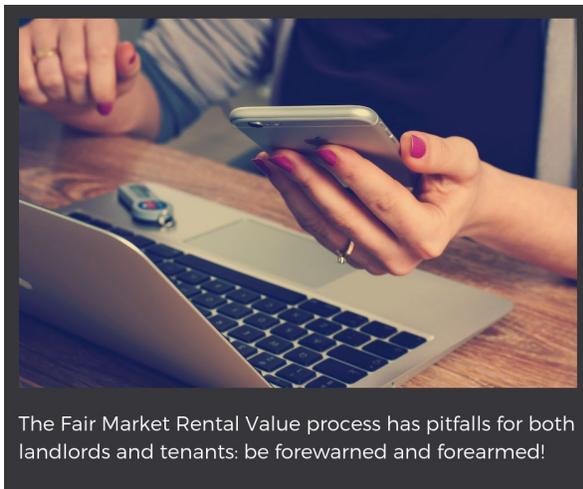


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Fair Market Rental Value in Commercially Leased Spaces: Considerations for Landlords and Tenants (Part Three)



Part One covered the basics of Fair Market Rental Value. In Part Two, we outlined the process of choosing an appraiser - and why that matters so much. This final installment in our series will cover other important considerations for landlords and tenants undergoing the FMRV process.

Considerations for both landlords and tenants

Our investigation of the Fair Market Rental Value (FMRV) process has highlighted the basic theory behind the practice, as well as the most common methods of arriving on a mutually agreeable rental value for the renewal of a lease.

There are, however, a number of considerations that both landlords and tenants should bear in mind. Ideally, one will take these into account when drawing up the language of the original lease, as it will be much more difficult to insert them into the process later. Let's examine a few possible scenarios.

Recall our hypothetical tenant, Meredith, with her 1300 sq. ft. bakery/cafe. Let's imagine that when she took over the space, she had to make a number of improvements in order for it to be a functional space.

Tenant Improvements

Should Meredith's improvements be factored into the FMRV? If Meredith were to leave, the landlord would be able to lease out a fully improved space at a much higher rate than he would have been able to let the space Meredith originally inhabited.

Did Meredith receive any reimbursement for her improvements, or did she get a reduction in her rent along the way?

What about Meredith's presence in the location? She could argue that her business anchors (for example) a small strip mall, which would decrease in value if she were to leave. Her bakery cafe brings foot traffic and more consumers, raising the value of the space at the entire shopping center. Should she have to pay more rent now because she's built a successful business?

The answers to these questions should ideally be written into the original lease, specifying how each will be handled when the renewal process begins. Structuring these considerations well in advance will also allow Meredith and her landlord to foresee their expenses, investments, and potential returns before embarking on major projects.

Right to Arbitrate = Right to Renew

In Part Two, we covered the Baseball Arbitration method. It is not uncommon to confuse "mediation," "arbitration," and "appraisal," in casual language, but these are in fact three very different things. In mediation, the two parties (e.g. Meredith and her landlord) meet with a neutral mediator and try to come to an agreement without binding determinations by a judge or arbitrator.

In arbitration, by contrast, a neutral party acts like a judge and makes binding decisions (as in the Baseball Arbitration method). Whichever party loses cannot decide that they do not want

to abide by the agreement - they are bound by the decision of the arbitrator. This process almost always involves legal representation.

Finally, an appraiser may be involved in all of these processes, but is not resolving disputes or making judgements. The appraiser is only making a determination of value according to the terms specifically provided in the lease. He or she cannot tell Meredith or her landlord what the lease means, whether it is fair, unfair, whether it has been breached, or make any other determination other than a valuation of the commercial property.

It is critical to note that not every lease includes an automatic right for a tenant to renew. Many leases do include a renewal right, and good ones specify the FMRV determination method. But without a right to arbitrate, there is effectively no right to renew.

For example, let us imagine that Meredith's lease doesn't include a right to arbitrate. Perhaps her landlord has discovered that he can charge another tenant with a similar business a much higher rent, and he quotes Meredith an extremely high renewal rate. Without a right to arbitrate, there is no guarantee that Meredith's landlord has to accept a reasonable renewal rate from her. It is an obvious ploy to force her out, but one that could have been avoided had the lease included a right to arbitration clause.

Again, good advance planning and appropriate expert advice (whether from a real estate attorney, or an appraisal expert) could help forestall many difficulties down the line.

It's All In the Timing

As is doubtless apparent, the negotiation process over FMRV can in some cases be a protracted one. What happens in the interim?

Does Meredith, for example, pay her old rent until a new rental value is established? Or is she required to pay the new rental rate from the beginning of the new lease period retroactively once a figure has been agreed upon?

It is wisest to include deadlines in the original lease specifying that the new rental rate be determined before the end of the old lease. That way, if neither party is satisfied, they both have time to make other arrangements, and there is no confusion about the rates for the new leasing period.

Fair Market Rental Value, when handled well and with foresight, can help both landlords and tenants continue in a mutually profitable business relationship for many years.

However, it is a complex negotiation that can trip up the unwary, the unprepared, or the uninformed, so securing expert appraisal services and advice is a smart investment for all parties at every stage of the commercial leasing process.

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:

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