitration agreement does not specify the number of arbitrators who are to form the arbitral tribunal, only one arbitrator will form the arbitral tribunal.

Purpose of rent review

Rent review occurs at predetermined intervals during the term of a lease and/or when a tenant exercises a renewal option, and has as its objective the adjustment of rent for the demised premises to the current market level for the specified term at the time of the rent review. The following case law articulates the basic philosophy behind a rent review clause.

In *Basingstoke and Deane Borough Council v. Host Group Ltd. [198811 All E.R. 824 at 828-30,* Nicholls LJ speaking for the court said that:

> *"The question... is one of construction of a rent review clause in a lease. In answering that question, it is axiomatic that what the court is seeking to identify and declare is the intention of the parties to the lease expressed in that clause. Thus, like all points of construction, the meaning of this rent review clause depends on the particular language used, interpreted having regard to the context provided by the whole document and matrix of the material surrounding circumstances... [T]he particular language used will always be of paramount importance. Nonetheless, it is proper and only sensible, when construing a rent review clause to have in mind what normally is the commercial purpose of such a clause. That purpose has been referred to in several... cases, and is*

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not in doubt. Sir Nicolas Browne-Wilkinson V-C expressed it in these terms in British Gas Corp. v. Universities Superannuation Scheme Ltd. [19861 1 All ER 978 at 980-981,[198611 WLR 398 at 401:

> *There is really no dispute that the general purpose of a provision for rent review is to enable the landlord to obtain from time to time the market rental which the premises would command if let on the same terms on the open market at the review dates. The purpose is to reflect the changes in the value of money and real increases in the value of the property during a long term.*
>
> *"The means by which rent review clauses afford landlords relief in respect of increases in property values or falls in the value of money is by providing, normally, for a valuer [appraiser], in default of agreement, to assess the up-to-date rent for the demised premises at successive review dates. In making that assessment, the valuer will be achieving the intended purpose of keeping the rent in line with current property values having regard to the current value of money if, but only if, he assesses the up-to-date rent on the same terms (other than as to the quantum of rent) as the terms still subsisting between the parties under the actual, existing lease."*

Depending on the time that has elapsed prior to rent review, the period covered by the rent review, and the real estate conditions prevailing at the time of the rent review, market rent at the time the review comes due may be less than, more than, or equal to the prior contract rent. However, the past contract rent and the circumstances surrounding its negotiation, as between a particular landlord and a particular tenant, are not to be considered in determining the market rent for the demised premises at the time of the rent review.

Determination of rent

The manner in which rent is to be determined is of utmost importance and will have a profound impact on the quantum of rent that an arbitrator deems appropriate for property/demised premises for which rent is in dispute. Depending on the language (construction) of the lease, either a 'subjective' or 'objective' approach will be applied by the arbitrator(s) in determining the quantum of rent.

Distinguishing characteristics of both the 'subjective' and 'objective' approaches in the determination of rent are detailed below:

Subjective approach

- The rent must be fair as between the actual landlord and the actual tenant (i.e., the parties to the dispute) having regard to all the existing circumstances relevant to any negotiations between them of a new rent from the review date.
- Considerations which would affect the minds of the parties (i.e., the actual landlord and the actual tenant) must be taken into account in determining the rent.
- Consideration of the manner or custom by which prior rent(s) was established between the actual landlord and the actual tenant must to taken into account in determining the rent.

Note: Case law which points to the "subjective" approach includes *Thomas Rates & Son Ltd. v. Wyndham's (Lingerie) Ltd. [1981] 1 All 1077 (C.A.),* and *Lear v. Blizzard [1983] 3 ALL E.R. 662 (Q.B.), Canadian National Railway Co. v. Inglis Ltd. (1992), 93 D.L.R. 461 (Ont. Ct. Gen. Div.), and Yonge-Eglinton Building Ltd. v. Toronto Transit Commission [1997], 89 D.R.S. 97-10109 (Ontario Ct. Gen. Div.)*

Objective approach

- A fair market rent would be one determined by rent paid under leases for similar purposes of like land (or premises) in the general area, or obtained in the market from one of probably several possible lessees (i.e., potential tenants other than the existing tenant).
- Any circumstance which affects the actual landlord and the actual tenant but which would not affect the hypothetical lessor and lessee is irrelevant.
- A reasonable rent for the premises would be that based on market value without reference to the particular parties (i.e., the actual landlord and actual tenant) or how the premises were built and paid for.
- A fair market rental must consider those bargaining advantages and disadvantages which exist at the particular time of the rent review or rent renewal.

The appropriateness of the rent is to be judged in the light of all the circumstances of the dispute — other than those relating to the landlord and tenant as actual legal persons — and that one of those circumstances is the rental values prevailing in the area.

That rent may depend to some extent on local factors such as deterioration of the neighbourhood. In assessing it, the appraiser will be assessing the reasonable rent that others, not just an existing tenant, would be prepared to pay for the use and occupation of the premises; the tenant's position will not be considered separately.

