



INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE AND MANAGEMENT

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STRAIGHTEN OUT RENTAL (AND OTHER RETAIL LEASE) DISPUTES BY CONNOISSEUR FORTITUDE

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ABSTRACT

Historically, Indians landlords hold the negotiating power. Specialty shop tenants occupying 30% of the floor space of shopping centers typically generate 70% + of their "value". Their information systems are poor, resulting in tenants operating in an uninformed environment. Legislation is inconsistent and there is a reluctance to enforce it. Experts can be called in when landlords and tenants cannot agree on the current market rent and this article seeks to help valuers to navigate the expert determination minefield and to avoid their findings being challenged. This paper concentrates on the retail property market.

KEYWORDS

IAMA, Market rents, Shopping centre industry.

INTRODUCTION

 Expert determination is not for the faint hearted. A party wishing to retain its position may frustrate proceedings. Related issues which the parties want the determining valuer to resolve should be isolated from the rental dispute but, if relevant, quantified and weighted. This article illustrates how the Institute of Arbitrators & Mediators' (IAMA) expert determination and arbitration training may assist valuers to settle rental disputes.

HERE ARE IMPORTANT ISSUES FOR VALUERS TO CONSIDER

- Firstly, the procedure advocated by IAMA.
- Secondly, the consequences if market rent is not properly quantified.
- Thirdly, there are some valuers who still fail to understand that the rental market can rise and fall (except for some old leases with ratchet clauses not yet outlawed by state tenancy legislation, with legislation taking precedent over a lease). We often read about the negative outcomes of determinations but seldom about positive outcomes or dispute resolutions. Those in fiduciary positions are better protected in an informed, transparent market. The valuer is only mentioned when a determination does not comply with the contract. Which falls under legislation or market rent as defined or when a party seeks an unrealistic result or attacks a weakness in the determination? This paper seeks to reduce the possibility of determinations being challenged. It also considers the consequences if rental income streams do not reflect market rent and capital value if the statutory provisions of the retail lease legislation are not complied.

BACKGROUND

The greater the disparity between "engineered" rents and market rents, the greater the need to settle disputes by Expert Determination for financiers, landlords, tenants, franchisors, franchisees, investors, developers, legislators and regulators. The greater the disparity between "engineered" rents and market rents, the greater the need to settle disputes by Expert Determination for financiers, landlords, tenants, franchisors, franchisees, investors, developers, legislators and regulators.

1. Distorted markets.
2. Not legislated for compulsory mediation and reference to expert determinations if mediation fails.
3. Limited independent information such as lease registers, centre, specialty shop, category performance levels and occupancy cost data (for informed negotiations).
4. Little unconscionable conduct precedent.

This has important consequences. At the rents charged, the centre owners via LPT's add more supply because the floor price is above "market rent" and businesses trade over longer hours viz. 7 days, incurring higher variable costs and producing riskier income streams. Eventually, the fiduciary responsibility of officers of our major corporations will be called to question and the asset valuer could become a scapegoat for these imbalances. Landlords instruct Asset valuers to revalue shopping centers on a "passing rental" basis with little reference to defined "market rent".

There is extensive research by organizations like Urbis JHD but few have analyzed the consequence of rent disproportionate with business opportunity, particularly in the retail arena. The wider industry's aim is to maximize income streams for the stronger party who "controls" the weaker party's "business" environment. In the Indian a tenant has an automatic right of renewal and rental disputes can be settled by expert determination thus moderating rentals whereas rentals in India have risen over a sustained period without adjustment and governments here do not appreciate the pressure placed on specialty shop operators by those in the retail industry, many of whom also earn performance fees as a percentage of all revenue collected. It is for these reasons that mall relationships here are adversarial. Our media does not understand or cover these issues, resulting in an "uninformed" market. Landlords, particularly in shopping centers, require tenants to disclose their trading figures, giving a landlord a significant advantage over the tenant's "business". Originally, this data was used to calculate turnover rent and manage tenancy mixes.

INTERNATIONAL ACCOUNTING STANDARDS AASB 138, THE INDIANS EQUIVALENT

The accountability of intangibles, AASB 138, includes leases and is critical for financiers, landlords and tenants, accountants, valuers (for consideration and weighting where rent is above market rent), legislators and regulators. Depending on tenure, rent paid, lease flexibility and extent of fit out, a business might have positive or negative value attached to its lease. If a business costs 1, 20, 00,000 Rupees (INR) to set up with negative lease terms, it might be reduced on the balance sheet! This will change every year but will decline over the lease period. A problem with the lease will act as a warning to a buyer. If a high percentage of businesses have little "value", fewer tenants will take up leases. Valuers will be forced not to capitalize unsustainable short-term, high-risk income streams into long-term capital, which could be fraudulent for reporting purposes.

