

STRUCTURING REAL ESTATE ARBITRATION CLAUSES:
A NEUTRAL'S PERSPECTIVE

By

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“When I use a word,” Humpty Dumpty said, in a rather scornful tone,
“it means just what I choose it to mean---neither more nor less.”

“The question is,” said Alice, “whether you can make words mean so
many different things.”

Lewis Carroll, Through the Looking Glass, 1872

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About the Author

Note to the Reader

Since this monograph provides a comprehensive treatment of real estate arbitration clauses, its major usefulness may be as a reference work. After reading the introduction those readers well versed in real estate and valuation concepts may choose to skip Part I and go directly to Part II starting on page 25; readers with little available time at the moment to read either Parts I or II may choose to go directly to the real estate arbitration clause checklist at the end of the monograph starting at page 52.

A large portion of this monograph in a different format is scheduled to appear in a future supplement to the legal treatise Negotiating and Drafting Office Leases by John Busey Wood and Alan M. Di Sciullo published by the Law Journal Press since 1995.

This monograph has been adopted for use by the University of California/State Bar of California Continuing Legal Education Program.

It should be noted that the writer is not a lawyer and that the views contained herein are based on his extensive experience as a neutral. Neither the writer nor his firm provides any warranties or guarantees that the statements and/or opinions expressed herein are appropriate or correct within the context of a specific situation or that they are foolproof from a legal perspective.

It is not the intention of the writer to come down on one side or another about solutions to substantive real estate disputes---such judgments must be left to specific real estate arbitration cases examined within each of their unique contexts and after testimony at hearings and the review of all documents, expert reports, transcripts, and pleadings.

Comments from readers are welcome and this writing will be revised and re-distributed from time to time as new trends are noted and useful feedback is received.

The writer is particularly interested in receiving examples of effective and/or dysfunctional arbitration clauses, stories about types of arbitration cases that experienced serious difficulties and citations of important legal case rulings on issues in specific arbitrations.

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Introduction

This monograph is focused on three categories of readers: real estate principals, lawyers, and arbitrators of real estate disputes. A central purpose of this writing is to identify an array of possible issues and some potential interpretations that at times may result in future consequences unforeseen at the time of drafting real estate arbitration clauses. Principals in transactions and their lawyers should consider these issues and others before agreeing to the features of a specific real estate arbitration clause.

Another of the writer's objectives is to produce a monograph that would provide a lawyer with the necessary combination of real estate, valuation, and dispute resolution knowledge that, when combined with his legal skills, would enable him to draft an effective real estate arbitration clause adapted to the context of a specific transaction.

A range of real estate and valuation concepts for possible utilization in arbitration clauses is described; then a range of possible alternative clause choices for facilitating the resolution of real estate disputes is explained. This writing encompasses a dispute resolution professional's structural suggestions based on extensive experience as a neutral. Appropriately, the writer leaves the actual drafting of a clause customized for individual real estate agreements to those who are licensed to practice law.

The writer has served as an arbitrator and mediator of a variety of real estate disputes. Although he does not have the benefit of a legal education, he does have extensive professional knowledge and experience in the real estate industry. A large volume of executed real estate agreements with issues in controversy have crossed his desk. It is clear that many of the arbitration clauses embedded in these documents were ambiguous and often embodied conceptual errors. Frequently, they described a flawed process for resolving disputes. Further, these clauses often omitted precise and clear wording that would have made the text more understandable and the actual intentions of the parties easier to fulfill at a future point in time. Did the drafters provide for constructive solutions or, unintentionally, the triggering of subsequent harmful financial results for one or both of the parties?

A few examples of adverse results that would have been hard to predict in advance should suffice to support the view that "blowback" or unintended consequences often occurs after arbitration clauses are triggered and the literal instructions contained in the clauses are fulfilled. A ground owner leases his site to a leaseholder for a possible total span of ninety nine years with this span of years further divided into an original lease term and a number of renewal periods. The leaseholder constructs an income producing improvement on the site. Years go by and the first renewal period is about to commence and a new market ground rent needs to be set for the renewal term considering the site's highest and best use. If neighborhood trends have changed dramatically, the existing improvements may no longer constitute the highest and best use of the site; consequently, the new market rent may make it impossible for the leasehold position to receive an adequate or, possibly, any return while utilizing the property as currently improved.

In an office lease rent re-setting for a renewal period a neutral may encounter a contemporary leasing market where a typical leasing framework of the past is no longer commonly found in the marketplace. For instance, in New York City in the immediate post-World War II decades the porter's wage rate formula served as a typical basis for measuring, however imperfectly, operating expense escalations in office space leases. This mechanism is no longer commonly utilized in new office lease agreements. How is the arbitrator going to establish the new market rent? Based on an outmoded lease framework that current market evidence does not directly and easily substantiate or based on the current practices now prevailing in the marketplace? If the current office market provides for free rent periods, tenant improvement allowances and amortization of such improvements, how are these current market features to be applied to an old space lease for a tenant already in occupancy? Can the arbitrator accurately and appropriately translate contemporary market conditions by adjustment into the context of a now structurally outmoded subject lease entered into years earlier? These challenges are further complicated by the fact that arbitrators do not have any authority to reform lease provisions.

The omission of words can also prove troublesome. A property owner develops an office building and net leases it to a single tenant for a twenty year period with additional renewal periods specifying that future net rent for each renewal term is to be set by arbitration. In a declining office market at the point of rent re-setting if a "not less than" minimum dollar amount is omitted, the rent for the renewal period could be less than the rent for the original term. The owner's initial capital investment, predicated on a certain economic level of rents, may fail to receive a current rate of return to sufficiently support the initial economic assumptions employed at the time of the original capital investment. This is particularly an issue in a build-to-suit "turnkey" development/leasing transaction.

The writer has served as a neutral in resolving a variety of real estate disputes and he knows that the drafting of an arbitration clause can be a tricky undertaking with positive or negative consequences that may not be obvious until many years later. The inclusion of an arbitration clause in a real estate agreement is often treated casually as an unimportant afterthought in the final phase of the drafting of the agreement. Ten, fifteen, twenty or more years after the clause wording is put in place, the agreed upon language, may have unforeseen consequences to landlord or tenant. Will the structure of an arbitration clause provide constructive solutions or adverse consequences?

In attempting to structure effective arbitration clauses it is clear that there is no standard language that is uniformly applicable and effective in all circumstances. Nonetheless, as the previous examples illustrate, the financial stakes for the respective parties can be high when the wording of the embedded clause does not serve the interests of a lawyer's client at a future date.

In customizing arbitration clauses for specific real estate transactions the parties should do their best to avoid what has been termed "pathological" arbitration clauses, namely clauses "...drafted in such a way that they may lead to disputes over the interpretation of

the arbitration agreement, may result in the failure of the arbitral clause or may result in the unenforceability of the award....”¹

Pathological “...arbitration clauses include clauses that are impossible or extremely difficult to implement, likely to breed disagreement during the arbitration, or likely to invite challenges to the award. These clauses are typically the product of too much specificity..., too little foresight about possible developments in the arbitration, or ambiguity/inconsistency in the clauses.”² The more heavily negotiated a detailed arbitration clause is the greater the chance that the resulting text will contain internal inconsistencies that will later come back to complicate a subsequent arbitral process.

The drafter must carefully navigate between the very long, detailed and complex clause where everything is spelled out in excruciating detail but this very specificity may not allow for unforeseen future circumstances, and the general *pro forma* clause which often says very little beyond, possibly, identifying the issue to be resolved, referring to a set of rules, identifying an administrative intermediary, specifying the number of arbitrators to be chosen and stating the threshold qualifications for potential arbitrators. Depending on actual circumstances either choice may lead to chaos and unforeseen consequences or to a good result.

Common sense and an understanding of the likely issues to be resolved in a future arbitration flowing from a specific real estate transaction should be guidelines for a drafter. In order to clarify such clause features the writer has provided a broad range of alternatives to facilitate such decisions.

This monograph has relevance for two generic categories of real estate disputes. The first dispute type includes cases whose core issues are rooted in valuation. These conflicts deal with the determination of market values and/or market rents such as controversies concerning the estimation of market rent upon the renewal of a ground or space lease, the value of a partial or fractional interest in a real estate asset as of a certain date or the value to be set for at a purchase option in unstated amount but specified to be at 100% or at some other percentage of market value. A stipulated discount to market value in a purchase option may have been employed as an incentive at an earlier point in time to obtain a key tenant.

The second category includes conflicts where market value or market rents may or may not play a part but where other non-valuation issues play the core role in the generation of the problem to be resolved. Such disputes may include property taxes and operating expense allocations and reimbursements; disputes about occupancy, operating and use issues; assignment and subletting controversies; commission, contract, and partnership disputes; land use and zoning issues; property or asset management agreements; hotel

¹ R. Doak Bishop, A Practical Guide to Drafting International Arbitration Clauses, Houston, King and Spaulding, 2000, p. 18.

² Frederick E. Sherman and Steven C. Bennett, “Avoiding Pathological ‘Pathological’ Arbitration Clauses,” in The Practical Lawyer, August 2006, p. 44.

franchise and management agreements; specific performance of a contract; actual or punitive damages; and a wide range of other problems.

As previously stated in the Note to the Reader, it is not the intention of the writer to come down on one side or another about solutions to substantive real estate disputes---such judgments must be left to specific real estate arbitration cases examined within each of their unique contexts and after testimony at hearings and the review of all documents, expert reports, transcripts, and pleadings.

Part I: Real Estate and Valuation Concepts for Use in Arbitration Clauses

Market Value, Market Rent, Contract Rent, Excess Rent and Deficit Rent

The definitions utilized in this section were formulated by the Appraisal Institute, the most widely recognized and authoritative professional valuation organization. The Appraisal Foundation, a quasi-public entity also promulgates definitions and, generally, the Appraisal Institute definitions are consistent with those of the Appraisal Foundation.

Some clauses specify the need to determine a real estate value or rent whose definition may be subject to controversy such as price, value, market value, fair value or market rent. More precisely, an arbitration clause may describe and provide for a dispute resolution process resulting in a market value conclusion for a property or the market rent for a ground leased site or for an office, retail or industrial space within a building or a market value conclusion for a partial or fractional interest.

Based on a definition provided by the Appraisal Institute Special Task Force on Value Definitions (1993) market value may be defined as:

“The most probable price which a specified interest in real property is likely to bring under all of the following conditions:

1. Consummation of a sale occurs as of a specified date.
2. An open and competitive market exists for the property interest appraised.
3. The buyer and seller are each acting prudently and knowledgeably.
4. The price is not affected by undue stimulus.
5. The buyer and seller are typically motivated.
6. Both parties are acting in what they consider their best interest.
7. Marketing efforts were adequate and a reasonable time was allowed for exposure in the open market.
8. Payment was made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.
9. The price represents the normal consideration for the property sold, unaffected by special or creative financing or sale concessions granted by anyone associated with the sale.”³

³ The Appraisal Institute, The Appraisal of Real Estate, Twelfth Edition, Chicago, The Institute, 2001, p. 24.

Subsequently, The Appraisal of Real Estate, Thirteenth Edition (2008) offered a re-stated definition:

“The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under duress.”⁴

Although it is briefer, the re-worded definition, in the writer’s view, is not an improvement in that it is less clear and direct. It also omits the words “undue stimulus” featured in the 1993 definition although the re-drafters may think that the same meaning is implicit in the later re-worded definition.

Market rent may be defined as: “The rental income a property would probably command in the open market; indicated by the current rents that are either paid or asked for comparable space as of the date of the appraisal.” In contrast contract rent is: “The actual rental income specified in a lease; may be a combination of base rent, percentage rents, and expense reimbursements.” Excess rent is the amount by which contract rent exceeds market rent; and deficit rent is the amount by which market rent exceeds contract rent.⁵

Valuation Approaches

When a potential conflict involves valuation issues, drafters may or may not wish to limit the valuation approaches, methods, and techniques that can be employed to arrive at a decision. The recognized three valuation approaches are the cost approach, the sales comparison approach, and the income approach. There are additional alternative methods and techniques within these approaches. Depending on the type of property to be valued and the context of local, regional, national or global marketplace circumstances, the methodologies having the most relevance to a specific task can be determined.

Often, the respective parties to a dispute will have conflicting ideas as to the appropriate weight to be given each approach, method, and technique. Examples of possible controversies are land comparable sales as contrasted with the land residual technique in periods of rapidly changing conditions in the marketplace and reproduction cost as contrasted with replacement cost in specialty property types.

Clause drafters are referred to the textbook entitled The Appraisal of Real Estate published by the Appraisal Institute and now in its latest (thirteenth) edition issued in 2008. There are even disputes between experts about some of the assertions set forth in

⁴ The Appraisal Institute, The Appraisal of Real Estate, Thirteenth Edition, Chicago, The Institute, 2008, p. 23.

⁵ Ibid., pp. 453-455.

this book and, of course, local practices vary and may not necessarily conform to general statements made in this or any other book. If a lawyer is in doubt about what valuation instructions, if any, that an arbitration clause should contain, a valuation expert should be consulted.

Uniform Standards of Professional Appraisal Practice (USPAP)

Lawyers may or may not decide to specify that valuation witnesses prepare appraisal reports in compliance with the Uniform Standards of Professional Appraisal Practice revised and issued every two years by the Appraisal Standards Board of the Appraisal Foundation.

Income Producing Properties

These properties are typically created to produce “bottom line” net operating income. This classification typically consists of office, retail, hotel, multi-family, industrial and special purpose properties such as movie theatres, bowling alleys and nursing homes. Such properties are categorized under the general rubric of commercial real estate. They are bought and sold based on buyers and sellers expectations concerning the present value of future benefits.

Highest and Best Use

Some arbitration clauses cite the highest and best use concept and some do not. Respective counsel will certainly advocate land use concepts that favor their client’s interests. Based on the expert reports and the documents, testimony and pleadings presented at the hearings the neutrals are left to determine the proper highest and best use. The financial stakes can be enormous.