Note: Case law which points to the 'objective' approach includes *Ponsford v. HMS Aerosols Ltd. [1978] 2 All E.R. 837 (H.L.)* and *Union Properties Inc. v. Monenco Advisory Services Ltd. [1996], 4 R.P.R. (3d) 295 (Alta. Q.B.)*

Subsisting lease terms

With respect to the subsisting terms of a lease, in the context of a rent review clause that made no direction for the existing terms of the existing lease to be taken into account on the review, in *Ponsford v. HMS Aerosols Ltd. [1978] 2 All E.R. 837 (H.L.), [1979] AC 63,* Viscount Dilhorne states that the task of the appraiser "surely is to assess what rent the demised premises would command if let [leased] on the terms of the lease and for the period the assessed rent is to cover at the time the assessment falls to be made."

In *Pearl Insurance plc v. Shaw (1985) 274 EG 490,* Vinelott J. said: "I think the court should lean against a construction which requires the rent fixed on revision to be ascertained without regard to the use which, under the lease, the tenant [lessee] is to be entitled to make of the demised premises, unless, of course, that intention is spelled out in reasonably clear terms. Otherwise, the effect of the review might be to impose on a tenant an obligation to pay a rent appropriate to a very profitable use, but one very obnoxious to the landlord, and one

which he had been careful to forbid in the strongest possible terms — the effect, that is, of making the tenant pay for something which he not only has not got, but which he cannot require the landlord to give him."

In *British Gas Corp. v. Universities Superannuation Scheme Ltd. [1986] 1 All ER 978 [1986] 1 WLR 398*, Sir Nicolas Browne-Wilkinson V-C, stated: "in general, and subject to a special context indicating otherwise in a particular case, the parties are to be taken as having intended that the notional letting [leasing] postulated by their rent review clause is to be a letting [leasing] on the same terms (other than as to quantum of rent) as those still subsisting between the parties in the actual existing lease."

In *Basingstoke and Deane Borough Council v. Host Group Ltd. [1988] 1 All E.R. 824 (C.A.)*, the Court, in construing the terms of the subject lease, stated: "[w]e approach the construction of para (vii), therefore, on the footing that, unless the paragraph otherwise requires, expressly or by necessary implication, or there is some context indicating otherwise, the parties are to be taken to have intended that the notional letting [leasing] assumed for the purpose of the rent review assessment was to be on the same terms (other than as to quantum of rent) as those still subsisting under the actual, existing lease."

In *Canadian National Railway Company v. Inglis Limited (1992), 93 D.L.R. (4th) 461 (Ont. Ct. Gen. Div.)*, Farley J. concluded in his interpretation of two lease renewals: "it is implicitly required by the terms of the leases to base the property value on the basis of a manufacturing use and not on an unrestricted highest and best use" and "that CN has a duty to act reasonably in the determination of the rental amount [a 'subjective' approach]" and "on that basis [is] entitled to use a formula involving the property value and a rate of return on investment."

In these two rent renewals, the rental to be paid at each rent renewal was left solely to the discretion of CN, being "an amount which in the opinion of the lessor is fair and equitable."

As indicated by the preceding cases, the arbitrator must consider all of the subsisting terms of the actual lease and the term for which the rent is to be fixed in determining the quantum of rent for the property or demised premises on a restricted highest and best use, unless the language of the lease explicitly, or by implication, indicates that an unrestricted highest and best use is appropriate.

Application of the 'objective' approach applies in the determination of the rent to be paid when the clause in the lease that defines how the rent is to be determined makes reference to market rent, or the underlying conditions of market rent. Only in the 'objective' approach, as previously detailed, are the following conditions implied:

- the demised premises are assumed to be vacant (unoccupied) and available for lease on the open market;
- the subsisting terms of the lease are assumed to exist at the time of rent review or rent renewal;
- there is a presumption of a hypothetical landlord (lessor) and hypothetical tenant (lessee);
- the locational attributes of the demised premises and the prevailing rents (actual and asking) in the area (market) are taken into account;
- the market conditions that prevail at the time of the rent review or rent renewal are taken into account;
- the legally permissible use(s) of the demised premises taking into account any restriction on use in the lease and under the existing land use controls (i.e., zoning by-law); and
- the principle of substitution, whereby the rental value of the demised premises tends to be set by the rent that would be paid by a hypothetical tenant to lease substitute premises of similar utility or inutility available at the time of the rent review or rent renewal.

Where the language in the lease is explicit in its reference to market rent, lease clauses such as the following are likely to be encountered and the 'objective' approach prevails:

- Fair market rent for the leased premises, as fixtured by the landlord, being the rent which would be paid, therefore, as between persons dealing in good faith at an arm's length.
- Fair market rent for the leased premises, being the rent that would be paid, therefore, on an unimproved basis as between persons dealing in good faith and at arm's length excluding

consideration of any signing bonus, leasehold improvement allowance, rent free period or other inducement payment.
- Fair market rental for similar buildings in similar locations having regard to the term remaining in the lease.
- Prevailing market rental for premises of substantially the same size, age, location and character.

