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NEWS

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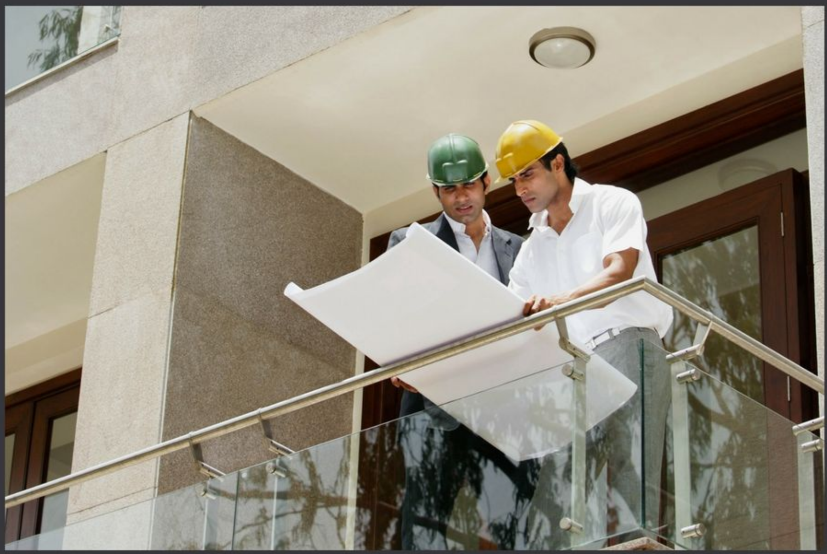
Fair Market Rental Value in Commercially Leased Spaces: Appraisal Methods (Part Two)



Who chooses the appraiser? Getting this part of a Fair Market Rental Valuation right is critical to a positive outcome for you or your client!

Part One focused on the basics, and in Part Two, we'll cover the common appraisal methods to arrive at a new rental value. Getting this right is key to a FMRV that is fair and equitable for both parties, so selecting the correct method is vital!

Part Two: Choosing an Appraiser?

Part One discussed the basics of a Fair Market Rental Value (FMRV) process - what it is, when it arises, and who might need one. We are examining these concepts through a hypothetical case of a small commercial bakery on a ten-year lease. Our tenant, Meredith, has leased a 1300 sq. ft. space to house her commercial bakery and coffee shop on a 10-year lease, which is due for renewal. Both the landlord and Meredith want to re-up, but both also want to ensure that the rent paid is fair and equitable. Naturally, Meredith wants the rent to be as low as possible, while the landlord wants to obtain a good return on his or her investment. Recall that FMRV is based on an analysis of **comparable properties with comparable leases**.

So who chooses comparable leases of comparable spaces? That's the job of an appraiser. That appraiser can be hired by the landlord or the tenant, or negotiated between them according to a prearranged system. Sometimes this will have been specified in the initial agreement, and sometimes not. If you're in the process of writing a lease or considering signing one, taking this into account at the beginning of the process can save a lot of trouble and negotiation down the line.

There are three common methods of choosing an appraiser and/or agreeing on a valuation: the Average Method, the Three Broker Method, and the Baseball Method.

The Average Method

This is probably the simplest method, but also the one most prone to poor outcomes. The landlord and the tenant each hire an appraiser to determine fair market rental value based on a set of common criteria. If the two appraisers' valuations don't match (which is likely), the amounts are averaged, and the resulting figure is declared the fair market value rent.

This method is fairly unsophisticated, and also prone to manipulation. Either party, for example, could game the system by submitting an abnormally high or low valuation. Maybe Meredith hires an appraiser who deliberately turns in a valuation well below average, which, when combined with her landlord's fair appraisal, results in a rental value that is a veritable steal for Meredith. Conversely, her landlord could employ an appraiser whom he knows will return an astronomical valuation. Moreover, it is entirely possible that an average of two appraisals could result in a rent that is not at all consistent with comparable leases of comparable properties. For that reason, many experts warn against adopting the Average Method.

The Three Broker Method

Because the Average Method is inherently problematic, some leases opt instead for a slightly adapted version. In the Three Broker Method, Meredith and her landlord each hire an appraiser. If the two appraisers agree on a fair market rent, the process is at an end. If, however, they cannot agree, then the two appraisers will instead agree on a third, impartial appraiser, who will independently calculate fair market rental value. (In some variations of the Three Broker Method, an average of the three valuations is used instead of the third appraiser's valuation.)

This is a popular option, as it incentivizes both the landlord and the tenant to choose reasonable appraisers in the first place to avoid further cost. However, it can be more expensive if a third appraiser is needed, and certainly it is possible that disputes might arise surrounding the third party's valuation. Furthermore, there is no guarantee that the third appraiser will not make an unreasonable valuation or an arbitrary decision.

Certainly the Three Broker Method is preferable to the Average Method, and it is very common in commercial leases, but if either party can foresee that the negotiation process might become contentious, they might be best served by the final method.

The Baseball Method

Few organizations are better at complex negotiations around value than Major League Baseball, and this final method is based in their player arbitration system. In the Baseball Method, the landlord and Meredith would each submit an estimate of fair market value to a neutral arbitrator whom they have mutually selected: what does Meredith think a fair rent would be, and what does her landlord think is fair?

The arbitrator must select one of the two proposals. He or she cannot average them or suggest an alternative, but is required to accept one option on the table, which then becomes binding.

Choosing a good arbitrator can mean that this method is most likely to produce an equitable and reasonable result, but it is also by far the most likely to be expensive, lengthy, and difficult. Because it is a binding arbitration process, each party typically hires an attorney, and has legal fees, arbitration costs, and potentially appraisal costs as well to consider.

On the other hand, baseball arbitration incentivizes both parties to submit reasonable estimates. If, for example, Meredith submits an estimate of fair market rental value that is largely reasonable, if a little on the low side, while her landlord is sky-high, the arbitrator is almost certain to select Meredith's estimate. The lack of compromise in this method is what drives both parties to be less partisan in their estimates.

Specify the method in the lease

No matter which method of establishing FMRV is chosen, the best method to avoid future conflict is to specify it in the original lease. Language like this, for example, would ensure that Meredith and her landlord undergo the Baseball Method when it comes time to re-negotiate her rent:

- "Each party shall submit to the arbitrator and exchange with the other, in accordance with a procedure to be established by the arbitrator, its best offer. The arbitrator shall be limited to awarding only one or the other of the two positions submitted."

- "The parties agree that they will exchange and provide to the arbitrator a copy of written proposals for the value of market rent. In rendering a decision, the arbitrator(s) shall be limited to selecting only one of the two proposals submitted by the parties."

Understanding the various methods, their pros and cons, and specifying one preferred method in the original leasing language can save both parties a tremendous amount of money, time, and trouble down the line.

In Part Three of this series, we'll examine some specific concerns landlords and tenants might have surrounding Fair Market Rental Value, and what to do about them.

If you or your clients might need appraisal services related to fair market rental value, or any other kind of commercial real estate valuation, please email us at LA@valbridge.com or call us at (626) 486-9327.

SOURCES/FURTHER READING:

- Walt Burton, "Baseball Arbitration to Settle Valuation Disputes – Don't Get Caught in Left Field," Thompson Burton (October 12, 2012).
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- John G. Kelley, "Easy as FMV: Modern Fair Market Value Renewal Methods," Law Journal Newsletters (July 2017).
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