The highest and best use concept may be applied to land as vacant and unimproved and/or properties as improved with an existing building. The highest and best use is defined as “The reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, and financially feasible and that results in the highest value.” In determining the highest and best use of an unimproved site four basic tests must be met; the projected highest and best use must be “...legally permissible, physically possible, and financially feasible and must constitute the most productive possibility of all reasonably possible alternative uses.”⁶ In analyzing the highest and best use of an improved property it may be that the existing use may constitute the property’s highest use or that physical changes, expansion, reduction or demolition is warranted by market forces. A substantial difference of opinion between the contesting parties as to the highest projected land use(s) can cause a dramatic variation in the valuation conclusions asserted by each side.

Sometimes, there is an inconsistency between the reasonably projected highest and best use of a site and the use clause in a ground lease. For example, perhaps, the most

⁶ Ibid., pp. 277-278.

reasonably supported highest and best use of a site is an office building but the use clause in the ground lease may limit the land's utilization solely to hotel use. In fact, this example figured in a famous 1967 case in New York City (Plaza Hotel Associates v. Wellington) where higher court rulings re-affirmed the ruling of the original court that directed the appointed appraisers to value the site on the basis of hotel, not office use, because the primary leaseholder under the terms of the ground lease was not allowed to utilize the site for an office building. It should be noted, however, that this judicial decision was not unanimous with the minority view being that the language in the governing clause was ambiguous and that the site should be valued as if unencumbered by the ground lease.

In this cited case the lease read in part: "Lessee shall pay rent for the interest of the land--equal to 3% of the value of the land (wherever permitted by the context) land use to mean land only, exclusive of improvements thereon."⁷ The clause certainly left plenty of room for the arguments asserted on both sides of the case. Such issues arise repeatedly in arbitration proceedings and the correct answer may be debatable. The appropriate decision is heavily dependent on the factual context of a case, the intent of the parties, and the specific language contained in the relevant real estate agreement.

In addition, current zoning is not necessarily the determining factor in projecting highest and best use. Property may be zoned to permit a certain use but unless there is probable market demand for that use the zoning classification is a label without substantive meaning. To the extent that typical market players will give weight to and pay a consideration for such a projected use it is an important consideration. If a re-zoning is postulated, it may be considered to the extent that typical market participants will pay some consideration in recognition of the probability of such a re-zoning.

In arbitration clauses where the highest and best use concept is not mentioned at all the argument about the appropriate land use assumption for valuation purposes can be intense and may account for a large variation in the valuation conclusions arrived at by the various experts involved in a specific case.

Space Measurement Standards

The various space measurement concepts include definitions of gross square feet, rentable square feet, and usable square feet. Depending on the age and functionality of buildings, loss factors vary widely. The typically acceptable measurement concept in shopping centers is gross leasable area (GLA). Industrial properties are typically measured on a gross building area (GBA) basis. Multi-family properties are measured both on a room count and/or a square foot basis. There are frequent disagreements about what constitutes a room or one half of a room.

⁷ See Harry K. Weiss, "Valuation of Long-Term Leases" in Gerald M. Levy (Editor-in-Chief), Arbitration of Real Estate Valuation Disputes, American Arbitration Association, 1987, p. 45 for a more detailed treatment of this case.

In office buildings distinctions are usually made between single tenanted and multi-tenanted floors. Real estate space measurement rules may vary from one city or metropolitan area to another and may even vary over time within the same market area. The parties in real estate transactions in many major cities often utilize the Building Owners and Managers Association International (BOMA) measurement standard. Yet, many leases do not even state the number of square feet being leased by the tenant but refer only to the “demised premises” and make reference to a line drawing contained in a referenced exhibit to a lease document. In a market cycle in which landlords have the upper hand in the supply/demand relationship, building measurements tend to expand; in tenant dominated markets, such measurements tend to contract.

Space measurements are subject to substantial variations. For example, in New York City, although the Real Estate Board of New York publishes “recommended” space measurement standards for office and retail space and room count standards for multi-family properties, these recommendations are not systematically implemented in the marketplace. “In 1955, for example, a rental brochure for 530 Fifth Avenue...offered the entire seventh floor, which was then 24,000 square feet. In 1979, the similarly configured sixth floor, 29,850 square feet. By 1982, the seventh floor had bloated to 30,580 square feet, exceeding the total plot size...by almost 3,000 square feet.”⁸ The space measurement issue presents a challenge in arbitration proceedings. What is the comparative physical basis for comparing other rent transactions to the subject property?

Bundle of Rights Theory and the Fee Simple Estate

Bundle of rights theory “...compares property ownership to a bundle of sticks with each stick representing a distinct and separate right of the property owner, e.g., the right to use real estate, to sell it, to lease it, to give it away, or to choose to exercise all or none of these rights”.⁹ A fee simple estate is: “Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.”¹⁰ There is no more complete form of ownership than a fee simple absolute.

Origins of Ground Leases

Leases are noted in the Book of Leviticus, Chapter XXV of the Old Testament where the jubilee year or every fiftieth year is described as a year of perfect rest; and alienated land is to revert to its owner: “In the year of this jubilee, ye shall return every man unto his possessions.” In addition, a method of valuing the transfer and/or the reversion of land even at a chosen earlier year is described and is tied to two factors, the value of the

⁸ The quoted example is found in Ruth G. Davi, “Those Incredible Growing Midtown Office Buildings,” in New York Magazine, April 3, 1995, pp.19-20.

⁹ The Appraisal Institute, The Dictionary of Real Estate Appraisal, Fourth Edition, Chicago, The Institute, 2002, p.37.

¹⁰ Ibid., p. 113

annual crop and the number of crop years remaining measured at the reversionary year.¹¹

In the Greek City States perpetual leases of agricultural and mining lands were created with a security payment in cash at the commencement of the lease and an annual rental payment often fixed at 4 percent of profits from the leaseholder's use of the property. In Roman times perpetual leases based on an annual rental amount or percentage of profits can also be documented.

Subsequently, ground leases existed in England before William the Conqueror's victory at the Battle of Hastings in 1066 and could be for a term as long as 999 years. In the contemporary world English aristocratic families such as those of the Duke of Westminster and the related Grosvenor Estate still have substantial land and improved property holdings subject to long term leases.

In the Late Middle Ages there are numerous examples of ground leases in municipal, state, and other public records in France, Germany, Italy and Spain. At times Jews were unable to own land in certain European countries and ground leases enabled them to own houses subject to the rights of landowners. At other times early capitalists preferred to be ground lessees in order to conserve capital for use in other economic activities.¹²

By 1700 ground leases existed in some of the American colonies beginning with Pennsylvania and Maryland which were settled by English colonists. In New York, founded by Dutch settlers, leasing of land started somewhat later. Vast tracks of land in New York State, some obtained by royal land grants were held by well established families. For example, the Van Rensselaer family owned the 726,000 acre Manor of Rensselaerwyck which had 3,063 tenant leases in 1839. Landlord-tenant relations were not always good. At the height of the Anti-Rent Rebellion in 1845 "... the uprising involved 10,000 tenant families in eleven counties with a total of 1.8 million acres under lease for lives or forever." In the Anti-Rent Rebellion tenant farmers rose up and refused to pay an annual perpetual consideration as lessees considering themselves enmeshed in "feudal servitude interminable."¹³ Over time many of the leased fee interests were bought by tenant farmers or the leases were converted to mortgages and, in time, fully, satisfied. Land subject to long term leases was held by wealthy revolutionary era families such as the Astors, Beekmans, Delafields, DeLanceys, Goelets, Livingstons and Van Rensselaers and even today leased fees are still held by some of these families.

¹¹ See The Encyclopedia Britannica, Eleventh Edition, Volume 15, The Encyclopedia Britannica Company, New York, 1911, p. 532.

¹² See Salo Wittmayer Baron, The Social and Religious History of the Jews, Second Edition Revised and Enlarged, Volume XII, Late Middle Ages and Era of European Expansion (1200-1650): Economic Catalyst, New York, Columbia University Press, 1967, pp. 40-44.

¹³ A detailed and fascinating account of the Anti-Rent Rebellion is contained in Charles W. McCurdy, The Anti-Rent Era in New York Law and Politics, Chapel Hill, University of North Carolina Press, 2001, 408 pp.

In Hawaii until 1848 ownership of land was controlled by the monarchy. A large proportion of the land area of all the islands is now owned by the US Government. Even with a series of land reform measures in the twentieth century a large proportion of the land in private ownership is held by a small group of land owners. In the past at the conclusion of a residential ground lease a leaseholder had to either negotiate a renewal of the lease or remove his dwelling or forfeit the improvements. Currently, under certain circumstances a leaseholder who entered into a ground lease since 1975 can, at the end of his lease term, abandon his improvements or cause the fee owner to pay him the fair market value of such improvements.¹⁴

Contemporary Ground Lease Framework

A ground lease may be defined as a long term lease of land; at the expiration of the lease term, often 99 years including an original term and specified renewal options, and, typically, subject to periodic rent re-settings, the land and any improvements erected thereupon revert to the land owner.

Sometimes, the full time span of a ground lease may be less than 99 years. This shorter number of years typically occurs when the improvements have a low floor area ratio (FAR) and the ratio of land value to total property value is high; examples are “big box” retail stores, restaurants, and automobile showrooms and service centers. Such ground leases may have terms of 25 to 30 years with the major constraints on the length of term being the ability to get financing for the leasehold improvements and the need to amortize the capital investment in the improvements over the term of a ground lease.¹⁵

The ground owner’s interest is either unsubordinated to any leasehold owner’s interest or is subordinated to such an interest. The act of subordination constitutes the agreement in writing of the possessor of a senior interest to make his interest lower in priority than that of the holder of a usually junior interest. Subordination exposes the ground owner to the risk of the possible loss of title to the site if there is an uncured leasehold mortgage default. Although not very common, in some transactions subordination may also refer to the deferment of the ground owner’s rent receipts in favor of a preferred return to the leaseholder.¹⁶

The owner of the land encumbered by a ground lease, typically, receives a periodic net rental from the tenant with the leaseholder responsible for the payment of property taxes, insurance and all other charges. If it is the intention that the leaseholder construct a new building, the original term of the ground lease before consideration of renewal options should be of sufficient length in years to allow the leaseholder to amortize his capital investment in the new improvements over the initial term.

¹⁴ See Benjamin Nell, “Ground Rents from Maryland to Hawaii: Leasehold Interests in Residential Real Estate,” Real Estate Issues, Fall 2006, pp. 55-59.

¹⁵ See Robert Wetmore and Chris Klinger, “Land Leases: More Than Rent Schedules,” in Urban Land, Volume 50, Number 6, June 1991, pp. 6-9.

¹⁶ Ibid., *passim*.

In setting rent mechanisms for renewal periods in long term ground leases there are three factors in play: land values, land rents and rates of return. The process is not without risk to both ground lessor and lessee. Over a long period of time interest rates, the Consumer Price Index (CPI) or another government sponsored index specified as a measure of inflation, and market rates of return can vary widely from year to year and the compounding or even straight line affects of successive rent increments can be enormous in their economic consequences. The reasonable assumptions that prevailed at the time the long term ground lease was established may be radically altered over the course of years. The assumptions and likely uses of the land that existed at the commencement of a ground lease may be subject to dramatic change based on trends in the marketplace over the length of the ground lease term.

Generally, throughout the United States as ground leases approach the time of rent re-setting for a renewal term or the final expiration date of the lease, primary leaseholders can experience a number of problems such as the unwillingness of financial institutions to extend new mortgage financing and the difficulty of primary leaseholders to continue to lease commercial space for sufficient periods of time acceptable to commercial tenants. Further, if there is uncertainty as to the level of future rent payable to the fee owner, primary leaseholders cannot reasonably project their future expense basis before leasing space to new commercial tenants. These dynamics served as an impetus for leasehold estate owner Rockefeller Center in New York City to purchase the underlying land from Columbia University in 1985.

As a result, it often happens that primary leaseholders seek to renegotiate the rental terms of their ground lease prior to the stated date of the renewal term or the final expiration date stated in their agreement with the fee owner. Often the *quid pro quo* is that the leaseholder pays a new level of rent to the land owner on an accelerated basis and the leaseholder can now calculate the profit margin and can again rent space to commercial tenants for an acceptable lease term.

Ground Leases: Unencumbered or Encumbered

Depending on which side they represent, lawyers may contend that if a clause calling for the valuation of land omits the phrase “as if unencumbered” in defining the “bundle of rights” to be valued, the arbitrator must consider the effect of the entire lease on the land value. Thus, for example, the length of time in renewal options could affect the economic practicality of constructing a projected new highest and best use. The specific facts in a particular case, the language of the agreement and the intentions of the parties are all important considerations in ruling on such matters.

A linked issue also discussed in the highest and best use section of this monograph concerns the effect, if any, of a lease agreement’s “use clause” on the findings of the arbitrator. If the land owner’s site has evolved and now has a more productive use, should he receive rent based on the updated and, possibly, more productive use or not? Can a tenant be compelled to pay rent for a postulated highest and best use when it is stipulated in the lease agreement that he is prohibited from actually employing that use at the

subject site? What was the intent of the parties? What does the language of the lease state? What can be ascertained about these and similar issues during an arbitration proceeding?¹⁷

There are also improved properties that are legal non-conforming uses; and, if intentionally or as a result of a natural disaster these properties are demolished they can not be re-built in their previously improved form. Special care must be taken in analyzing such properties.

Ground Lease Renewal Options and Rent Re-Settings

Generally, in most situations it is not difficult to predict the respective priorities of land owner and leasehold estate owner in rent disputes. Landlords want to collect high rents and primary leaseholders want to pay low rents.