FACTORS ADDING OR DECREASING THE "VALUE" OF A LEASE

Factors adding "value"	Reducing or negative value	Comment
Long tenure say 5+5+5 years	Shorter tenure say 4 – 6 years	Leases in the INDIA can be 10+10+10 years, with automatic renewals. With less tenure, one must amortize set-up costs over shorter term.
"Market rent" can be ordered by court in INDIA	Rent well above "market rent"	Rent established using principles in tenancy legislation and definition of market rent.
Lower set-up costs	Higher set-up costs	Affects amount to amortize over term and residual available for rent.
Flexible lease terms, regular reviews to market rent	Inflexible lease, rigid rental structure viz. CPI + 1.5% pa	Flexible leases result in market rental outcomes and lower risk on income streams. Rents must be able to rise and fall without a ratchet.
A combination of the above	Same	With no options or renewal opportunity, a business must proceed with selling down stock and close.

Other factors which will increase and decrease the value of a lease

Good and poor management of tenancy mix	Diminution of cash flows must be taken into account under AASB 138, e.g. Failure to manage tenancy mixes, causing higher risk.
Valuers who do not adopt market rental into rental valuations or cannot interpret "evidence"	A valuer who cannot adopt or "test" evidence and separate the business and site goodwill should not determine market rents and produce inflated valuations which often require forensic financial analysis.
Failure to provide quiet use and enjoyment	Reduces business potential and decreases value of lease.
Failure by Tribunals and Courts to enforce legislations and make decisions in equity	This will put pressure and force our judicial systems to award damages in equity.
Investment in a court or tribunal action	An "investment" to protect one's position viz. a director of a retail business, forced to protect their asset under corporations law via a court action, might see a favorable outcome as an "asset" on the balance sheet.

SOME EXAMPLES

Two scenarios, two businesses in two similar centers with similar business potential:

- First, the landlord with flexible leases and security of tenure who manages tenancy mixes, procures, apportions, charges and audits outgoings and utility charges efficiently properly promotes and allows market forces to drive development.
- Secondly, the landlord who develops centers he owns and manages, duplicates tenancy mixes erodes the cash-flow via profit on management fees, outgoings and utility charges inflates refits via subsidiary companies before they are depreciated. Whose leases are inflexible, have fixed increments and limited/short tenure. Comparing and contrasting the two is easy. Dough nut franchise one will have a strong balance sheet and goodwill whereas franchise two, which also cost 1,20,00,000 (INR) to set up, will have little or negative value because AASB 138 requires the value of the lease to reflect any negative value of the intangible assets, including the lease.

DOUBLE WHAMMY – INTELLECTUAL PROPERTY AND GOODWILL

The double whammy will be the adverse affect on intellectual property, trademarks and goodwill of a business. Staff with limited employment, because the business has no tenure, will move on intellectual property associated with the business or customer lists and addresses, shown as an "asset", must be given negative "value". A business making no net return has negative goodwill, so the host that houses it – a shopping centre will have significantly diminished value! AASB 138 will become an important consideration, from a valuer's point of view, to determine rents and asset valuations and will provide a "check and balancing factor" for the professional valuer to lean on.

THE NOMINATION AND APPOINTMENT

Firstly, the valuer is nominated to determine the market rent as an expert. Often this appointment is made by a Tribunal Registrar and in some states, the API Divisional President for some retail leases (and commercial and industrial leases). The process commences with a referral to valuation by an express term in a lease. Sometimes there is an attempt to reach agreement on a valuer by submitting the names of three valuers who are often rejected due to perceptions of bias or a matter of protocol. On being nominated by the Registrar, one should seek as many details as possible in order to avoid any conflict of interest. If there is any doubt, one should disclose a possible conflict, at which time the parties can accept or reject the appointee. There is nothing precluding a valuer from making a submission on behalf of a party to an appointed expert.

CONFIRMATION OF VALUER'S ACCEPTANCE AND TERMS OF APPOINTMENT

A standard letter of appointment can become a binding "Expert Determination Agreement" and many principles and procedures from IAMA are of considerable use, and must observe the requirements of the legislation.

- Acknowledge this is a "dispute" to be settled by determination.
- Address both parties in the same letter, signaling that they will be treated equally.
- Confirm that natural justice and fairness can be expected.
- Point out how the appointment has arisen.
- Set out one's professional fees and payment terms.
- Use a method of charging to assist to settle the dispute.
- Ask the parties for information that will be required.