Where there is no explicit or implied reference to market rent, lease clauses such as the following may be encountered, which point to a 'subjective' approach:

- During each 10-year period of the term, the annual rent shall be the annual rent agreed upon by the landlord (lessor) and the tenant (lessee).
- Such rents as shall have been agreed between the lessor (landlord) and the lessee (tenant).
- To fix a fair and proper sum to be paid as yearly rent.

When establishing the jurisdictional authority of the arbitral tribunal, it is extremely important that the parties to the arbitration, by mutual agreement, instruct the arbitral tribunal to apply either a 'subjective' or 'objective' approach in determining the quantum of rent to be paid at the time of the rent review or renewal option. However, if at all possible, the 'subjective' approach should be avoided, as it presents an unexplored minefield of speculative factors and considerations that could be presented by the parties to the arbitral tribunal.

Applying non-market criteria of the 'subjective' approach is unlikely to lead an arbitrator to determine a rent that is fair between a particular landlord and a particular tenant. A number of 'what if' valuation scenarios might have to be explored, which would likely generate more than one estimate of rental value. Still, it would be difficult for an appraiser to know how to proceed in preparation for an arbitration hearing when the 'subjective' test is to be applied by the arbitrator without knowing in advance what type of appraisal evidence the arbitral tribunal will actually rely upon in determining a rent that, in its discretionary judgement, is fair.

Market rent (objective approach)

The 11th edition of *The Appraisal of Real Estate (1996)* at page 142 defines market rent as *"the rental income that a property would most probably command in the open market."* This brief definition fails to fully capture the conditions inherent in market rent as applicable to rent review or rent renewal. A more suitable and expansive definition of market rent is suggested as follows:

Market rent in the context of a rent review or rent renewal may be defined as: the rent that the property would most probably command in the open market at the time of the rent review or rent renewal for a stipulated period, pursuant to all of the subsisting terms and conditions of the existing lease, save and except the quantum of rent, the hypothetical landlord and hypothetical tenant each acting prudently and knowledgeably, and assuming the rent is not affected by undue stimulus.

Implicit in this definition is the consummation of a lease agreement as of a specified date for a specified term, with the use and occupancy of the property conveyed to the hypothetical tenant in exchange for the payment of rent to the hypothetical landlord, under conditions whereby:

- the hypothetical landlord and hypothetical tenant are typically motivated;
- both hypothetical parties are well informed or well advised, and acting in what they consider their best interests;
- a reasonable time is allowed for exposure in the open market;
- payment of rent is made in cash in Canadian dollars; and
- the rent represents the normal consideration for the property under the subsisting terms and conditions of the existing lease.

An estimate of market rent should be linked to an estimate of reasonable exposure time. Exposure time is the estimated length of time the demised premises, under the subsisting terms and conditions of the existing lease, would have been exposed for lease on the open market prior to consummation of a hypothetical lease at market rent on the rent review date (appraisal date) between a hypothetical landlord and a hypothetical tenant. The overall concept of reasonable exposure time encompasses not only adequate, sufficient and reasonable time, but also adequate, sufficient and reasonable effort. Reasonable exposure time can be expressed as a range and can be based on one or more of the following:

- statistical information about number of days on the market reflected by current listings and actual leases for comparable properties/premises;
- information gathered through verification of comparable lease transactions; and
- interviews with market participants such as leasing agents, property managers, landlords, developers, etc.

Valuation model

The 'objective' approach points to the concept of comparison and triggers use of the direct comparison approach, which for the purpose of estimating market rent may be defined as: the process in which a market rent estimate for a property is derived by analyzing the submarket, in which the property competes, for actual and asking rents for competing properties of similar utility.

Comparative analysis focuses on similarities and dissimilarities, including lease terms and conditions, among

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competing properties and for any differences between the rental comparables and the subject property for which an adjustment is warranted. The corresponding rental rate of the rental comparable is adjusted quantitatively and/or qualitatively to reflect the characteristics of the subject property.

A fundamental premise of the direct comparison approach is that the market rent of a particular property is directly related to the actual and asking rents of comparable, competitive properties.

Fair rent (subjective approach)

Black's Law Dictionary (Centennial Edition 1891 - 1991) defines fair as follows: "'[h]aving the qualities of impartiality and honesty; free from prejudice, favouritism, and self-interest. Just; equitable; even-handed; equal as between conflicting interests. See also equitable; reasonable."

Defining the elements of a fair rent, and trying to determine on what basis fair rent is to be estimated 'subjectively' in rent review or rent renewal of an existing lease, is an extremely difficult task. But, as in the 'objective' approach, all the subsisting terms of an existing lease, save and except the quantum of rent, must be considered, even when the inquiry is restricted to a particular landlord and a particular tenant. However, there is case law which logically mandates application of generally accepted appraisal principles in a 'subjective' approach.