Typical Landowner and Leaseholder Priorities in Attractiveness in Terms of Land Use:

Land Owner's Priorities

1. Value based on highest and best use
2. Value based on existing use.

Leasehold Estate Owner's Priorities

1. Value based on existing use
2. Value based on highest and best use

Rent Re-Settings Tied to Legal Encumbrances:

Land Owner's Priorities

1. Unencumbered
2. Encumbered

Leasehold Estate Owner's Priorities

1. Encumbered
2. Unencumbered

Ground Leases: Land Values, Rates of Return and Market Rents

In the process of establishing a land value or a ground rent for a renewal term there are three interrelated factors: land values, rates of return and market rents. Often, in dense urban areas, contemporary comparable land sales and/or ground lease transactions may be few in number or even non-existent: "To deal with this problem, some leases call for arbitration of land value, indicating that the land rent is to be determined by applying a specified rate of return to that value. Presumably, the rate was appropriate at the time the lease was negotiated, but it may or may not be a "market" rate at the time of arbitration. Because both the value of the land and the proper rate of return may vary from time to

¹⁷ Besides the Plaza Hotel case cited in the Highest and Best Use section of this monograph other New York cases dealing with this and similar issues include but are not limited to United Equities, Inc. v. Mardordic Realty Co., Inc (1959), 140 Broadway Company v. Dewey, Ballantine, Busby, Palmer & Wood (1983), New York Overnight Partners v. Joan Gordon et. al. (1996), and 936 Second Avenue L.P. v. Second Corporate Development Co., Inc. et. al. (1998).

time, it most equitable to have the arbitrators determine the land rent, which is a function of both land value and the rate of return.”¹⁸

Yet, it must be remembered that in determining a new rent, a neutral must follow explicit valuation instructions, if any are stated in a specific arbitration clause. It is not the mandate of an arbitrator to reform the lease.

An alternative to the various ground lease rent mechanisms previously described are profit sharing allocations between the ground owner and the leaseholder based on a combination of “...net cash flow from operations and ...net proceeds from transfers of interests in and financings of, the tenant’s leasehold estate.”¹⁹ If such an arrangement is to be considered, there must be precise definitions of what is to be included and excluded and provision for auditing of revenue, expenses, and cash flow before and after debt service based on third party financing. These types of arrangements may prove difficult to monitor effectively.

Space Leases: Initial Term, Rent Pattern, Frequency of Renewal Terms and Rent Re-Settings

Long term space leases in America came into existence after the Civil War and percentage retail leases were created by 1915. In subsequent decades the structure of leases grew more sophisticated and complex.

Commercial space leases usually consist of short term leases for one to seven years whereas long term leases feature ten to twenty five year original lease terms and one or more renewal periods of five to ten years each. Multi-tenant commercial office leases often call for a fixed rent with specified rent increases at certain points in time or rent increases tied to government indexes such as the Consumer Price Index (CPI) or Wholesale Price Index (WPI) published by the U.S. Bureau of Labor Statistics. In addition, a tenant’s pro rata percentage share of property taxes and operating expenses over specified base dollar amounts or over the expenses occurring in an identified base year that may be identical to a certain calendar year or to a lease year are often a tenant’s payment responsibility. Gross leases in their purest form are usually short term in duration and often roughly call for the tenant to pay a gross rent and the landlord to pay property taxes and all of the operating expenses. In a modified gross lease the landlord pays some but not all of the operating expenses. Sometimes, office tenants may have expansion options and, less frequently, termination options that may include a termination payment to the landlord.

Single tenant office leases may be structured on a triple net basis. Triple net lease terminology implies a rent net of property taxes, operating expenses, and repairs and

¹⁸ Peter S. Brooks, “Resolution of Renewal Rentals in Land Leases” in Real Estate Issues, Warren, Gorham and Lamont, Volume 26, Number 3, Fall 1996, pp. 32-38.

¹⁹ See Steven Simkin and Manuel E. Lauredo, “Tailoring Rental Terms: Profit Sharing Accounts for New Development”, Reprinted from New York Law Journal, July 13, 2005.

maintenance. Such leases are also called “credit” or “bond” leases if the tenant has a very strong credit rating provided by one of the three major rating agencies. This type of lease is generally seen as preferable by a landlord since he can more reliably depend on the rental stream to support debt service and to obtain re-financings on favorable terms in a normal economic environment.

Build-to suit-leases and sales leasebacks generally are for a lengthy term of years typically 25 to 40 years to allow development costs for new structures and purchase prices for existing buildings sufficient time to be amortized. Sometimes, the face contract rents in these types of lease transactions may not reflect market rent trends at the point in time that they are consummated but may be artificially set higher or lower than typical market rents.

Retail lease rent patterns can include flat rents, a combination of minimum rents plus an overage or percentage rent against sales above a certain specified sales amount, a straight percentage rent against gross sales, and graduated leases on a step up or step down basis.

In negotiating a rent pattern for a proposed lease transaction it is also important to weigh the relative frequency of rent re-settings against the attendant administrative and professional fees generated by frequent arbitration proceedings.

Leased Fees, Leasehold Estates, Sandwich Positions and Sub-Leaseholds

A leased fee was originally a fee simple that was subsequently encumbered by a lease. The tenant in such a lease is also known as the owner of a leasehold estate.

A “sandwich” lessee was originally a primary leaseholder who subsequently leased his interest to a new party who then became the holder of the “operating” lease. The “sandwich man” collects rent from the operating position and pays rent to the owner of the land that is subject to the lease and retains the positive spread or bares the burden of the negative spread.

Partial and Fractional Interests

Some people use the terms partial and fractional interests interchangeably but in the classic literature of real estate there is a distinction with partial interests referring to such portions of the division of the bundle of rights as a leased fee (originally a fee simple now subject to a lease for a certain number of years), a leasehold position (the lessee’s interest), a “sandwich” position is a “...lease in which an intermediate, or sandwich, leaseholder is the lessee of one party and the lessor of another.”²⁰

A fractional interest denotes the ownership of a majority or minority interest in a fee simple or in a leased fee or leasehold estate. Minority interests are often characterized by lack of control, limited marketability, longer marketing time, illiquidity, and the difficulty of using such interests as collateral for financing. When there is no one

²⁰ The Dictionary of Real Estate Appraisal, Fourth Edition, p. 256.

controlling interest, there may be difficulties in arriving at a consensus on important decisions. Often, but not always, such interests are discounted; however, if the various parties in ownership, acting in concert, intended that the interest be treated on a pro rata basis, there may not be a discount. The concept of a control premium may sometimes be warranted for a majority interest or when one of the fractional interest holders is attempting to re-assemble a fee simple interest in the entire property and there are one or more “holdout” fractional owners whose consent is needed and a purchase premium is required to overcome resistance to sale. There are other variations in context that may call for a discount or premium adjustment or for sale at a level equal to a pro rata share of the market value as a whole. In other words, the value of an interest in property may be greater than, equal to, or less than a mathematical pro rata share of the value of the entire ownership.

The clearest explanation of the nuances of partial and fractional interests that the writer has found reads as follows: “Fractional,” “undivided” and “partial” interests are customarily used synonymously, but the terms may differ in degree....partial ownership is construed to signify ownership representing less than 100% of the fee simple interest. Various leaseholds, easements, mortgages, equity interests, horizontal and vertical rights, and rights pertaining to timber or minerals are also considered partial interests.”

“Fractional or undivided interests are all partial because they relate to either partial rights or multiple ownership of a particular interest or right. For example, a leasehold interest in a warehouse or the title to a dwelling unit in a multi-story condominium is a partial interest, but it will also be a fractional or undivided interest if it is owned by more than one entity.”²¹

Fractional interests can be documented at much earlier periods since there are recorded fractional ownership interests in the medieval European ghettos. By the very nature of ghettos, space was in scarce supply and families and even unrelated parties shared ownership of houses through the convention of fractional ownership interests.²²

An undivided interest connotes “Fractional ownership without physical division into shares.”²³ An undivided partial interest is “An interest in a specific property that is shared by the co-owners; no co-owner can unilaterally convey or encumber any specific part thereof.”²⁴

Partition: “A division into severalty of property, especially real estate, held in joint ownership; the legal separation of undivided partial interests such as co-ownership in real estate. This division of real property into separately owned parcels according to the

²¹ Harold D. Albritton, Controversies in Real Property Valuation: A Commentary, Chicago, The American Institute of Real Estate Appraisers, 1982, pp. 118-119.

²² Baron, op. cit., pp. 40-44.

²³ The Dictionary of Real Estate Appraisal, p. 299.

²⁴ Ibid., p. 299.

owners' proportionate shares, which is usually pursuant to a judicial decree, severs the unity of possession, but does not create or transfer a new title or interest in property."²⁵ Problems may occur, not all of which are suitable for resolution in an arbitration proceeding. Resort may also be had to other alternative forms of dispute resolution or to the courts.

Joint Ventures

A joint venture is a partnership of two or more parties who join together, usually on a temporary basis, to complete a specific real estate project. Often, the active party is a real estate developer who contributes his experience, expertise, and effort to complete the project and a financial partner who contributes all or a majority of the capital and financing. If problems arise during the project or, even if the project is executed without major difficulties, a time will come for the dissolution of the joint venture and the need to value the respective interests of the parties. If the parties cannot agree on the measurement of their interests and/or the process of dissolution, the matter may be the subject of an arbitration proceeding.

Life Estates and Remainder Interests

A life estate may be defined as the "total rights of use, occupancy, and control, limited to the lifetime of a designated party, often known as the life tenant."²⁶ The term of a life estate is the actual length of life of the identified person. Actuarial tables are a necessary component in determining the typical number of years that such an encumbrance will likely continue to affect the property rights of the remainder or reversionary interest. Often, investors purchase property so encumbered by making an informed bet on how many years will elapse before the demise of the occupant and the simultaneous extinction of the life interest. At that point the property passes to the owner of the remainder interest who may occupy it or deploy it to produce income.

Cooperative Ownership Concept

Generally, this concept is limited to a multi-family property. An occupant of an apartment within the larger property has a proprietary lease linked to a specific unit and is obligated to pay his or her proportionate share of taxes, insurance, operating expenses, reserves and debt service in the same ratio of the number of shares the occupant of the unit owns to the total universe of share ownership in the property as a whole.

Condominium Ownership Concept

Condominium ownership is "A form of fee ownership of separate units or portions of multi-unit buildings that provides for a formal filing and recording of a divided interest in

²⁵ Ibid., p. 299.

²⁶ The Dictionary of Real Estate Appraisal, Fourth Edition, p. 165.

real property.”²⁷ Although typically identified with multi-family properties, it also may apply to certain office, retail, hotel, and industrial properties.

Air Rights and Transferable Development Rights

Air rights and transferable development rights in common usage are often used as synonymous terms but they are really not precisely the same.

Air rights are: “The right to undisturbed use and control of designated air space above a specific land area within stated elevations. Such rights may be acquired to construct a building above the land or building of another or to protect the light and air of an existing or proposed structure on an adjoining lot.”²⁸

Transferable development rights (TDRs): “A development right that cannot be used by the landowner, or that the owner chooses not to use, but can be sold to landowners in another location....TDRs are said to be transferred from a landowner in a *sending district* to the use of a landowner in a *receiving district*.”²⁹

Air rights and transferable development rights are valuable in dense urban areas where there is a relative scarcity of land available for similar development. “As a general proposition, it may be said that air rights attain value when the capital cost of creating them is less than the value of available and similar land.”³⁰

Purchase Options, Rights of First Refusal, and Buy-Sell Provisions

Sometimes, as an inducement to a tenant to lease space, a tenant or another party is given an option or successive options to purchase a property at a future point or points in time. The purchase price at a certain specified time may be in a specifically stated amount or in an unstated amount but, possibly, at an explicitly stated percentage of future market value or at the full amount of such value at the point of the exercise of an option.

Among the possible conflicts in the exercise of such an option are issues concerning the price to be paid, possible adverse income tax consequences, allowable mode of financing, percentage of cash to change hands at the point of exercise of the option and the allocation of expenses at the closing of the transaction. Ideally, these and other potential points of dispute should be thought out, agreed upon, and explicitly treated in the arbitration clause and/or in other sections of the original agreement and at least referenced in the arbitration clause; the scope of conflict can be narrowed in this way.

²⁷ The Dictionary of Real Estate Appraisal, Fourth Edition, p. 59.

²⁸ The Dictionary of Real Estate Appraisal, Fourth Edition, p. 9.

²⁹ Ibid., p. 295.

³⁰ John Robert White, “George Washington Bridge Approach: A Case Study”, p. 75 in Real Estate Valuing, Counseling, Forecasting: Selected Writings of John Robert White, Chicago, American Institute of Real Estate Appraisers, 1984, 275 pp.

Purchase options may sometimes be at explicitly stated prices or at a future market value to be determined at the point of exercise of the option. “A purchase option may only give the lessee the right to purchase the property or make an offer if an offer to purchase is made by a third party. This provision is referred to as a right of first refusal. A purchase option can restrict marketability. The option price, if stated, may well represent a limit on the market value of the leased fee estate.”³¹ In addition, when a right of first refusal exists as a form of purchase option, there may be a dispute about whether or not a valid third party offer has been made which, if valid, triggers the option holder’s need to decide whether or not to exercise the right of first refusal.

In a typical bi-lateral buy-sell agreement one partner states the price and the other partner decides whether he will be a net buyer or a net seller of his interest.

A Variety of Other Legal Ownership Interests

Partnership disputes are often the subject of arbitration proceedings. “A partnership is a business arrangement in which two or more persons jointly own a business and share in its profits and losses.” “In a general partnership, all partners share in business gains and each is personally responsible for all liabilities of the partnership.” A limited partnership is “an ownership arrangement consisting of general and limited partners. General partners manage the business and assume full liability for partnership debt, while limited partners are passive and liable only to the extent of their own capital contribution.”³²

A general or limited partnership interest may be subject to arbitration to determine its value. Such a value determination must consider a number of factors including but not limited to whether the interest is a minority or majority interest, degree of decision making powers and whether or not the interest can be easily marketed to third parties. Disputes often arise between partners as to the *quantum* of value of such an interest and whether in arriving at such a value determination whether or not pro rata, discounted, or premium treatment of the interest is warranted. If the parties have initially agreed as to how such a partnership interest should be treated in arbitration, they should specifically state the manner of treatment.

There are other ownership interests such as corporations, limited liability companies, tenancies in common, joint tenancies and many other interests each of which can present specific problems, not all of which are suitable for resolution in an arbitration proceeding. In such instances resort may be had to other forms of alternative dispute resolution or to the courts.

Mortgages and Notes

A mortgage constitutes a lien on real property with the accompanying note constituting the borrower’s promise to repay the lender. Arbitration is usually appropriate in a number

³¹ The Appraisal of Real Estate, Thirteenth Edition, p. 479.