Establish whether there are other agreements that could affect the outcome e.g. verbal or customary practice.

The last point implies that retail rental valuations are more subjective than objective. A landlord may seek a rent of X based on development costs, plus return, letting up time etc, but a tenant, with fiduciary responsibilities not to trade as an insolvent company, may see no merit in the "asking" rent. In simple terms, no "acceptance" for a binding contract, free from duress, misrepresentation and so on no agreement and no lease. The test, under the definition and legislation, would fail and so would the determination under the particular retail lease with a particular permitted use because willing, informed hypothetical parties should not accept lease terms that are not market based. The expert must determine the rent according to the "contractual provisions giving rise to the Expert Determination" where legislation applies under that Act. If the expert acts outside the terms of the agreement and the prescriptive requirements under legislation, his determination is susceptible to attack.

LEASES AND LEASE TERMS

The original motivation to write "Market rent: what is it?" (Gilbert 1995), was to define market rent in a retail context. Until then little research had been done, even world-wide. Since the IVSC introduced its definition in 2008, the topic has been extensively written about - see Google. Early research showed that leases prepared by different landlords each instructed valuers how to do their task in various ways, which could distort the rent. Without prescriptive lease renewal dispute resolution mechanisms in legislation, it could be used as a sword at lease renewal. The greater the disparity with leases procured under non-market conditions, the greater the risk that income streams and capital value distortion will increase, raising the stakes for reporting and governance reducing the process to a single definition would reduce subjectivity. It follows that any term in a lease that contradicts the Act or definition could be null and void. On the other hand, relevant instructions that carry weight and do not contradict legislation can be taken into account. The valuer must peruse the lease before commencing with a market valuation.

HANDLING PROCEDURE

The state Commercial Arbitration Acts refer to "misconduct.". "Misconduct" must be avoided and IAMA's "Expert Determination Rules" introduce a framework and procedures to prevent an expert from inadvertently carrying out an act where one is guilty of misconduct.

- Role of the Expert Rule 5 to: determine the dispute as an expert and not as an arbitrator avoid delays and expenses adopt suitable procedure be independent act fairly, give opportunity to submit its case and make submissions; and the "Rules" or "Process" (including the Expert's jurisdiction) shall be submitted and determined by the expert.
- General Duty of the Parties Rule 6 to: do all things to assist with the Process attend the Preliminary Conference (or be represented) comply with directions or ruling ordered by the Expert take steps to obtain decisions of a Court on questions of law.
- Confidentiality Rule 7 to; keep all information confidential sign Confidentiality Agreements except if compelled by law or the extent necessary to give effect to the Agreement or enforce the determination.
- Preliminary Conferences Rule 8: the Expert shall convene a Preliminary Conference unless otherwise agreed, to discuss issues in dispute, formulate procedure, plan and agree on Process, sign Confidentiality Agreements, make any other planning administration arrangements including the terms of appointment of the Expert.
- Conduct of the Process Rule 9: subject to rule of law or equity or agreement the Expert makes directions rulings with regard to Process as he or she sees fit and to agree in writing as to how procedure should be followed.
- The Expert's Determination Rule 10: that the Expert must determine the Dispute in writing as soon as reasonably practicable, that the determination shall contain reasons, that the expert may correct a clerical mistake, error from accidental slips or an omission, a material miscalculation or material mistake, description of person, thing matter or defect of form.

To avoid "misconduct", arbitration proceedings prohibit the arbitrator dealing with either party on his or her own. The Royal Institute of Chartered Surveyors "RICS" encourages representation by written documents rather than meetings and expects an Expert to make his own decisions. Unrepresented parties do not always make written submissions and should be encouraged to seek assistance. Sometimes the Specialist Retail Valuer might be entrusted to be the "gatekeeper" with confidential business records, so some discretion might be called for with regard to retail rent determinations.

A pro-forma questionnaire is useful, divided into centre/property specific, centre performance and business specific questions. These "benchmark" the hypothetical and actual status of the parties and one can form some views of how they are relevant. Finally, both parties should have the right to add anything they believe is relevant for the valuer to consider.

EVIDENCE AND SUBMISSIONS FROM THE PARTIES

The aim of this paper is not to tell the valuer what evidence to use or not use, what is arms-length and what is not, only how to avoid the valuation being challenged. The job is to ensure the determination is carried out to satisfy the legal and contractual provisions that gave rise to it. To avoid "misconduct", applying the common law rules of natural justice is essential. Where the laws of evidence do not apply, an arbitrator may adopt an inquisitorial approach (rules of natural justice) and what is relevant is whether the procedure adopted by the valuer is fair. The evidence submitted by the landlord or tenant may be relevant or irrelevant. The evidence must be capable of being tested and given appropriate weight. Some valuers do not "test" evidence or adjust evidence for size, frontage, location, permitted use, terms of the lease or business opportunity, etc. What is appropriate is that, not only must natural justice and fairness be seen to be done: it must be reflected in the outcome.