In *Canadian National Railway Company v. Inglis Ltd. [1992]* upon rent renewal, the determination of rent as stipulated in the lease was left entirely to the discretion of CN, the landlord, with "the rental to be paid by the Lessee during such renewal period... fixed in an amount which in the opinion of the lessor is fair and equitable." According to Farley J., from the phraseology of the clause "it does not appear that the parties agreed that CN should fix the rent at whatever rate it wished" and "it appears that CN owes a duty of care to Inglis [the tenant] to come reasonably to what it says is fair and equitable between CN and Inglis."

CN's usual practice, pursuant to a formula, purportedly was to fix the

annual rental at an amount equal to its standard rate of return on investment, reported as 12 per cent of the mean fair market value of the land, based on its (unrestricted) highest and best use, over the five-year period in question. Over the five-year period in question, Inglis could not realize the full potential of the site based on an unrestricted highest and best use. Moreover, one of the provisions in the existing lease stated that "[t]he demised premises shall be used, subject to all the conditions hereof, for the purpose only of erecting and maintaining thereon suitable buildings and other structures for manufacturing purposes in connection with the lessee's business."

The court concluded that, while CN was "entitled to use a formula involving the property value and a rate of return on investment, it is implicitly required by the terms of the leases to base the property value on the basis of a manufacturing use and not on an unrestricted highest and best use." The judge went on to state "there is an obligation upon CN to be able to demonstrate that the annual rental was set on a fair and equitable basis. That demonstration must certainly involve an explanation to Inglis that its [CN's] formula is one that an objective bystander [an independent third party] would say was rationally based and took into consideration and gave appropriate weight to relevant factors."

"However, not only must the formula be one that CN could justify to the bystander, the components would also have to withstand the same scrutiny. A formula of rent equals fair market value of land times rate of return on investment would be useless **if CN were to play pin the tail on the donkey as to its choices of rate of return and land value.**" [Emphasis added]

The judge likened this situation to CN picking "an appraiser who had no experience in the field on valuing this type of property (e.g., if the appraiser were experienced in only appraising single-family dwellings) or for CN to be satisfied with an appraisal that did not conform with the generally accepted principles [i.e., *Uniform Standards of Professional Practice*] (e.g., if the appraiser suggested that a valid capitalization of earnings rate would be based on the appraiser's birthdate or be the same (without explanation) as that accepted in 1935). **To be valid the appraisal must be more than a lucky guess by either CN or its chosen appraiser.**" [Emphasis added]

In *Margaret Jane Buchanan v. Robert Copeland and Huguette Copeland [June 20, 1995]*, a case involving a small triangular landlocked waterfront parcel, the value of which was in dispute, in dealing with the issue of compensation as bound by a prior court order speaking of "reasonable" compensation and making reference to the *Conveyance and Law of Property Act*, which sets out: "according as may under all the circumstances of the case be most just, making compensation for the land, if retained, as the court directs," the judge concluded "that the meaning of **compensation** must include both an objective element as provided by the facts set out in the appraisals together with a subjective element as provided by a consideration of the facts and circumstances of the case and the equities arising therefrom." [Emphasis added]

Before being permitted to address the issue of compensation over the disputed parcel, the judge had to make a determination of whether an appraisal prepared by an AACI, which was mutually agreed upon by the parties, would be binding on the parties. The judge made two inquiries: whether the report of [the appraiser]... constitutes a valid appraisal prepared in accordance with generally accepted valuation principles; whether any of the values set forth in the report by [the appraiser]... are binding upon either or both of the parties hereto in determination of the issue of compensation.

The judge concluded that: "I find that the answer to these two questions is in the negative. It is impossible to rely on [the]... appraisal. Indeed he [the appraiser] himself, by the end of his cross-examination, agreed that all of his values had to be adjusted because of several errors. Accordingly, I find that the report... **is not a valid appraisal.** [Emphasis added] The impact of this finding is that the agreement between the parties, which was clearly binding and intended to end the litigation, is not enforceable because [the] ... appraisal is not a valid appraisal." It was also noted that the common intention of the parties was "that the underlying quality of the appraisal (must) be unimpeachable so that both parties can at least feel that they have had the benefit of a professional valuation."

The sentiments expressed by the parties as to their expectations of the appraisal echo those contained in the preamble of the *USPAP*, which in part states "[i]t is essential that a professional appraiser arrive at and communicate his or her analyses, opinions, and advice in a manner that will be meaningful to the client" and that "[t]he users of appraisal services should demand work performed in conformance with these standards." ✦

Endnote

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Part II of II

Rental dispute arbitration

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Ground leases

The determination of rent is a far more complex valuation problem when it involves a ground lease. Ground leases are typically long-term, ranging anywhere from 20 to 99 years plus, with long intervals between rent reviews.