³² All three definitions in this section are in The Appraisal of Real Estate, Thirteenth Edition, p. 124.

of creditor-debtor disputes including: “(1) a demand for payment by a debtor on a promissory note or by a guarantor under a guaranty where collateral is not involved, (2) a debtor’s claim or counterclaim against a creditor alleging lender liability, (3) a debtor’s claim against a bank lender for payment of an improperly endorsed check, and (4) a guarantor’s assertion of suretyship defenses.”³³

Frequently, there are “carve out” or exception provisions in arbitration clauses concerning the mortgage, note, and related real estate loan documents. One typical carve out exception “... is when a creditor takes steps to protect its rights by exercising statutory remedies against the collateral in a judicial proceeding, such as a foreclosure or replevin action.” Another possible carve out exception “...is when the creditor seeks preliminary injunctive relief, from a court in order to preserve the existence, location, condition or productive use of the collateral (i.e., maintain the status quo).”³⁴ In such instances creditors do not want to submit their interests to the control and judgment of a neutral when they have explicit and effective remedies in law that they do not want to see diminished. Secured creditors are not likely to delay in enforcing their legal remedies when, for example, the withholding of rent can halt debt service payments that in turn can generate a mortgage default and possible foreclosure.

Both lenders and borrowers have rights. Neutrals have to make sure that both parties are treated fairly in matters involving lender/borrower conflicts that find their way into arbitration proceedings

A Selection of Other Types of Disputes

Other real estate disputes that may be the subject to arbitration include: property management and asset management contracts; landlord-tenant disputes involving use clauses, property taxes, and operating expenses and their apportionment between landlord and tenant; subletting and assignment; lease defaults; measurement of damages; partnership disputes; real estate brokerage commission disputes; standards of practice for real estate and construction lenders and for real estate brokers. The property types involved in such conflicts may include unimproved land, office buildings, shopping centers and free standing retail outlets, hotels, multi-use properties, industrial and distribution facilities, and special purpose properties such as healthcare facilities, bowling alleys and movie theatres.

In the closely related construction industry disputes have involved construction loans and business issues such as timely completion in conformance with plans and specifications, appropriateness of change orders, business interruption, measurement of damages, and

³³ Donald Lee Rome and Davis M.S. Shaiken, “Arbitration Carve-Out Clauses in Commercial and Consumer Secured Loan Transactions,” in Dispute Resolution Journal, volume 63, Number 3, August-October 2006, p. 2.

³⁴ Ibid., p. 2.

lost profits as well as technical issues about materials, methods, and workmanship utilized in the construction of buildings and site improvements.

Part II: Choices for Real Estate Arbitration Clauses

Appraiser vs. Arbitrator Nomenclature

Especially in many older real estate agreements drafters have often used the term “appraiser” instead of the term “arbitrator.” Employment of this term is a confusing practice since the typical work product of an appraiser in his primary function is the preparation of an appraisal report where the reasoning for every step of the valuation process is provided. This choice of nomenclature often leads to confusion as to what the decision maker who is termed an appraiser is supposed to produce as a final work product in resolving the dispute and what his role in the proceeding actually should be. Generally, in the writer’s view, it would be preferable for drafters to use the term arbitrator.

Arbitration awards without reasons given are generally issued in real estate disputes. Providing a “reasoned” award similar to a reasoned appraisal report may enable a disappointed party to more easily appeal and, possibly, overturn an award. The dispute resolution process could then just be an initial step in a sequence leading to expensive and protracted litigation, the very result that dispute resolution was put in place to avoid.

There is another contradiction between appraisal practice and arbitration practice. In an appraisal report an appraiser “certifies” to a specific “market value”; in a three person arbitration panel, if two of the arbitrators are selected by the respective parties and, if each of them previously wrote an appraisal report concerning the subject property, one or both of them may subsequently provide a joint conclusion with the neutrally selected third arbitrator in the form of a sworn award with a consensus market value. An appraiser would have first certified to one market value in his appraisal report and, subsequently, agreed to another market value in form of a sworn oath in an arbitration award! This is an unseemly result.

The writer brought the problem described above to the attention of the original American Institute of Real Estate Appraisers, one of the predecessor organizations of the current Appraisal Institute. In a tripartite proceeding where each party selects one of the panel members any chosen panel member who previously prepared an appraisal report should be released from the findings of that report. In such a case a panel member would be free to consider anew all the facts and opinions that he previously considered and all new facts and opinions that are brought to his attention during the arbitration process.

This view was subsequently set forth and defined in the Code of Professional Ethics and Standards of Professional Practice (1984) of the American Institute of Real Estate Appraisers: “Members of such panels, convened by operation of a legal contract, statute, or court order, may be called upon to serve in the role of arbitrator, umpire, mediator,

decision maker, or “appraiser” (when the role of the Member or Candidate is not limited to a prior report writing task, but is expanded to include a quasi-judicial function). Nothing in this Code of Professional Ethics should be construed as prohibiting Members or Candidates...from serving in such a capacity....Generally, the written decisions rendered in such a context are brief in nature and need not discuss the documentation, reasoning or methodology utilized in arriving at the decision....When such an activity is preceded by an appraisal assignment, it is not a violation of this Code...to recommend a value or decide on a course of action at variance with his or her own prior conclusion so long as it is done in the interest of resolving the dispute equitably to the benefit of all parties. In so doing, the appraiser (in this context) reconsiders all facts and opinions which led to his or her prior conclusion in addition to all new facts and opinions which come to his or her attention during the arbitration or appraisal proceeding.”³⁵ If not so sanctioned, how is a consensus decision to be reached in such a described process if two of the appraisers are bound to the valuation conclusions of their prior reports?

At the heart of an effective dispute resolution process is the unconstrained dialogue without a prior commitment by an individual decision maker when the panel is seeking a group conclusion. The provided process should constructively support such a goal; otherwise, indecision and stalemate may be the result. In addition, the protections against liability for arbitrators is well developed in most state jurisdictions while the liability protections for appraisers in such a context may be less clear in some jurisdictions. When you step in the middle of a conflict, a neutral should be provided suitable protection. In some jurisdictions “...appraisal does not have the finality of an award in arbitration.”³⁶ Yet, in some other jurisdictions the distinction between appraisal and arbitration proceedings has been reduced or eliminated.³⁷

Scope of Issues Subject to Arbitration

The clause should specify that the respective parties are committed to the arbitration of certain identified issues; other issues may be excluded from the process. In addition, the parties to an agreement and any successors, assigns, and guarantors of a transaction should be explicitly committed to the arbitration process. Generally, if the arbitration clause remains silent about the issues subject to arbitration and those that the parties do not intend to be arbitrated, the clause will usually be broadly interpreted by neutrals and by the courts. By all means, if there are issues the parties do not want to be subject to arbitration, the clause should specify which issues are subject to arbitration and which issues are excluded from the process; such a clause is called a “split clause.”

³⁵ American Institute of Real Estate Appraisers, Code of Professional Ethics and Standards of Professional Practice, Chicago, The Institute, 1984, pp. 13-14.

³⁶ Bernard H. Goldstein, “Real Property Appraisal vs. Arbitration,” in Gerald M. Levy (Editor-in-Chief), Arbitration of Real Estate Valuation Disputes, New York, American Arbitration Association, 1987, p.101.

³⁷ See Yaroslav Sochynsky and Mariah Baird, “Tailoring the Arbitration Clause: Accommodating Client Needs in Real Estate and Other Transactions,” in Golden Gate Law Review, Summer 1991, pp. 281-305.

Issues Already Decided

In matters of *res judicata* (Latin: “a thing already decided”) a party to an arbitral proceeding is barred from arbitrating the same issue against the same party if the issue was already decided on the merits in a prior litigation or in an award in a prior arbitration. An arbitrator should not rule on such an issue.

Designing the Sequence of Activities Culminating in an Arbitration Decision

Initial Diagnostic Methods

Prior to either choosing and/or pursuing a formal arbitration, a clause may specify that the parties to a particular dispute may agree to participate in one the following optional diagnostic methods possibly leading to an early settlement of their dispute and avoiding a more expensive process in time, energy, money and emotion:

Fact Finding is a neutral’s determination of the basic facts of a dispute and the identification of areas of agreement and disagreement. Depending on the scope of the work agreed upon by the claimants, the neutral may or may not make settlement recommendations to the parties.

Case Evaluation is performed by a neutral experienced in the subject matter of the dispute. He reviews the substantive case by listening to each side’s presentation and submissions and posing questions. Subsequently, the neutral summarizes the strengths and weaknesses of each position. If the parties then agree to continue working with the neutral, they may reach a voluntary resolution of the dispute.³⁸

Dispute Resolution Process Spectrum

In preparing arbitration clauses the drafter may specify one or more methods, individually or in sequence, for resolving a future dispute. The chosen method or methods can be derived from a wide range of possible processes.

As a prelude to an arbitration, negotiation and then, possibly, mediation, may be specified as first steps. If successful, the use of such a process would eliminate any need for a subsequent arbitration. In both negotiation and mediation, if and until an agreement is reached by the affirmative assent of all parties, no party relinquishes control of the outcome. Neither the negotiator for any side nor a mediator may unilaterally impose a result on the parties. Only mutual consent can make a definitive agreement possible in these pre-arbitration processes.

³⁸ The texts of the Initial Diagnostic Methods, Dispute Resolution Process Spectrum, Possible Limitations on Arbitral Decision Making, and Possible Expansion of Arbitral Decision Making sections of the monograph are largely drawn with some modifications from the CRE Real Estate Dispute Resolution Protocol; the present writer was the primary drafter of that document. Readers who would like to review additional methods may refer to Gerald M. Levy, “Resolving Real Estate Disputes,” in Real Estate Issues, Volume 24, Fall 1999, pp.1-9.

Negotiation is an interest-based decision-making process. Participants bargain to resolve differences of opinion concerning the apportionment of responsibilities and benefits. Negotiation is the most frequently employed dispute resolution method in the professional, business and personal realms and is the “mother of all methods.” Currently, the two major schools of negotiation theory are designated as integrative (“win, win”) and distributive (“win, lose”). In negotiation the parties maintain full control of the process and any agreement reached requires the consent of all parties. When negotiation fails, parties increasingly turn to dispute resolution to avoid the risk, expense, time, and emotional stress of litigation.

Mediation is a voluntary non-binding confidential method of assisted negotiation under the auspices of a neutral third party. Its features include voluntary exchange of information and presentations by each of the parties to the dispute. The mediator meets with both or multiple parties, usually in a joint session at the beginning and at the end of the formal process and, in the interim, in caucuses with each side separately. The mediator may employ “shuttle diplomacy” in trying to assist the parties in reaching an agreement. If agreement is achieved, it is usually confirmed in writing and signed by all parties to the dispute; when practical, in the form of a final agreement, or when that is not possible, in the form of a signed term sheet that is as comprehensive as circumstances permit. Subsequently, a fully documented and executed agreement may be put in place.

Arbitration is a binding process in which knowledgeable subject matter professionals (generally, one or three) serve as third party arbitrators. After opening arguments by each side together with direct examination, cross-examination, re-direct examination, a closing summation and/or receipt of a post-hearing brief, the arbitrators reach a decision which is binding on the parties and may be entered as a court order to ensure enforcement. Arbitration may or may not include legal counsel, discovery or a transcript. Usually formal hearing sessions are conducted by the arbitrators but strict adherence to the legal rules of evidence or civil procedure is not customarily required; yet, elementary fairness to all parties in the arbitral process must be observed. As contrasted with litigation, arbitration is a confidential process which provides expeditious and comparatively inexpensive resolution of disputes by an arbitrator knowledgeable about the issues in controversy.

Some other available phased dispute resolution methods include:

Mediation/Arbitration (Med/Arb) is a two phase process. First, a mediation process occurs. If the parties with the aid of a neutral mediator succeed in achieving a resolution of their dispute, there is no second phase arbitration process. If the mediation is unsuccessful, the parties agree on a new neutral or panel of three neutrals (all as the parties wish) who hears the evidence and render a binding arbitration decision resolving the dispute. In the alternative, the parties may agree to permit the first phase mediator to serve as the second phase arbitrator or arbitration panel chair. Allowing the initial mediator to be involved in the arbitration phase, however, is unusual and not acceptable to many experts. Such a mediator may have been given access to information in

confidence by one or more of the parties during the initial mediation phase that could affect his judgment in the arbitration phase.

Mediation/Arbitration² (Med/Arb²) is a variant of Mediation/Arbitration. If in a first phase mediation some issues may be agreed upon and some issues may still remain unresolved, all the parties may agree to allow the mediator to decide the remaining unresolved issues unilaterally; if all the parties do not concur in this instruction, a second phase arbitration occurs either with another neutral, a new three neutral panel, or the first phase mediator acting as a second phase arbitrator or panel chair. The same reservation concerning the continuing involvement of the original mediator is noted as in the process described immediately above.

Arbitration/Mediation (Arb/Med) is the reverse of Mediation/Arbitration (Med/Arb) in that an arbitration is the first phase process but the panel's award is sealed until the parties subsequently try to reach an agreement through mediation under the auspices of a neutral who was not involved in the arbitration; if the parties fail to resolve the matter within a specified time period, the previously sealed award is opened and it becomes the official decision in the matter in dispute. If the parties do reach agreement through mediation, the panel's sealed award is not opened and is destroyed.

Possible Limitations on Arbitral Decision Making

Final Offer or "Baseball" Arbitration limits the selected arbitrator's authority to picking exactly one party's or the other party's proposed result. In its purest form the arbitrator has no discretion beyond this exact instruction. The theory behind this method is that each side, fearing that its proposal will not be chosen, will be forced into a "zone of reasonableness." In actual arbitration practice each party's proposal may give no sign of being influenced by this theory. If the arbitrator does not agree with either choice, he will still be forced to choose "the least worst" of the proposals. An additional possible result is that the parties, dreading the idea of allowing the arbitrator to choose one of the proposals resulting in a clear winner and a clear loser, will themselves agree to settle the matter with each other before the neutral has a chance to choose.