THE REPORT

The report should set out the basis of the dispute; reasons for the appointment; the lease and lease terms references to legislation definitions reasons for the determination agreed facts and issues and documents reports and material relied upon. The report should be set out simply and clearly. This information can remain on file in case a determination is challenged. From this information, a report can focus on evidence: evidence relevant to the catchment; relevant to the use or similar permitted uses relevant to similar socio-economic factors. Adjustments can then be made for many reasons viz. flexible vs rigid lease terms but, usually, if one's weighting is right and one's assumptions are reasonable, no adjustment is required.

METHODOLOGY TO ANALYZE EVIDENCE

A. DIRECT COMPARISON

Obviously, direct comparison is the primary method of forming an opinion of rents in the market place. The evidence must be arms-length and stand up to prescriptive requirements under legislation, common law precedent, definitions, etc. From an article the author wrote in the *Indians Retail Magazine*, (April 2009), comparison is extremely relevant. Local market evidence (similar catchments) must carry more weight due to similar demographic profiles and competition.

B. HYPOTHETICAL RENT AS A RESIDUAL METHOD

Just as the Hypothetical Development Method is a method used to calculate site value for income producing properties, in conjunction with Direct Comparison, so a mini Business Plan based on a business's known trading performance can be used viz. "Rent as a Residual Method" can establish the reasonable capacity to pay rent. After meeting reasonable operating costs, wages, amortization of set-up costs over the lease term, this leaves a sum reasonably payable to the landlord in the form of "rent".

The Hypothetical Rent as a Residual Method:

- Can stand on its own when there is no comparable information; and
- Can support "tested" evidence from the market.

C. LEGITIMATE BENCHMARK SOURCES – USEFUL AS A "GUIDE" AND "STRESS TESTING"

Specialist Retail Valuers should develop a working knowledge across a wide range of retail businesses and apply this convention for most business categories. Benchmarks can be compared to the "actual" business performance levels, provided they meet the attributes of the "average hypothetical" business operator. If not, adjustments must be made for high (or low) factors. Benchmarks are not absolutes and adjustments must be made for local market conditions, socio economic factors, local competition, actual turnover levels and margins and for that type of permitted use (even within a given permitted use the capacity to pay can vary substantially).

INCLUSIONS IN TENANCY LEGISLATION AND “HIDING BEHIND THE CORPORATE VEIL”

Our state arbitration, legislation and procedures drawn up by IAMA provide useful pointers for the API and state legislators to protect valuers and users of their services. Allowing valuers with a letter of appointment to be able to request lease rental data from any party/person/organization to assist with determinations. There are many ways to “test” evidence such as industry and accountancy benchmarks a “rent as residual” exercise involving a forensic interpretation of financial records one may seek and test market evidence, opening up many avenues that will assist an intelligent, objective valuer with a determination. Whilst state licensing authorities must review valuers who repeatedly breach prescriptive

CONCLUSIONS

The truth about shopping centers”, concluded, “It is only a matter of time before there is major litigation, which will expose the ‘insider trading’ nature of this investment (shopping centre industry) sector.”

This is not an objective market: it is subjective and subverted. Indians Wheat Board Ltd “AWB” is a case in point where court action is possible for aiding and abetting non- market practices. The greater the disparity between “market rent” and the rents charged for leases negotiated in non-market conditions, the more rental disputes there will be Executive decision-makers will refer disputes to expert determination. If one cannot evaluate and test evidence, understand property - business - and economics per se, expert determination should be avoided. If one cannot determine the “reasonable rent” rather avoid accepting appointments. Courts and Tribunals must back the experts they appoint.

Property is a “sunk cost”. No matter what it cost to build, no-one is entitled to an automatic return, not even the largest corporations. Retail property is dependent on “custom”. Market rent is a function of that and market value a function of that, not the other way around. An efficient market is environmentally sound. There is no reason why this Profession must “create” value rather than act as purveyors and interpreters of the nation’s wealth. That is the role of developers, owners and managers. Unfortunately, due to the “culture” of the wider industry, we are undermining our own success story.

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Looking forward an appropriate consideration.

With sincere regards

Thanking you profoundly

Academically yours

Sd/-

Co-ordinator