A rent review clause that points to market rent for a property as if unencumbered by the ground lease and any improvements, and without any restriction on highest and best use, involves a two-step valuation procedure similar to the following:

1) The market value of the fee simple interest in the land based on its highest and best use is estimated by application of the direct comparison approach, which involves comparison of similar sites which have recently sold and/or are available for sale at the time of the rent review to the subject property. (See *Standard Life Assurance Co. v. Parc IX [1991]*)
2) Although, in this example, the market value of the fee simple interest in the land assumes an indefinite period of ownership, the application of an appropriate annual rate of return on the market value of the land must be consistent with the term for which the rent review is being fixed, to be reflective of market rent.

Assuming that the market rent is to be fixed for a term of 21 years from the rent review date, it is important that the rate of return be tied to the cost of capital for a similar period. Annual rates of return indicated by other ground leases are correlated with the cost of capital (i.e., annual yields on Canada Bonds) corresponding to the time of the rent reviews and for similar periods to isolate the spreads between the returns on the ground leases and the yields on the Canada Bonds.

Detailed as follows are three actual long-term ground leases, which reflect rent reviews at 20- and 21-year intervals, where the annual rate of return is stipulated in the lease or had been ascertained. The corresponding Canada Bond annual yields with maturities of 20.17 to 22.75 years indicate an average spread of about 1.30 per cent less than the annual ground lease rates.

Assuming that Canada Bonds with a 21-year maturity at the time of the rent

TABLE 1

Lease Commencement Date	Renewal Period (Years)	Lease Rate	Bond Quote Date	Bond Term (Years)	Bond Yield	Percentage Spread Lease/Bond
1-Aug-59	20	6.25%	31-Jul-59	20.17	4.95%	1.30%
1-Aug-67	21	7.00%	1-Aug-67	22.75	5.81%	1.19%
2-Jun-69	21	9.00%	2-Jun-69	20.92	7.61%	1.39%

Sample Size: 3 pairs (Ground Leases & Canada Bonds)
Average Ground Lease Renewal Term: 20.67 years
Average Bond Maturity Date: 21.28 years
Average Percentage Spread: 1.29% rounded to 1.30%

"The courts are sending a clear message that, where matters require expert appraisal evidence, whether of a 'subjective' or 'objective' nature, witnesses called to give testimony are expected to possess the professional qualifications and requisite skills essential to properly deal with the valuation issue(s) in dispute."

review are yielding 7.0 per cent annually, an annual rate of return of 8.30 per cent (7.0 per cent + 1.30 per cent) would be applied to the market value of the land to arrive at an estimate of market rent.

Note: Where a ground lease cannot be ignored and has a remaining term of, say, only 20 years from the date of rent review, only a limited number of (lower order) uses could be considered in a restricted highest and best use analysis, which would result in a lower estimate of market value for the land encumbered by the ground lease, and lower estimate of market rent. A use clause restriction would have a similar negative impact on the market value of the land and on market rent. (See *Canadian National Railway Company v. Inglis Ltd. [1992]*)

Expert appraisal evidence

As indicated in *Canadian National Railway Company v. Inglis Ltd. [1992]* and *Margaret Jane Buchanan v. Robert Copeland and Huguette Copeland [June 20, 1995]*, both cases point to the importance placed on appraisal competency and adherence to generally accepted valuation principles *Uniform Standards of Professional Practice (USPAP)*, even when elements of a 'subjective' approach are to be applied to issues of value relating to real property. Two additional cases that further point to the courts' unwillingness to accept appraisal evidence from unqualified witnesses are:

In *John Reay and Lease All Equipment Corp. Ltd. v. Landcorp Ontario Limited et al [1993]* where the market value of 16 individual properties was in dispute, speaking on behalf of the Ontario Court (General Division) Forestell M.P. commented as follows: "There was considerable argument over [an individual's] qualifications as to whether he was or was not a certified appraiser. I determined that he was not a certified appraiser but, on the other hand, I qualified him as an expert in commercial real estate based upon his experience in the field. I was, however, concerned with his evidence when he **attempted to indicate to the Court that he had taken all of the courses required to be certified as an appraiser and that he chose not to apply for certification because of some lofty or high-minded ideal concerning the Institute and some of its appraisers. It was only when Exhibit 23 was produced by... counsel for the Plaintiff, that the truth came out that he had completed only one credit course with the [Appraisal] Institute [of Canada].**" [Emphasis added]

In *642947 Ontario Limited v. Fleischer [1997]*, in a dispute over an agreement of purchase and sale of a commercial property, the appraiser presented as the defendants' expert, although he had been in business for approximately 10 years and had appraised plus or minus 1,000 commercial properties over those years, Greer J. observed that **the individual was "not an accredited appraiser [Accredited Appraiser Canadian Institute] (AACI) by the Appraisal Institute of Canada (AIC). [The individual] had never given evidence in court before and I was not prepared to accept him as an expert witness.** The report presented by [the individual] ... was signed by him and [an AACI]." [Emphasis added] The judge acknowledged the AACI was qualified as an expert witness, who was allowed to give "evidence about the report."