There are a number of variations to the pure final offer process described above and they include (1) "modified final offer" arbitration where the arbitrator finds neither party's proposal acceptable and provides his own proposal which, if accepted by both parties, becomes the final result and, if not acceptable, the arbitrator must then choose the original proposal submitted by one of the parties; (2) "repeated offer" arbitration where the proposals submitted are unacceptable to the arbitrator and the parties are instructed to submit new proposals from which the neutral makes a choice; (3) "multiple offer" arbitration where the parties each simultaneously submit more than one offer and the arbitrator states which side has provided the best offer then the other party can pick which of the multiple offers submitted by its opponent that it prefers; (4) "night baseball" arbitration where the arbitrator renders a preliminary award before seeing the individual proposal of each party and then he modifies the preliminary award to be equal to the individual party proposal closest to his preliminary finding which then becomes the final

award in the matter at issue; and (5) “multiple” issue arbitration where each side submits one or more proposals for the resolution of each issue of the several issues in dispute and the arbitrator can compose an award issue by issue and arrive at a new sanctioned synthesis which become the complete multiple issue award document.³⁹

In “bounded” arbitration the parties pre-agree on the limits of the range in which the final arbitration award will be allowed to fall and the preliminary award of the arbitrator (he does not previously know the bounded range) will need to be adjusted if it is not within this range. If the preliminary award is below the lower limit of the range, it will be adjusted upward to be the same as the lower limit; and if the preliminary award is above the upper limit, it will be adjusted downward to be identical to the upper limit. If the preliminary award is within the range or is identical with the lower or upper limit of the range, it will automatically become the final award without any adjustment.

Clause drafters have many arbitral decision making limitations from which they can choose or they may leave the matter completely in the hands of the arbitrator.

Possible Expansion of Arbitral Decision Making

If provided for in an arbitration clause or by subsequent agreement of the parties, the powers of the arbitral panel may be expanded. A possible expansion of powers follows:

Ex Aequo Et Bono (“According to What is Just and Good”) Arbitration references a proceeding in which the sole arbitrator or panel of arbitrators is instructed to decide a dispute on the basis of good faith and fair dealing and thus sanctioning the panel’s going forward beyond agreements between the parties to fulfill such an instruction. This instruction is rare but may occur between family members or close friends who want the opportunity for a continuing relationship with each other.⁴⁰ It should be noted that this instruction is infrequently employed in arbitration and may be more suitable in a mediation process. Is the neutral wise enough to carry out such an instruction? The resulting award may be very subjective.

Relating Choice of Dispute Resolution Process to the Magnitude of Expenses

Saving money on the dispute resolution process is not likely to be the top priority in a large complex dispute. Sometimes, in small and moderate size disputes, the relatively high expenses incurred on all sides for funding the process to the point of an award issuance may make any positive result for a client, a Pyrrhic victory.

The expense dimension is likely to increase geometrically when some or all of the following situations occur: delays in agreeing on the choice of arbitrator or arbitrators, squabbles about whether discovery will or will not be permitted and, if allowed, the

³⁹ Douglas Yarn (Compiler and Editor), Dictionary of Conflict Resolution, San Francisco, Jossey Bass, 1999, 545 pp., *passim*.

⁴⁰ Ibid., p. 171.

extent of discovery, prolonged arguments about what issues are subject to the specific arbitration process at hand, identifying a large number of witnesses to be heard, initiation of several postponements and rescheduling of time lines and other matters that prove contentious and time consuming.

The number of specific features involved in the design of an arbitration clause can also have a significant impact on the aggregate expenses that will be generated in an arbitration proceeding. It is important to balance the twin risks, “the two sides of the sword,”---complexity and simplicity---to achieve a level of total expenses that is consistent with the benefits to be gained from the described arbitral process.

Flexibility

In drafting an arbitration clause one should be flexible enough to build into the process opportunities for informal negotiation by the parties, respective counsel and, even on some occasions, to authorize party-appointed arbitrators (but not the neutrally selected third arbitrator) to work together to attempt to resolve the conflict before the beginning of the formal deliberative phase with the neutrally-selected arbitrator. If such negotiations are successful, the parties may prefer a settlement so achieved than waiting for a final award to be issued. If a settlement is reached in such an informal dual track manner, then, if the parties desire, the arbitrators may be asked to incorporate the agreement into a “settlement and consent award” and issue it. This action will facilitate enforcement by a court of competent jurisdiction.

Case Management Agreement

Case management agreements among counsel for the parties may be an effective tool in making the dispute resolution process more timely, efficient, and economical. The negotiation of such a document can allow the parties to reach pre-agreement on many ministerial matters before the arbitral process begins and can provide detailed instructions to the neutral(s), such as: prior negotiation, prior mediation, administered vs. *ad hoc* arbitration, scope of issues to be considered, governing law, provision for interim remedies, locale, published or customized rules, agreed upon modifications to a set of published rules, arbitrator qualifications, number of arbitrators, withdrawal of an arbitrator during arbitral process, consolidation, evidentiary guidelines, legal fees, pre-judgment and/or post-judgment interest (compounded or simple), punitive damages (if any); injunctive remedies, enforcement provisions, discovery and discovery management, any special powers of the arbitral panel chairman, and other matters.

The lawyers for the parties, having negotiated such a document, can present it to proposed arbitrators as a detailed road map for completing the arbitration. Much time and money can be saved in the subsequent arbitration process by using a case management agreement.⁴¹

⁴¹ See Tom Arnold, “Avoiding Arbitration Booby Traps,” in The Practical Litigator, Volume 8, Issue 1, January 1997, pp. 31-56.

When there is an identified set of rules and an administrative agency in place as an intermediary, a case management agreement is not generally necessary or advisable. In fact, such an agreement may cause problems if there are inconsistencies between it and the cited rules.

Detailing and Refining the Arbitral Process

Instructions on Rent Re-settings for Renewal Terms

Some arbitration clauses call for the arbitrator to value the property and then apply a certain specified percentage rate to determine the new rent for a renewal period. Alternatively, the clause instructions may call for the higher of such a rate or the prime rate or the Consumer Price Index or the Wholesale Price Index. The use of indexes in this context could be similar to playing a game of Russian roulette! For example, at a few points in time the prime rate exceeded 20%!

Effective Date

Either the effective date of the finding should be obvious in the real estate agreement or should be specified in the arbitration clause. If a relatively rapid change in upward or downward market trends should occur at the proximate time of the stipulated effective date, there is likely to be controversy as to what market participants reasonably knew and when they reasonably knew it. Sometimes, market evidence that occurs after an effective date may be acceptable if it confirms a trend already evident as of the effective date but not subsequent evidence that indicates a reversal of a trend that was discernible as of the effective date.

The writer has been involved in some arbitrations where the “as of date” of the decision was specified as one date and the date for the new economic impact to occur was deferred to a much later date. One possible reason behind this deferral of time for the new rent to be charged is to give the economics of property operations and resulting contract rent cash flows time to catch up with the realities of contemporary market rent levels in growth markets.

Option to Renew: Before or After Determination of the Renewal Rent

In structuring lease renewal terms and arbitration clauses it might be preferable for the tenant to find out the new rent before exercising its option to renew. If the tenant must first exercise the option before finding out the new rent determination, it could not only cause some financial problems but the landlord might well be left with a bankrupt tenant in occupancy with all the disadvantages and expenses that such a situation can entail.

Administered vs. Private Arbitration

Arbitration clause drafters may specify either administered arbitration with an organizational intermediary such as the American Arbitration Association or a private *ad hoc* arbitration proceeding with the administration provided by the arbitrator. The administering agency acknowledges the receipt of claims, composes lists of arbitrators for submission to the parties, oversees the neutral selection process, decides if the neutral has a disqualifying relationship when the parties disagree on this issue, serves as facilitator of communications between the parties and the arbitrators, and expedites the execution and transmission of the award to the parties' respective counsel.

The advantages of an administered arbitration proceeding include a formal mechanism for preventing *ex parte* communications between either party and the arbitrator and a formal set of rules provided by the sponsoring organization which has been challenged by prior cases and, subsequently, refined. Further, administering agencies often have extensive experience in dealing with arbitrator disclosures and possible real or apparent conflicts of interests. Such groups may also have experience in "...legal complexities, such as transnational enforcement, non-appearance of a party, or objections to jurisdiction for which an experienced administrator has procedures designed to assure a smooth hearing and enforceable award."⁴²

The advantages of private arbitration are that administrative expenses may be reduced and, in certain circumstances, completion of the process may be accelerated. The relative effectiveness of an *ad hoc* process is dependent on the willingness of a neutral to administer the case and his efficiency in performing this function.

In *ad hoc* arbitration there are fewer safeguards preventing *ex parte* communications between a party and a neutral.⁴³ In addition, the functionality of such an approach is also dependent on the effectiveness of rules drafted and customized for a specific case.

Citing a Specific Set of Rules

After reviewing various sets of published arbitration rules clause drafters may choose the arbitration rules of a specific organization. Before specifying the set of rules to be cited in the arbitration clause the drafter determines if there are any rules that should be omitted or amended and/or other rules added. Typically, when a specific organization's rules are cited, the organization is also selected to be the administrative intermediary.

⁴² Bruce E. Meyerson and Corinne Cooper (Editors), A Drafter's Guide to Alternative Dispute Resolution, Committee on Dispute Resolution, Business Section of the American Bar Association, Chicago, 1991, p. 46.

⁴³ Ibid., p. 46.

Define Technical Real Estate Terms

In order to reduce controversies over the meaning of technical terms in an arbitration clause the drafter should define such concepts.⁴⁴ Yet, in the process of attempting to define such terms, misconceptions about the meaning of various concepts can produce errors.

Other Relevant Factors

Parties to a real estate agreement often are reluctant to specify all the other relevant factors that should be considered in a future dispute between the parties. At the time of the drafting and execution of the original transaction agreement the parties may believe that it is hard for anyone to predict all of the relevant factors long in advance of an actual proceeding. Depending on the context of a specific real estate dispute and the original motivations of the parties, a number of other previously unidentified factors may or may not be relevant.

Submission Process

There are three usual routes to the submission of a dispute. It can be triggered by an arbitration clause in a real estate agreement; it can be initiated by mutual agreement of the parties to submit the case to an administering agency or to an *ad hoc* arbitration; and, in some cases, a court mandated or encouraged mediation process and/or arbitration occurs.

Besides completing the necessary submission papers by at least one of the parties a statement of claim is submitted and the second party may issue a response and counter claim.

Confidentiality

Generally, arbitration proceedings are thought to be confidential. Yet, if a court order for enforcement is sought or there is an appeal of the arbitration award to a court of competent jurisdiction, the decisions of such courts are generally readily available to the public.

Often, the parties choose arbitration because they have a strategic reason to keep the results confidential. It is the arbitrators who are usually bound to maintain confidentiality; the parties are often not so bound. If the clause drafter wants confidentiality to be observed by all participants, he should explicitly so state in the clause.

⁴⁴ An authoritative source for real estate terms is the aforementioned Dictionary of Real Estate Appraisal, Fourth Edition published by The Appraisal Institute; in law one may either pick a source tailored to a specific legal jurisdiction or, possibly Bryan A. Garner, Editor-in-Chief, Black's Law Dictionary, Eighth Edition, St. Paul (MN), West Group, 1999.

Time Line

A timeline recitation in an arbitration clause may be an important tool in keeping the arbitration process on track and putting the parties, their respective counsel, and the arbitrators on notice to move the case along to resolution by a stated outside time limit. It also helps keep total expenses to a reasonable level. In setting an approximate timeline, however, it should not be so hurried or arbitrary that the instructions prove difficult to fulfill; otherwise, a party who is unhappy with the award may have a wedge issue for launching an appeal in court.

Within the text of some arbitration clauses a timeline for conducting the arbitration process is already specified and may at times be too rigid and, therefore, can be self-defeating. For example, one clause specified that that within ten days of an arbitrator's appointment the arbitral hearings had to commence, could take no more than one day and that an award had to be rendered within twenty four hours after the close of the hearing. Given the need to coordinate the daily schedules of the principals, their lawyers, and witnesses with that of the arbitrator, this instruction may prove difficult to fulfill. In addition between the completion of the hearing and the deadline for rendering of the award little time may be left for careful consideration before an instructed rush to judgment. Understandably, one or more of the parties may fear a possible dilatory motivation by another party. Yet, timeline requirements should be realistic and may be better left to an arbitral decision at a preliminary conference early in the process. The arbitrator should prevent the repeated actions or inactions of a party from delaying or defeating an efficient arbitration process.

Locale

The arbitration clause should specify the locale of the hearings after also giving consideration to the domiciles of the parties and the availability of congenial substantive and procedural laws. The choice of locale "...implies generally a choice of the applicable procedural law, which in turn affects questions of arbitrability, procedure, court intervention and enforcement."⁴⁵ Often, the chosen locale of the arbitration proceeding will be in the geographic area which includes the subject property in order to provide accessibility for a property inspection.

Choice of Law

As already mentioned, the choice of law is closely entwined with the choice of locale. The text of the clause may specify that the arbitration process is subject to the Federal Arbitration Act or the laws governing arbitration and its enforcement in a certain state. Generally, arbitrators, unless otherwise instructed are not bound by the formal rules of civil procedure or evidence. If the parties have explicit wishes about following procedural or substantive legal rules, either Federal or the law of a certain state, they

⁴⁵ American Arbitration Association, "Drafting Dispute Resolution Clauses: A Practical Guide, New York, The Association, 1998, p.21

should so specify in the arbitration clause.⁴⁶ Every effort should be made to avoid future conflict of law disputes. The Federal Arbitration Act is located at 9 USC Sec.1, et seq., and the New York State arbitration statute is contained in Article 75 of the New York CPLR. In other states a focused search can identify the specific statutes.

Jurisdictional Challenges

It is sometimes asserted by a potential party to an arbitration proceeding that the arbitrator lacks the authority to hear and decide a certain issue. Generally, rulings on such challenges are the purview of the courts but a drafter may explicitly confer on the arbitrator the ability to rule on challenges.⁴⁷

Severability

Typically, real estate agreements provide for severability: if any portion of the arbitration clause or the real estate agreement as a whole shall be declared void or unenforceable by any court of competent jurisdiction, the remaining text of the arbitration clause can still be enforced.

Inclusion or Omission of “Not Less Than” or “Not More Than”

Landlords will usually want a market rent for the next renewal period in a ground or space lease that has a “collar” providing that in no event will the rent set for the next renewal period be less than the amount paid in the immediately prior period. On the other hand, the lessee will prefer a market value or market rent determination with no minimum or “collar” rent but with the possibility a rent maximum “cap” or “no more than” rent ceiling. These collar and cap provisions must be thought out carefully by drafters. For example, if a lease is subject to a collar provision for a renewal term which happens to occur in a down market cycle such a provision, although apparently protective of the landlord’s interest, may cause a valuable tenant to move when, with some flexibility, the landlord might be able to retain the tenant.

Appropriate Characteristics of Potential Arbitrators

In specifying even briefly in an arbitration clause the qualifying criteria for potential arbitrators, the clause drafter should weigh the relevant importance to be given substantive industry knowledge vs. the importance of procedural skills and experience in administering the arbitration process. Undoubtedly, both are important but giving exclusive weight to one or the other will often not well serve the parties. A lawyer who is an arbitrator in a real estate valuation case may have great procedural expertise but if

⁴⁶ See Neal Blacker, “Drafting the Arbitration/ADR Clause: A Checklist for Practitioners,” in Practical Lawyer, March 2000, Volume 46, pp. 55-62.

⁴⁷ See Thomas J. Stipanowich, Editor and Peter H. Kaskell, Associate Editor, Commercial Arbitration at its Best: Successful Strategies for Business Users, New York and Washington (DC), Center for Public Resources and American Bar Association, 2001, p. 47.

he or she is not grounded in substantive valuation knowledge and experience it is hard to see how the award will be fair except by sheer good luck.

Similarly, a substantive expert who is uninformed or ineffective about procedural issues and about decision making within the context of the arbitral process will not likely be effective as a neutral. If the arbitral panel is composed of three arbitrators with a diverse range of relevant training, knowledge and skill sets, this problem can be easily solved.

Conflict of interest inquiries and disclosures by potential or appointed arbitrators is necessary. Canon I of the Code of Ethics for Arbitrators in Commercial Disputes states that an arbitrator should only accept appointment if satisfied that:

- “(1) that he or she can serve impartially;
- (2) that he or she can serve independently from the parties, potential witnesses, and the other arbitrators;
- (3) that he or she is competent to serve; and
- (4) that he or she can be available to commence the arbitration in accordance with the requirements of the proceeding....”⁴⁸

In making disclosures arbitrators should consider their own relationships and any known relationships of relatives and business associates and other circumstances that may merit disclosure. When in doubt as to the need to disclose, it is good practice to do so. In making a disclosure one should answer the generic questions: who, what, when, where and how.

There is also the continuing obligation on the part of a neutral for disclosure as new potential conflicts of interest come to the arbitrator’s attention. Sometimes, there are situations that are trivial but their non-disclosure may cause perception problems or the suspicion of unfairness from the perspective of one or more of the parties. In a particular arbitration proceeding, when a party subsequently discovers a potential conflict even of a minor or “cosmetic” nature that was not previously disclosed by a neutral, it arouses suspicion and indignation. Justice Louis D. Brandeis once said: “Sunlight is the best disinfectant.”

Arbitration Panel or Sole Arbitrator

Traditionally, in a large number of cases, clauses specify that each party would pick one of the decision makers, variously described as a real estate appraiser, arbitrator, expert, broker, freeholder, neutral person or umpire. If the two persons chosen do not agree on a collective decision, they then try to agree on the selection of a third person. If they fail to agree on the choice of such a person, an impartial organization, the judge of a court of competent jurisdiction, the president of the local bar association or some other independent person or the representative of a mutually respected institution is called upon to make the selection.

⁴⁸ American Bar Association and American Arbitration Association, Code of Ethics for Arbitrators in Commercial Disputes, New York, American Arbitration Association, 2003, 11 pp.

This very common tripartite method for picking decision makers presents a number of concerns. The most vexing issues focus on the appropriate roles and responsibilities of each of the party-appointed decision makers. Should a party to a dispute choose one of the “judges”? Can an expert who is appointed by one of the parties maintain both the appearance and substance of impartiality? Can an expert both advise one of the parties and also be a dispute resolution decision maker? Does each of the parties desire impartiality in the expert they select or are they looking for an effective advocate? The practice of specifying in the text of an arbitration clause that the parties to a dispute will each choose an arbitrator who will participate in the final decision creates other problems. The opinions of the party-appointed individuals often differ by a large margin. Frequently, the significant variation of opinions can be explained by sincerely held disparate views based on differing assumptions. Sometimes, however, unrestrained advocacy is the major reason for wide variations. Each party to a dispute may choose an expert who may favor its interests.

A particularly unfortunate outcome could emerge if one claimant’s expert is an “advocate” while the other party’s expert lives up to standards of professional practice, and the “impartial” third person subscribes to a “split-it-down-the-middle” philosophy. In such a situation, the interests of the “honest” expert’s client may have been inappropriately and adversely affected.

When deciding on the number of arbitrators to be employed in a specific dispute, there is often a dilemma between capturing the necessary balance of expertise, experience and opinion within the panel, on the one hand, and, on the other hand, keeping the time and expense dimensions of the case contained. Further, the greater the number of members on a panel the more scheduling difficulties and delays are likely to be encountered and the more time will be devoted within the group to accommodating one’s peers. Yet, the quality of the final award could well be improved with extensive discussion and debate resulting in the preparation of a properly balanced award.

In recent years there has been a trend toward utilizing single arbitrators in a larger percentage of cases. This trend is based on an effort to reduce the aggregate amount of professional and administrative fees, particularly in disputes involving small dollar amounts. In addition one decisive arbitrator will be more effective in managing a case than a panel of three members. Further, if only one person is going to have leverage in the award decision making, why not just have a sole arbitrator and let the other two experts serve as witnesses?

Another infrequently discussed alternative is to pick a panel of two members, possibly one lawyer and one industry substantive knowledge expert. Less time will be expended in internal group dynamics and the two complementary professional backgrounds, given a congenial and cooperative approach by each of them, can often produce a wise and fair decision. Yet, in a few cases there is always the risk of deadlock.⁴⁹

⁴⁹ See Tom Arnold, *op. cit.*, *passim*.

Although in some real estate disputes the present writer has served as a party-appointed arbitrator and would so again, he prefers a neutrally selected sole arbitrator in smaller matters. In large complex cases where a variety of expert backgrounds may be useful, the writer prefers a panel composed of three neutrally selected arbitrators.

Tripartite Panel: Decision Making Dilemmas and Variations

Another area of concern in tripartite panel selection involves the dialogue and decision making process. Assume, for example, that a new rent is to be set for a renewal period of a ground lease. The clause specifies that the rent is to be set at a fixed percentage of the current market value of the site. Decision maker Terra Firma, chosen by the landlord, estimates a value of \$10 million; decision maker Edifice, selected by the tenant, estimates a value of \$7 million. As a result of subsequent dialogue, Terra Firma knows or assumes that the third arbitrator's tentative estimate is \$9 million, a conclusion closer to his valuation than to Edifice's. Terra Firma is unyielding because he assumes that the third arbitrator is unlikely to agree with Edifice's estimate of \$7 million and he may be forced to choosing Terra Firma's \$10 million conclusion. As it turns out, the third expert concludes that endorsing either of what he deems to be two extreme opinions is inappropriate. He seeks, what he believes to be, a fairer resolution of the dispute.

Under variously permitted circumstances, the third arbitrator may lead his colleagues to different outcomes:

- If Terra Firma is inflexible at \$10 million, the third arbitrator may attempt to persuade Edifice to accept a valuation of \$9 million. This effort may not be fruitful.
- The operative arbitration clause in the legal agreement may specify that after the passage of a reasonable amount of time and the expenditure of conscientious effort, the third arbitrator can certify that there is no majority agreement, and he can assume the power to decide the matter. A third arbitrator who possesses this authority has substantial leverage with the party-appointed arbitrators.
- The operative clause may specify that in the event of a deadlock, the third arbitrator is empowered to declare an impasse. Subsequently, he would have no further obligations in the matter and a new third arbitrator would be chosen. Critics of this option contend that the impasse power, if widely exercised, would defeat arbitration as a timely and efficient alternative to litigation. Yet, a third arbitrator who also has the power to declare an impasse, has continuing leverage once he makes his tentative conclusion known to the party-appointed arbitrators.

These situations do not exhaust all the possible difficulties that could occur during the dialogue and decision making process if a panel of arbitrators is selected in a tripartite manner.⁵⁰

Choices in Tripartite Panel Design and Decision-Making

Numerous proposals have been advanced for reducing the difficulties experienced in tripartite proceedings. Some of the suggestions deal with the method of arbitrator selection, others with the dialogue and decision making process. These proposals are described as follows:

Blind Selection: Each claimant selects an arbitrator but the selected person is notified of the appointment by an intermediary and the name of the client is withheld from the arbitrator until the unanimous or majority decision is executed and delivered. It is not clear, however, how the parties could ensure that an arbitrator would remain ignorant of the selector's identity.

Witness and Arbitrator: Each claimant selects a witness and an arbitrator as does an impartial third party. The witnesses research, analyze and prepare reports about the conflict which they exchange and then they critique each others findings. Subsequently, they appear at hearings conducted by all three of the arbitrators. A majority decision of the arbitrators then decides the matter.

Separate Data Collection Only: Each claimant and an independent party select an arbitrator. Each of the first two professionals separately collects the necessary data prior to their initial meeting. All three meet and undertake analytical efforts and decision making and at least a majority's decision binds the parties.

Collective Professional Work: The three arbitrators meet and engage in the collective tasks of data collection, analysis and decision making. At least a majority of the three expert panel agrees on an award decision.

Agreement of Party-Appointed Arbitrators or Third Party Neutral's Sole Decision: The first two party-appointed arbitrators must arrive at a common conclusion within a specified time period. If they fail to meet the deadline, all power to decide is transferred to the third person and the functions of the first two professionals are limited to presentation and submission of evidence and opinions.

Arithmetic Average: All three experts write a separate report and the decision consists of the arithmetic mean average of their three individual value estimates. This method may produce capricious results because erratic estimates directly affect the mean average. This approach assumes that the claimants will be better served by a collective average judgment or a forced consensus.

⁵⁰ With modifications this section is taken from Gerald M. Levy, "Issues and Solutions in Real Estate Appraisal, Arbitration, and Mediation Proceedings," in Real Estate Issues, Volume 26, Number 3, Fall 1996, p. 9.

The Final Offer or “Baseball” Clause: As previously discussed the third arbitrator’s function is limited to choosing one of the value estimates presented by one of the first two party-selected arbitrators. Advocates believe that this technique will compel each of the first two arbitrators to submit conclusions that fall within a “zone of reasonableness.” It is theorized that each of the first two arbitrators would be concerned that the third arbitrator would choose the other arbitrator’s conclusion as the most reasonable alternative and, as a result, each of the first two arbitrators would be under pressure to submit a balanced conclusion at the beginning of the process. In practice, however, this theory does not always influence the party-selected arbitrators and the third arbitrator is left with the task of choosing “the least worst” choice. In addition, some experts believe that this procedure denigrates the professionalism of the two originally selected arbitrators and ignores the probability that, acting in a knowledgeable and impartial manner, most professionals will arrive at an equitable decision without arbitrary constraints.

“Night Baseball” Clause: Such a clause specifies that after a tripartite panel of arbitrators reaches its decision the previously sealed individual proposals of the parties are opened and the arbitrators then choose the proposal that is closest to the panel’s own conclusion and that proposal becomes the final award. If the panel’s initial decision is at the midpoint of the range between the now opened individual proposals, the arbitrators’ initial decision becomes the written award.

Arithmetic Average of the Two Conclusions that are Closest in Dollar Amount: Each of the arbitrators arrives at a separate individual conclusion. The binding decision then consists of the average of the two conclusions that are closest in result to one another. Like the baseball clause, this mechanism tries to discourage extreme conclusions and is an incentive to the creation of individual conclusions that are within the “zone of reasonableness.”

Neither High nor Low: Each of the three decision makers arrives at an individual conclusion. The binding decision is the median average conclusion. This arrangement attempts to ensure that wild or erratic determinations by individual experts will not prevail.

This lengthy list of variations on the tripartite method of selection, dialogue and decision making is not exhaustive and that fact highlights the potential imperfections and difficulties of a system of each party unilaterally selecting one of the arbitrators. The ideal spirit of arbitration is “Come, let us reason together.” Unfortunately, the ideal is more difficult to achieve in tripartite proceedings.

Selecting the Chair Person

If there is a sole neutrally selected arbitrator, he, obviously, oversees the process; if there is a tripartite panel of arbitrators with the first two chosen by the parties at interest, the third arbitrator either chosen by agreement or by an impartial administering organization serves as chair; and where there is a panel of three neutrally selected arbitrators either the

parties will jointly agree on selecting the chair or, if they fail to agree then the administering organization (if any), a designated impartial person will make the selection or the arbitrators themselves may choose the chair.

Disagreement on Selection of Sole Neutral or Chairman of a Tripartite Panel

When the parties or their party-appointed arbitrators cannot agree on the choice of the sole neutral or the third arbitrator of an arbitral panel, clause drafters often specify that a judge of a certain court or the president of the local real estate board will make the choice. Unfortunately, such individuals are not always knowledgeable about these issues and, even given good faith and no conflict of interest, the neutral chosen may or may not be up to the task of deciding such matters.

To reduce the possibility of a deadlock between the two party-appointed arbitrators the writer suggests that such arbitrators agree to prepare a list in alphabetical order of either three or five professionals who would be acceptable to the preparer as the third arbitrator. The lists would be simultaneously exchanged and, if there are one or more names in common on the two lists, one of those names in common can be designated to serve as the third arbitrator. Sometimes there will be no names in common on the two lists. The two arbitrators can prepare a second list and hope for better luck. Yet, the lack of a name in common may indicate that each of the party-appointed arbitrators has widely differing assumptions as to the desirable types of knowledge and experience that an ideal third arbitrator should possess.

Powers of the Arbitrator

Generally, the legal system has granted arbitrators broad powers in the absence of contractual limitations to the contrary. For example, the Supreme Court of California in a 1994 case stated that broad language "...abolishes any meaningful limitations on the scope of the remedies that an arbitrator may award in deciding a contract dispute" but not limited to, specific performance of a contract."⁵¹ In addition, both the Real Estate Industry Rules (Including a Mediation Alternative) and the Commercial Arbitration Rules of the American Arbitration Association provide that "The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties...."⁵² If the parties to a real estate agreement are not comfortable with the neutral having such far ranging powers, they should explicitly limit his authority in the arbitration clause.