The courts are sending a clear message that, where matters require expert appraisal evidence, whether of a 'subjective' or 'objective' nature, witnesses called to give testimony are expected to possess the professional qualifications and requisite skills essential to properly deal with the valuation issue(s) in dispute. *USPAP*, the North American standard for developing and communicating an appraisal, includes a competency provision which requires that, "[prior to accepting an assignment or entering into an agreement to perform any assignment, an appraiser must properly identify the problem to be addressed and have the knowledge and experience to complete the assignment competently."

To formulate sound decisions, arbitrators, like judges, must be presented with cogent appraisal evidence that is comprehensive and self-evident, which can only be obtained from reliance on complete and self-contained appraisal reports. A complete and self-contained appraisal under *USPAP* is one in which all of the data and analyses used to develop the

opinion of value are included in the report, so no further file documentation is required.

Appraisers, although retained and compensated by their clients, have an overriding professional and moral obligation to assist the arbitrator by providing full and complete disclosure in the development and reporting of their unbiased opinions. The following appraisal requirements should be imposed upon the parties to a rental dispute either by the arbitrator or by mutual agreement of the parties in their submissions to the arbitrator:

- Appraisers to be relied upon as expert witnesses and give testimony at the arbitration hearing must possess either the MAI (Member of the Appraisal Institute of the US) designation or the AACI designation of the AIC.
- Appraisers must attest to being currently certified under the mandatory continuing education requirements of their respective appraisal bodies.
- Appraisers must attest to not having been the subject of any disciplinary action of their respective appraisal bodies within five years of being retained.

All appraisals must be prepared as complete and self-contained reports in compliance with *USPAP*, and all review appraisals must be prepared in compliance with *USPAP*.

USPAP, and the importance of those standards in the development and presentation of sound appraisal theory, is best understood by an arbitrator who is professionally designated (i.e., MAI or AACI) and qualified as a real estate appraiser. With respect to evidentiary issues, arbitrators have been reluctant to impose any meaningful criteria to assess the qualifications of a witness posing as an appraiser even when it is clear that an individual is not professionally accredited and lacks the skill and knowledge to qualify as an expert witness.

Equally disturbing is the lack of concern expressed over the independence, objectivity and integrity of the so-called expert witness. Under these circumstances, it should come as no surprise, in a venue shielded from public view and scrutiny, that the environment is ripe for advocating 'junk science' as acceptable appraisal theory without fear of rejection and reprisal. Arbitrators have shown a reluctance to shoulder a 'gatekeeping' responsibility over the relevance and admissibility of expert evidence and have failed to effectively combat against the unethical 'expert-for-hire' witness.

Courts in the US have grown weary of so-called experts and, since a 1993 landmark decision of the Supreme Court — *Daubert, et al v. Merrell Dow Pharmaceuticals, Inc.* — most of the lower courts have responded by imposing the following four conditions to test the relevance and admissibility of expert evidence, including appraisal evidence:

- whether the theory or technique can be and has been tested;
- whether the theory or technique has been subjected to peer review and publication;
- the technique's known or potential rate of error; and
- the general acceptance of the theory or technique by the relevant scientific [peer] community.

A pre-condition of the *Daubert* test, as it might be applied to the admissibility of appraisal evidence, is whether the reasoning or methodology underlying the appraisal technique or appraisal theory will assist the arbitrator in understanding or determining a fact in issue, and whether the appraisal technique or appraisal theory is relevant to the issue in dispute (i.e., determination of rent) before the arbitrator.

Some of the observations of the courts in Canada as to evidentiary expectations of expert witnesses are provided as follows: in *Mazur v. Moody (1987)*, Chief justice McEachem of the B.C. Court said:

"It is not the Provence of expert witnesses, viva voce [orally] or by filing written reports, to construct scenarios that may or may not have any basis in reality and then to give in evidence an opinion about the amount of the plaintiff's loss."

On expert witness credibility in the context of privilege of documents prepared in contemplation of litigation, in *McIlvaney v. Maguire, [1979] 6 W. W. R. 152, 13 B.C.L.R. 391, 11 C.P.C. 289* (S.C.), speaking for the B.C. Supreme Court, the judge said:

"So long as the expert remains in the role of a confidential advisor, there are sound reasons for maintaining privilege over documents in his possession. Once he becomes a witness, however, his role is substantially changed... It seems to me that, in holding out the witness's opinion as trustworthy, the party calling him impliedly waives any privilege that previously protected the expert's papers from production... That constitutes an implied waiver over papers in a witness's possession which are relevant to the preparation or formulation of the opinions offered, as well as to his consistency, reliability, qualifications and other matters touching on his credibility."

Continuing in a similar vein with respect to independence and objectivity of an expert witness, in *R. v.*

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Lavallee (1990), 55 C.C.C. (3d) 97 (S.C.C.), speaking for the Supreme Court of Canada, Justice Sopinka said:

"Where, however, the information upon which an expert forms his or her opinion comes from the mouth of a party to the litigation, or from any other source that is inherently suspect, a court ought to require independent proof of that information. The lack of such proof will... have a direct effect on the weight to be given to the opinion, perhaps to the vanishing point."