⁵¹ Robert R. Salman and Suzanne A. Salman, "Points to Ponder for Arbitration Agreement," in Practical Lawyer, January 1997, Volume 43, No. 1, pp. 31-38.

⁵² Rule 45 of the Real Estate Industry Arbitration Rules (Including a Mediation Alternative) and R-43 (a) of the Commercial Arbitration Rules both published by the American Arbitration Association, September 1, 2007.

Withdrawal of an Arbitrator

If death or disability causes a vacancy, provision should be made for filling the vacancy. This situation is even more problematic if it occurs after the arbitration process is underway. If originally there was a panel of three neutrally selected arbitrators, the parties may agree not to replace the now absent arbitrator but with an even number of arbitrators there is always the previously mentioned risk of stalemate.

Scope of Work

Initially, an arbitrator is responsible for reviewing the preliminary materials submitted by the parties and taking a leadership role in any preliminary conferences with respective counsel. Prior to the formal hearings the neutral should review any documents, expert reports, and pre-hearing briefs made available by the parties. At the formal hearings the arbitrator should make sure each side is provided a full and fair hearing and that, unless waived, direct examination, cross-examination and re-direct examination of each witness occurs. The arbitrator is free to ask questions throughout the process but he is not responsible for shaping each side's case. As the formal hearings draw to a close, respective counsel will deliver an oral summation and/or transmit a post-hearing written brief. During the arbitration if there are parallel settlement discussions, a neutrally appointed arbitrator should not be involved in them and, if the discussions do not resolve the matter, the arbitrator should not be informed of their substance prior to rendering and transmitting an award. After the arbitrator reviews the briefs for any last questions and, if there are none, the hearings are then closed.

Before preparing an award the arbitrator systematically reviews the evidence submitted including expert reports, documents, transcripts and pleadings. A neutral is not typically allowed to perform any original research or other investigations unless specifically authorized to do so by the parties.

Exculpation

An arbitrator steps into the middle of a conflict between two or more parties and at least one party is likely to be unhappy with the final award. In order to prevent any attempt to influence the arbitrator by threats of serious legal, economic or personal consequences it is important that an arbitrator receive exculpation from liability. In addition, any out-of-pocket expenses and legal fees incurred as well as the neutral's usual professional hourly rate for time expended should be the responsibility of the party or parties who brings any formal legal action against the arbitrator or involves the neutral in any other legal or administrative proceeding. In the writer's view the ideal protection would be for the arbitrator to receive all the protections and immunities afforded federal judges.

Code of Ethics

There is a revised Code of Ethics for Arbitrators in Commercial Disputes sponsored by the American Bar Association and the American Arbitration Association which became

effective on March 1, 2004. In this Code of Ethics clarification is provided concerning the ethical responsibilities of party-appointed arbitrators. They must now state whether or not, subsequent to their appointment, they will act in a neutral fashion in the arbitral hearings and deliberations or whether they will be an advocate for the party who appointed them. Each party-appointed arbitrator must also declare whether or not and when they will or will not communicate with the party who appointed them. The Code of Ethics is complex and detailed, and it should be reviewed by respective counsel before clause drafting and again reviewed before the commencement of a specific arbitral process.

Consolidation

If there are a number of related claims, they can be consolidated in a single arbitration proceeding with the agreement of the parties and the panel.

Bifurcation

By agreeing to bifurcation the hearing process can be divided into two successive phases with liability decided in the first phase and damages, if any, in the second phase.

Mode of Exchange of Information and Discovery (if any)

In litigation, discovery is a process often utilized in an effort to determine the relevant facts in a dispute and thus, hopefully, narrowing the issues with the expectation of saving time and money. In practice, discovery is often abused and is made so broad in scope that it becomes a substantial burden for one or more of the litigants.

Typically, there is no absolute right to discovery in arbitration unless it is specified in the clause or in the set of rules cited in the clause or by the subsequent agreement of the parties. When unlimited discovery is allowed, the arbitration process may come close to resembling a protracted litigation and many of the advantages of arbitration such as a timely and less expensive outcome may be diminished. At the discretion of the neutral a limited amount of discovery may be permitted for good cause. Neutrals should usually set limits on its use so that arbitration does not just become litigation by another name. If discovery is permitted, among its goals are obtaining all relevant documents, correspondence, professional reports and opinions. When a party's cooperation is lacking, an arbitrator has the power to approve subpoenas in most states.

The extent of discovery may be defined in the arbitration clause and the supervisory powers of the arbitrator can be made explicit or may be left to the discretion of a sole arbitrator or the chairman of a three person panel or may require rulings by the panel as a whole. In a case where all necessary documents are available to each side discovery is usually unnecessary; when documents are accessible by only one side or another, then the use of discovery is more plausible.

In determining whether or not discovery is to be allowed one arbitrator poses four questions to the parties: “Is the information likely to lead to the discovery of admissible or relevant evidence? Will granting the request for discovery help avoid surprise at the hearing? Will granting the discovery request serve to expedite the hearing? Is the information sought necessary to ensure the parties’ due process rights and to guarantee a fair hearing?”⁵³ If the answer to one or more of these questions is in the affirmative but the proposed method of discovery is possibly onerous, the neutral then explores with respective counsel whether there is a more “...efficient and cost-effective way...to obtain the relevant information.”⁵⁴

Inspections

Before or during hearings an inspection of the subject property by the neutrals and the asserted comparable market transactions may occur and often the clause drafter should specify that an inspection will occur. It is good practice for the parties and respective counsel to be given the option of being present for such an inspection.

Expert Witnesses

An arbitrator should determine whether technical experts will produce reports and the nature and extent of their testimony including what issues each expert will cover. Provision should be made for the exchange of technical reports prior to the commencement of the formal hearing sessions. Often, experts on both sides of the case will provide critiques of each other’s reports. Respective counsel should select well prepared witnesses who listen to the questions asked and answer them responsibly and truthfully.

Occasional Direct Hiring of Technical Experts by Neutral

Generally, a neutral performs no original research or investigations but may possibly undertake an inspection. Occasionally, by pre-agreement or subsequent sanction of the parties prior to hearings, a neutral may hire technical experts to provide certain findings to aid him. The expenses incurred in such an assignment are paid by the parties usually on a pro rata basis.

Design of Formal Hearings

Typically, before formal hearings get underway there are one or more preliminary conferences or hearings where a series of deadlines is decided upon for the exchange of information, discovery (if permitted), description of agreed upon facts, witness lists, documents and exhibits and submission of expert reports and pre-hearing briefs (if any).

⁵³ Alfred G. Feliu, “Discovery in Arbitration: How Much is Enough?” in Thomas E. Carbonneau and Jeanette A. Jaeggi (Editors), American Arbitration Association Handbook on Commercial Arbitration, New York, The Association, 2006, p. 251.

⁵⁴ Ibid., p. 253.

At the formal hearings, generally, the claimant and respondent present their respective cases in that order. Typically, there are opening statements and each witness is subject to direct examination, cross-examination, and redirect examination. In rare instances if a witness lives at a great distance or is ill, telephonic testimony or audio-visual teleconferencing may be permitted. An arbitrator may ask questions at any point in the hearing sessions. There may be oral summations by each side and/or post-hearing briefs. The hearings are not officially closed until all subsequent required documents and briefs have been submitted by respective counsel and, under some arbitration rules, until the neutrals have had an opportunity to review all submissions to determine if there are any further questions they wish to ask the parties.

On some occasions the parties may agree to a “documents only” process without witnesses or formal hearings and the neutrals review the submitted documents and reports and engage in a deliberative process with each other and arrive at an award in the matter being considered.

Transcript

A transcript of the formal hearings by a court reporter is often advisable since it is a helpful assistance to a neutral in reviewing accurately the substance of the hearings and in formulating awards. A transcript also can protect an arbitrator from unfounded accusations of unfairness and, on a few occasions, alas, can be useful to a party in appealing an actual lack of fairness in the conduct of a supposed neutral.

Summation or Post-Hearing Briefs

In small and medium size cases without a heavy volume of documents and numerous issues or complex quantitative calculations a concise oral summation at the conclusion of the formal hearings may be sufficient. In large and complex cases of a highly technical nature a written post-hearing brief may be preferred by a neutral.

Deliberations

In a case where there is a panel of three or another number of arbitrators there will be deliberations among the arbitrators in order to arrive at a decision concerning the issues in dispute. All the arbitrators should fully participate in these deliberations. The decision will be in writing and will be in a form to be determined either by the agreement of the parties before the case begins or by the decision of the arbitrators at a later point in time.

On some occasions an arbitrator may send written “broadsides” to fellow arbitrators attempting to change their views through use of injudicious language, threats or other efforts to intimidate them. Such actions not only diminish the trust among arbitrators but may inappropriately come into the possession of a party who is unhappy with the final award and may be used as a weapon in attempting to appeal an award. This type of problem occurs occasionally in arbitrations employing tripartite panels.

Range of Remedies and Alternative Award Forms

Interim Decision

To prevent the wasting of assets or to clarify the scope of a particular arbitration, a party may request a ruling on some issue on an expedited basis. This may or may not be appropriate in a particular situation. It should be cautioned that neutrals should proceed with care concerning such requests. There is the concern that at such an early point in the process a neutral may not have received and reviewed sufficient evidence to understand completely all the aspects of a case before making an expedited ruling.

Sanctions

Based on the set of rules selected or possible instructions in the arbitration clause itself sanctions may be employed by the arbitrators in circumstances such as the abuse or frustration of the arbitral process in general or, if discovery is permitted, the abuse of the discovery process. For example, counsel for a party may assert that his client is not withholding relevant information from the other side. An arbitrator may reply: "Please review that assertion because if it is later determined that pertinent information was purposely withheld there is likely to be an adverse consequence in the award."

Equitable Relief

Under appropriate circumstances and after considering allowable actions in the relevant jurisdiction arbitrators may provide for specific performance of a contract or for injunctions against certain acts.

Damages

Some state jurisdictions allow a variety of damages such as liquidated or punitive; some do not. Keep these variations in mind in your choice of law decision. Regardless of the state jurisdiction, if any types of damages do not reflect the parties' intentions, the clause drafter may specifically exclude them from consideration.

Interest

When the resolution of a dispute does not occur contemporaneous with the identification of the monetary issue to be resolved, the amount of interest (if any) may be substantial in amount. There is the possibility of pre-judgment and post-judgment interest. In some cases accrued interest for monies due is specified in the arbitration clause; other clauses may remain silent about this issue. Further, the rate of interest and whether it is to be calculated on a straight line or compounded basis may be specified, left to the discretion of the arbitrator or omitted.

Legal Fees

Under the “American Rule” unless a contract clause calls for the winning side’s reasonable legal fees to be paid by the losing side, legal expenses are typically borne as incurred. Sometimes, an arbitration clause may specify that the legal fees of the winner shall be paid by the loser. Yet, in some case outcomes, there is no identifiable winner or loser. Confusion and controversy will be avoided by explicitness in the clause as to the treatment to be accorded such expenses.

Administrative Intermediary Fee

Usually such expenses are shared equally by the parties but some clauses provide that they be borne entirely by the losing party. Yet, as previously mentioned, in some types of decisions it may not be possible to identify such a party.

Arbitrator Fees

When there is a sole arbitrator, the fee is the responsibility of all the parties on a pro rata basis. In tripartite panel designs, generally, each party pays the entire fee of the arbitrator it selected and the third arbitrator’s fee is paid in equal shares by the parties. When there is a panel of three neutrally selected arbitrators, all the fees of the entire panel are typically paid on a pro rata basis by the parties

Findings of Fact and Findings of Law

Typically, it is a standard assumption that the rules of evidence and civil procedure need not be followed precisely in arbitration proceedings. Yet, there is always the need for basic fairness to be provided to all parties.

In drafting arbitration clauses lawyers may specify that the award must include findings of fact and findings of law. An arbitration clause may also state that the decision must be in accordance with substantive law. If the arbitrators are not lawyers but neutrals picked for their technical expertise in the subject matter of the dispute, these directives may prove problematic.

Perhaps, if clause drafters want findings of fact and findings of law, they might best choose neutrals who are lawyers but in the process they may be giving up the often greater technical subject matter knowledge of non-lawyer experts. On the other hand, it is possible that such clause directives can be met by specifying in the arbitration clause that the panel include at least one lawyer. An alternative variation would be to instruct the arbitrators to provide “necessary reasons.”

Alternative Award Forms

Unlike Great Britain where arbitrators often provide written reasons for the conclusion reached by the neutral, commercial real estate awards in the United States usually do not

provide the reasoning underlying the decision. The standard thinking is that to give reasons is to make it easier for the losing party to attempt to overturn the award and, therefore, such a form of award would weaken arbitration's effectiveness as an alternative to litigation. Generally, if a reasoned award is desired, it should be explicitly stated in the arbitration clause and in accepting appointment under the terms stated in the clause, the arbitrator will be obligated to provide such an award. A more extensive reasoned written decision might aid the participants in the dispute by providing those insights that could prevent the creation of a similar problem in the future.

In some award documents when there are multiple claims, dollar amounts may be allocated to specific categories with stated dollar amounts and other award issues itemized but reasons may or may not be given contingent on the neutral's pre-arranged agreement with the parties or the neutral's subsequent decision concerning the form of the award.

Staff Review by Administrative Intermediary

The purpose of this review function is to check for appropriate use of terminology, consistency, inclusion of all necessary award components, and any obvious errors in the draft award. This review is not for the purpose of altering the substantive decision set forth in the award draft.

Finality of Award Except for Limited Grounds for Appeal

If the parties intention is that the arbitration process should resolve the specific dispute between the parties, they should so state in the clause that the arbitral decision shall be final and binding.

Although an application to the arbitrator for modification of an arbitration award may be entertained for minor matters of ministerial error, clarity and explication, the basic substance of an award usually cannot be changed once an award is issued. If an award was easily reversible or could be substantially modified, a core value of arbitration would be lost, i.e., the finality of the decision and an end to conflict. Further, an arbitration award may be enforced by a court of competent jurisdiction to ensure that the parties carry out the decision of the arbitrator.

The major exceptions to this final and binding doctrine would occur in those rare instances involving corruption, fraud or undue means, partiality, procedural misconduct, overstepping of powers or the refusal of the arbitrator to receive or hear relevant evidence.

Enforceability of the Award and the Entry of Judgment

In preparing an arbitration clause the drafters should make sure that the text conforms to all applicable statutes and court decisions in order to ensure that an award flowing from a

specific arbitration proceeding can be enforced in the legal system. The clause can provide for entry of judgment in a court of appropriate jurisdiction.

Summary and Conclusions

Hopefully, the reader is convinced that the casual or careless wording of arbitration clauses can cause unintentional but immense damage or extraordinary advantage to one or another of the parties. The words in arbitration clauses should be clear and precise in conveying their meaning. Justice Oliver Wendell Holmes, Jr. explained the variable meaning of words in Towne v. Eisner (1918): “A word is not a crystal, transparent and unchanged; it is the skin of a living thought, and may vary greatly in color and content according to the circumstances and the time in which it is used.”

Adverse consequences can sometime flow from arbitration clauses that are either to specific and rigid or two broad and vague; the “two sides of the sword” are very much in evidence in these extreme versions of real estate arbitration clauses.

In addition, no party wants to give up control of the outcome but in the end if you believe you have a good case trusting the neutrally selected arbitrator is usually a wise policy. To fail to do so is to risk possible distortions and a decision possibly less cogent and effective than it might otherwise be.

A simple example illustrates this viewpoint. In many arbitration clauses in ground leases the directive is to determine the market value of the land and then to multiply the land’s market value by a specified fixed rate percentage stated in the arbitration clause of the ground lease agreement. Yet, in the many years that may elapse between the stipulation of the rate and the arbitration of the new ground rent, the specified rate may not then represent a market level and the directive will produce a final result that will not then be a market ground rent! Why not just direct the neutral to decide on the market ground rent? It is clear that the drafter of this particular arbitration clause did not want to allow any discretion to the arbitrator but was the drafter’s client well served?

Possibly, the most important question in real estate is: what is the future rate of absorption? When the arbitration clause is drafted, the dimensions of future supply and demand are almost impossible to determine years prior to an actual arbitration. Is it not sensible to unshackle the arbitrators and enable them to exercise their reasonable judgment at a future time?

Giving up all control and trusting in neutrals is not easily accepted by the parties but in the many years that the writer has acted as a neutral and observed others acting in similar circumstances he has never seen any indication that a neutrally selected arbitrator has, with knowledge and aforethought, “thrown a decision.” Ironically, often the risk of a rigidly exacting arbitration clause or a clause overly vague may prove at a future point in time a greater hazard than actually placing one’s trust in neutrally selected professionals! The two edged sword of too much specificity or too much generality is a theme that drafters of arbitration clauses should consider.

Drafters should carefully review the range of relevant substantive and procedural issues before doing their best to draft a clear, thoughtful and balanced arbitration clause. The goal should be to set forth in understandable language the agreed upon assumptions and intentions of the parties; hopefully, thereby reducing or eliminating the potential for ambiguities and future doubts about the nature of an arbitrator's responsibilities in reaching a fair and equitable decision.

Obviously, the characteristics of different properties and the interests of individual parties vary; thus, it may not be possible to create a perfectly customized and very detailed arbitration clause in each transaction. Indeed, it may be prudent to leave the decisions on many issues to the judgment of neutrals. The often unpredictable nature of future circumstances and the context of the situation that may then prevail often support this approach. Yet, in drafting appropriate arbitration clauses, attorneys should consider the special interests of their clients and provide for those interests in precise language whenever their balanced judgment indicates that the advantages of specificity are likely to outweigh the risks of unpredictable adverse consequences that could occur in the future.

Checklist: Structuring Real Estate Arbitration Clauses

While preparing the real estate arbitration clause a drafter may review and consider the following issues among others for possible inclusion in the arbitration clause. The drafter may have reason to choose to omit many of the specified features outlined below either because a concept is not relevant to a specific matter or because it is considered too risky in the specific context of a certain real estate transaction:

Types of Issues Subject to Arbitration

Types of Issues Not Subject to Arbitration

Valuation Issues:

Describe Property to be Valued

Valuation Premise: Highest and Best Use or Existing Use

Unencumbered or Encumbered

Vacant and Unimproved or as Improved

Unsubordinated or Subordinated

Instructions (if any) on Valuation Approaches

Effective Date

Mode of Deriving New Rent for Renewal Period:

Market Rent Estimate or

Market Value of Property Multiplied by Specified Rate or

Market Value of Property Multiplied by Specified and Accessible Public Price Index or

The Higher or Lower of two or more of these Specified Methods

Possible Tripartite Panel of Arbitrators

Arbitrator or Appraiser Specified as Neutral (One, Three or Different Number)

Specify Non-Valuation Issues Subject to Arbitration (if any)

Scope of Non-Valuation Issues Excluded from Arbitration

Specify Initial Diagnostic Methods (if any)

Specify Other Pre-Arbitration Dispute Resolution Methods as Conditions Precedent such as Negotiation and/or Mediation (if any)

Possible Limitations on Arbitral Decision Making or Possible Expansion of Powers

Specify Administered or *Ad Hoc* Arbitration Process

Cite a Specific Set of Arbitration Rules (with any Modifications, Omissions and/or Additions)

If Administered Arbitration Process, Specify Administrative Entity

Define All Technical Terms

Describe Submission Process

Confidentiality Provision

Time Line (if any to be specified)

Locale

Choice of Governing Law: Federal Arbitration Act or the Arbitration Law of Specific State

Severability

Inclusion or Omission of “Not Less Than” or “Not More Than”

Appropriate Characteristics of Potential Neutrals

Arbitration Panel or Sole Arbitrator

If Tripartite Panel, Choices in Panel Design and Decision-Making

If Tripartite Panel, Mode of Selection of Chairman

If Selection Disagreement, Fallback Selector

Powers of the Arbitrator(s)

Any Special Powers of Chairman

Mode of Compensation of Arbitrator(s)

Sanctions (if any)

Interim Relief (if any)

Interest: Pre-Judgment and/or Post-Judgment (if any)

Damages (if any)

Allocation of Other Fees and Expenses

Withdrawal of an Arbitrator and Substitution Process

Exculpation from Liability for Neutrals

Subject to ABA-AAA Code of Ethics for Arbitrators in Commercial Disputes

Consolidation

Bifurcation

Mode of Exchange of Information and Discovery Criteria (if any)

Pre-Hearing Conference

Inspections

Expert Witnesses

Direct Hiring (if any) of Technical Experts by Neutrals

Design of Formal Hearings

Range of Remedies

Specify Form of Award: Without Reasons or Reasoned

Findings of Fact and Findings of Law (Optional)

Decision to be Final and Binding

Decision to be Enforceable by Court of Competent Jurisdiction

GERALD M. LEVY, MAI, CRE, FRICS

Gerald M. Levy is President of Gerald M. Levy & Co. LLC in New York City. He has served variously as Adjunct Professor and Clinical Associate Professor at the Real Estate Institute of New York University (NYU) where he has taught real estate finance, real estate credit and risk management and negotiation and dispute resolution. At present he leads the strategic real estate management group at NYU where he is responsible for supervision and course development for valuation and feasibility analysis, commercial lease analysis, asset management, acquisition and disposition, restructurings/workouts and enterprise management and leadership.

Gerald M. Levy & Co. LLC offers professional services in the following areas: arbitration and mediation, expert testimony, litigation support, restructurings and workouts, business representation in transactions, complex valuation, corporate real estate strategies and executive education. The firm provides professional services on a local, regional, national and international basis.

Mr. Levy was Managing Director, Real Estate Finance Group of The Chase Manhattan Bank (now J.P. Morgan Chase). At various times he has had transactional and managerial responsibility for real estate and construction finance in every region of the United States; commercial banking; urban development; leasing; property acquisition and disposition; construction and environmental services; loan restructurings and workouts; asset management, leasing and sale of foreclosed real estate assets; and underwriting, valuation and consulting.

He was Senior Vice President and General Manager of the Real Estate and Corporate Services Division of pre-merger Chemical Bank with worldwide responsibility for these functions. Mr. Levy has supervised real estate and construction activities in 40 countries in Europe, the Middle East, Africa, Asia and North and South America and in 35 American states. He formerly served as Senior Vice President of Merritt and Harris, Inc., a national real estate and construction consulting firm; and Director of Valuation and Consulting for the Alexander Summer Company. Mr. Levy began his career in urban redevelopment.

Mr. Levy holds a BA from Columbia University and an MA from Harvard University and is a graduate of the Chemical Bank Executive Management Program taught by the Faculty of the Harvard Business School and the Yale School of Management. He is a Member of the Appraisal Institute (MAI) and The Counselors of Real Estate (CRE) and is a Fellow of the Royal Institution of Chartered Surveyors (FRICS). Mr. Levy is a New York State licensed real estate broker; New York State certified general real estate appraiser, an academic member of the International Council of Shopping Centers (ICSC) and the Institute of Real Estate Management (IREM) and an associate of the Urban Land Institute (ULI) and the Mortgage Bankers Association of New York (MBANY).

He is a member of the Roster of Neutrals of the American Arbitration Association (AAA), arbitrator for the Financial Industry Regulatory Authority (FINRA) and designated as mediator, arbitrator and “chair qualified” by The Counselors of Real Estate. Mr. Levy is a member of the Association for Conflict Resolution, the New York State Dispute Resolution Association and an associate member of the American Bar Association and its Sections on Dispute Resolution; Litigation; Real Estate, Probate and Trust; and its Construction Forum. He was trained in arbitration by AAA and FINRA and in mediation and negotiation by the Cornell School of Industrial and Labor Relations and the Harvard Negotiation Institute. Mr. Levy has served as a neutral in real estate, construction, securities and commercial disputes.

Mr. Levy has been a speaker at conferences sponsored by U.S. Department of Housing and Urban Development, U.S. Agency for International Development, Urban Land Institute, Mortgage Bankers Association of America, Counselors of Real Estate, Appraisal Institute, American Institute of Certified Public Accountants, International Association of Corporate Real Estate Executives, National Realty Club, Society of Industrial and Office Realtors, Real Estate Board of New York, Association of the Bar of the City of New York, New York State Bar Association, American Bar Association, Young Presidents' Organization, American Arbitration Association, Chartered Institute of Arbitrators (England), Arbitrator's Institute of Canada, Royal Institution of Chartered Surveyors, Anglo-American Real Property Institute and many other groups.

He has lectured at Harvard, Yale, Stanford and Columbia Business Schools; Massachusetts Institute of Technology; Wharton School of the University of Pennsylvania; Amos Tuck Graduate School of Business Administration at Dartmouth College; Colgate Darden Graduate School of Business Administration at the University of Virginia; and Cornell and Fordham Law Schools; and for the University of Amsterdam. Other institutions at which he has lectured include Rutgers and Northeastern Universities, Pratt Institute and Connecticut College. Under the sponsorship of the U.S. Agency for International Development and other organizations, he has conducted seminar sessions on American real estate markets and methods of real estate analysis for delegations of public officials and practitioners from China, Japan, Russia and the Ukraine.

Mr. Levy served as Editor-in-Chief and co-author of Arbitration of Real Estate Valuation Disputes (American Arbitration Association). He recently completed a monograph entitled Structuring Real Estate Arbitration Clauses: A Neutral's Perspective. He has also been a contributing author of the Corporate Real Estate Handbook (McGraw-Hill); Institutional Real Estate Strategies (Urban Land Institute); Modern Real Estate Financing: A Transactional Approach (Little, Brown); Real Estate Development and Construction Financing (Practising Law Institute); Critical Issues in Arbitration (American Bar Association); and Ground Leases and Land Development (New York State Bar Association). His writings distributed by Chase Manhattan Bank or predecessor Chemical Bank include: Construction Loan Decision Making, Foundations of Real Estate Analysis and Facilities Development Manual. His articles have appeared in Real Estate Review, Real Estate Issues, Arbitration Journal, Appraisal Journal, Valuation, Case and Comment and Real Property Law Newsletter. Mr. Levy is currently

a member of the editorial board of Real Estate Issues, the journal of the Counselors of Real Estate, and he was a columnist for the Real Estate Finance Journal ("The Advisor's Bench"), and member, Advisory Board of the Real Estate Review, Real Estate Finance Journal and RTC Real Estate Journal.

He was the drafter of the Real Estate Industry Arbitration Rules (Including a Mediation Alternative) and predecessor Real Estate Valuation Arbitration Rules sponsored by the American Arbitration Association. These earlier Rules were cited and incorporated by reference in the U.S. Land Exchange Facilitation Act governing land transactions undertaken by the U.S. Departments of the Interior and of Agriculture. In addition, the new Rules have been published in the Martindale-Hubbell Dispute Resolution Directory. Mr. Levy has recently drafted the Protocol and the Rules for the CRE Real Estate Dispute Resolution Program. His writings have been cited in Building as an Economic Process (Prentice Hall) and Managerial Real Estate (Prentice Hall) and his teaching abilities recognized in Down to Earth (Society of Real Estate Appraisers).

Public service activities have included service as National Vice Chairman of The Counselors of Real Estate, a member of its Executive, Budget and Finance, and Education Committees, and a member of the Board of Directors and Chairman of its Dispute Resolution Program and a member of Litigation Support/Expert Witness Task Force; Program Chairman and Member of the Board of Directors of the Metropolitan New York Chapter of the Appraisal Institute; director, The Settlement Housing Fund; member, NYU Appraisal Advisory Council. He has been a director and member of the Executive Committee of the American Arbitration Association, Chairman of its Real Estate and Investment Committees and Chairman of its National Real Estate Valuation Council. Mr. Levy has been a member of the Advisory Board of the Wharton School Real Estate Center at the University of Pennsylvania; and director, Community Preservation Corporation, Housing Partnership Development Corporation, Grand Central Partnership, Community Partnership Development Corporation, Alliance for Resident Theatres and Ledig House; member, Mayor of the City of New York's Housing Task Force; and member, Advisory Board; State of New York Mortgage Agency. Mr. Levy served as a participant, National Security Seminar at the U.S. Army War College; and as Chairman, Parents Council of Haverford College. He was awarded Haverford's Charles Perry Award for outstanding service to the College; New York University awarded him its Distinguished Service Award for major contributions to new course development and restructuring the real estate curriculum; NACORE (now CoreNet Global) honored him for his corporate real estate writings.

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