Arbitrators would be wise to adopt similar tests in gauging the relevance and admissibility of expert evidence if they wish to enhance the legitimacy of arbitration as an effective alternative to a court proceeding, where the standards for admissibility of expert testimony are significantly higher. A pre-arbitration hearing should be mandated by the arbitrator to deal with the admissibility of expert evidence to ensure that the evidence to be presented has relevance to the issue in dispute.

When only one party to an arbitration has retained a professionally accredited appraiser holding membership in a recognized appraisal body, that party may be placed at a distinct disadvantage in opposition to a party that has retained an unqualified appraiser under no compulsion to act independently and ethically and to comply with generally accepted appraisal principles, i.e., *USPAP*.

Two potential concerns could flow from this situation: 1) a party could claim that it has not been treated equally and fairly; and 2) that there is a reasonable apprehension of bias. Both circumstances might be grounds for setting aside an award of an arbitral tribunal. However, to succeed on these grounds, the aggrieved party must have made its concerns known at the arbitral hearing and sought court intervention before the arbitrator issued the final award.

An arbitrator's decision based on acceptance of a questionable valuation premise, also may be grounds to have an award of an arbitral tribunal set aside. Nonetheless, if the parties, in their submissions to the arbitrator, had agreed that the decision of the arbitral tribunal was to be final and binding (i.e., prohibiting appeals on questions of law or questions of mixed fact and law), the courts in some jurisdictions would not likely set aside the arbitrator's award.

For example, in *Standard Life Assurance Co. v. Parc-IX (1991), 82 D.L.R. (4th), 721, 3 O.R. (3d) 782, 28 A.C.W.S. (3d) 2 (Div. Ct.) (Parc IX)*, the Ontario Divisional Court refused to set aside the award of the arbitral tribunal as the parties had agreed that the decision of the arbitral tribunal would be final and binding.

Standard Life Assurance Company applied to the court by way of judicial review for:

1. An order setting aside the decision of the board of arbitrators, (the 'board') dated September 14, 1991, wherein the board found the land market value of

the lands to be $4.25 million, and substituting, therefore, a land value of $13.5 million.

2. Alternatively, an order returning the arbitration to the same board (or a new board) with a direction that the land market value be determined without reference to the presence of the apartment building constructed on the property, the ground lease, or the provisions of the *Residential Rent Regulation Act*, 1986, S.O. 1986, c. 63, the *Rental Housing Protection Act*, 1986, S.O. 1986, c.26, and the *Condominium Act*, R.S.O. 1980, c. 84.

The dispute involved a property in the City of Toronto subject to a 99-year ground lease, commenced in 1964, which called for a review every 25 years to re-establish "the fair market value of the property as if it were unimproved" so that a new annual rent could be imputed for the next 25 years based on 6.75 per cent of the re-established market value. A 17-storey apartment building was constructed on the site in 1964, prior to the enactment of rent control legislation in the Province of Ontario in 1975.

As the rent control legislation evolved, which initially had been introduced as a so-called temporary measure, by the time of the first rent review of the ground lease in 1989, rent levels on existing apartment buildings had become artificially deflated, vacancies were virtually non-existent, and demolition or conversion to condominium use was essentially prohibited under the *Rental Housing Protection Act*, which had been introduced in 1986. Further, condominium development is not permitted on land encumbered by a ground lease in the Province of Ontario.

On the face of the arbitral award, it appears that determination of the market value of the property 'as if it were unimproved' of $4,250,000 was based on the legislative constraints existing at the time of the rent review, which precluded demolition of the building or its conversion to condominium use, and encumbrance of the land by the ground lease, which precluded condominium development.

Had the property not been encumbered either by the building or the ground lease, the arbitral tribunal indicated that it would have assigned a market value of $13,500,000 based on its unrestricted highest and best use as a condominium site.

The divisional court rejected the reasoning of the arbitral tribunal and concluded that the market value of the land should be $13,500,000, because the adjustment clause required the value of the land to be fixed as if it were freehold (unencumbered by the ground lease), without buildings or other improvements on it. The fact that the existing apartment building could not be demolished or converted was deemed irrelevant to the valuation.

Despite the faulty valuation premise and the significant annual rental loss of $624,375 to Standard Life for 25 years (6.75 per cent of the difference of $13,500,000 and $4,250,000), the court refused to intervene and set aside the arbitral tribunal's award as the parties had agreed in their submissions to the arbitral tribunal that the board's decision would be final and binding.

Note: A similar decision was reached by the Ontario Court of Appeal in *Royal Trust Corp. of Canada v. Gardenview Properties Ltd.* (unreported November 1, 1991), where the market value of the land was determined 'as if it were unimproved.'

Expert reports

Appraisers retained by the parties to a rental dispute to give evidence as expert witnesses should submit their written reports well in advance, say, 90 days of the scheduled arbitration hearing so that each party has ample opportunity to review the merits of each others' position. Following the exchange of the experts' initial appraisal reports, each party should have its expert conduct a thorough written review of the opposing party's appraisal report. The review must be prepared in compliance with *USPAP* and include comments on the appropriateness of the appraisal methodology and reasonableness of the valuation conclusion, and identify significant errors of omission and commission, either property-specific or market-derived.

Exchange of the follow-up review reports should occur shortly before the arbitration hearing commences. Preparation of follow-up review reports benefits both parties to the rental dispute as the strengths and weaknesses of each appraiser's appraisal report will no doubt have been highlighted in the reviews and perhaps bring about a negotiated rent between the landlord and tenant, in which case significant savings will have been realized by not having to proceed with the formal arbitration hearing. Even if the follow-up review reports do not lead to a negotiated settlement between the landlord and tenant, the review reports will be of considerable assistance to the arbitral tribunal in its determination of rent, especially if the hearing is not to be transcribed, and are likely to reduce the amount of time required of the expert witnesses to give oral evidence at the hearing.

Arbitration's dark side

Arbitration is a private matter conducted behind closed doors. Only the parties to the dispute, their repre-

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sentatives, their counsel, and their witnesses are permitted to be present at the hearing. All information not in the pubic domain and presented at the hearing is treated as confidential, and everyone who participates in the arbitration is banned from using any information, of which they have no prior knowledge, outside of the arbitration. The proceedings and arbitrator's decision (award) are not open to public scrutiny, and court intervention is generally restricted to errors in law, which should not be confused with errors in judgement.

An arbitrator is to be independent of the parties and is expected to act impartially. Potential difficulties can occur in a rental arbitration if the appointed arbitrator is a lawyer, who on different occasions has appeared as counsel, and in the process retained the same appraiser who is to appear before him while acting in the capacity of an arbitrator. An appraiser giving expert testimony before an arbitrator for whom on past occasions he has acted as an expert witness may have his testimony (when not warranted by the evidence) favoured to the detriment of the opposing party.

Arbitral conduct

For arbitration to continue as an effective and viable alternative to civil proceedings in dealing with rental disputes between private parties, not only will arbitrators be expected to be conversant and knowledgeable as to generally accepted appraisal principles, but they will have to hold themselves to the highest ethical standards. *Black's Law Dictionary Centennial Edition (1891-1991)* defines ethics as: "of or relating to moral action, conduct, motive or character; as ethical emotion; also, treating of moral feelings, duties or conduct; containing precepts of morality; moral. Professionally right or befitting: conforming to professional standards of conduct."

Acting as an arbitrator carries with it onerous ethical responsibilities to judge disputes in a morally wise and responsible manner.

- An arbitrator must not communicate with a party to the dispute without the knowledge and participation of the other party.
- Each party must be granted equal time and ample opportunity to fully develop and present its case, and respond to the opposing party's case.
- Questions posed by the arbitral tribunal of expert witnesses should be solely confined to matters bearing on the issue in dispute, and witnesses should be extended the courtesy to respond with complete answers.
- An arbitrator must refrain from advancing opinions to which the parties' expert witnesses have not been given an opportunity to respond.
- Before issuing its decision (award), the arbitral tribunal has an obligation to objectively and carefully review and weigh the evidence presented, and demonstrate the courage to refrain from averaging the rental estimates indicated by the appraisals in a misguided attempt to please all of the parties to the dispute.
- An arbitrator owes a duty to all of the parties, including the expert witnesses, to provide an unbiased, reasoned and clearly articulated written decision grounded on credible evidence.[2]
- An arbitral decision must never be written in a manner that conceals the facts of the rental dispute so as to deliberately obstruct or prevent judicial review.

Arbitral education

Rental arbitration provides an excellent opportunity for both the Appraisal Institute of the United States and the Appraisal Institute of Canada to expand their sphere of influence over valuation in an arbitral setting. It would be a natural extension of the broad range of valuation work currently being performed by accredited members less likely to be unduly influenced than a chief arbitrator of an arbitral tribunal consisting of two additional arbitrators, each a party-appointed nominee. Appointment of a sole arbitrator would also substantially reduce the cost of arbitration.

Parties to a rental dispute should exhaust all avenues to negotiate a settlement rather than proceed to arbitration, as the cost of arbitration can be very expensive and the outcome unpredictable. If the parties to a rental dispute must proceed to arbitration, they should agree on application of an objective approach (i.e., market rent) in establishing the rent to be paid during the rent review or rent renewal period in dispute; agree on procedural and evidentiary rules for the arbitration; and choose an arbitrator wisely, as incompetence or negligence is not grounds for setting aside an arbitrator's award through judicial intervention of the court, unless the decision of the arbitral tribunal is patently absurd.✦

Endnotes

2. The parties may mutually agree to accept an arbitral decision without any written reasons as to the rationale for the award, which precludes any possibility of judicial review.

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