

## Use ‘Baseball Arbitration’ to Settle Rent Disputes at Renewal Time

Here’s an all-too-common scenario: A tenant’s renewal option says the renewal rent should be set at the fair market value of the space at the time the lease expires. When the lease expires, the tenant says that the renewal rent should be \$30 per square foot. But you determine that the space would rent for \$60 per square foot on the open market.

The next step for you and the tenant could be a costly, time-consuming court fight. Or it could be a quick and relatively cheap procedure called “baseball arbitration,” says New York attorney Jacob Bart. Baseball arbitration is a good way to resolve disputes about real estate values, especially fair market rent disputes, he says. If your lease provides for baseball arbitration, you’ll have a handy way to resolve any fair market rent disputes that come up.

We’ll tell you what baseball arbitration is and how to include it in the procedures your lease sets out for determining the fair market rent in a renewal. And there’s a Model Lease Clause on pp. 3–4 that you can adapt and use for that purpose.

### Baseball Arbitration Basics

Baseball arbitration got its start as a way to resolve salary disputes between major league baseball teams and players who had become free agents, notes Bart. It has since become popular in commercial real estate.

Briefly, here’s how baseball arbitration works for a fair market rent dispute: You and the tenant submit to “binding arbitration.” That means that you and the tenant pick an arbitrator and agree to abide by the arbitrator’s decision. You and the tenant each tell the arbitrator what you think the fair market rent figure should be. The arbitrator chooses either your fair market rent figure or the tenant’s fair market rent figure—no compromise is allowed. The arbitrator picks the figure that he believes is more reasonable and realistic.

If either you or the tenant proposes an unreasonable and unjustifiable figure, the arbitrator will likely choose the other side’s proposed figure. As a result, you and the tenant are more likely to try hard to come up with a reasonable and realistic figure, notes Bart.

### Advantage over Conventional Arbitration

Like many owners, you may find baseball arbitration more appealing than conventional arbitration because it solves one of the major drawbacks of conventional arbitration. In conventional arbitration, you and the tenant present your cases, and the arbitrator decides on a figure, which typically splits the difference between the amounts you each sought. For example, if a tenant wants to pay \$30 per square foot and you want to charge \$60, the arbitrator might pick \$45. So you may be reluctant to entrust valuation disputes to conventional arbitration, even though it may be cheaper and faster than a lawsuit.

Baseball arbitration solves that problem by requiring the arbitrator to pick one figure or another, not some compromise figure in-between, notes Bart.

### What Lease Should Say

If you decide that baseball arbitration is right for you, you’ll need to set out in the lease how it works. You should include the baseball arbitration procedures, along with other procedures to determine the fair market rent for the renewal term, in a clause you place in the same lease section as the renewal option clause. (Note that the fair market rent is called “Market Value Rent” in our Model Lease Clause) [Clause, par. a].

Your lease clause, like our Model Lease Clause, should set the following five steps:

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## MODEL LEASE CLAUSE

### Set Procedures to Determine Fair Market Value Rent

The following lease clause, drafted by attorney Jacob Bart, sets procedures to help you determine, with a minimum of dispute, the fair market rent of a renewal term. Paragraph a says that the base rent during the renewal term will be equal to fair market rent. Paragraph b discusses how the fair market rent will be determined. Paragraph c sets up an arbitration procedure to determine a fair rent if there's a dispute. Paragraph d cancels the arbitration procedure if the tenant

and you propose rents that differ only slightly. Paragraph e sets a mechanism to adjust the rent at a later date if the new base rent isn't set by the start of the renewal term. Make sure that you define "Exercise Date," "Expiration Date," "Initial Term," and "Renewal Notice" elsewhere in the lease.

Show this clause to your attorney before putting it into your lease.

#### RENEWAL AT MARKET VALUE RENT

- a. Market Value Rent During Renewal Term.** If Tenant shall exercise the Renewal Option in accordance with the terms and conditions of Clause [insert # of renewal option clause] hereof, then during the Renewal Term, the Base Rent shall be equal to the annual fair market rental value of the Premises as of the Expiration Date, [insert formulation, e.g., taking into consideration all relevant factors that would customarily be considered in making such determination with respect to renewals of existing leases] (the "Market Value Rent"), as determined as provided in Paragraph b hereof and with no changes in the Base Operating Year and the Base Tax Year.
- b. Determination of Market Value Rent.** The initial determination of Market Value Rent shall be made by Landlord. If the Renewal Notice shall so request, Landlord shall give to Tenant written notice of Landlord's initial determination of the Market Value Rent (the "MVR Notice") by [insert date that's one month after the tenant's deadline to exercise its renewal option] months prior to the Expiration Date. If the Renewal Notice does not contain a request that Landlord furnish the MVR Notice, Landlord shall give Tenant the MVR Notice at least [insert #, e.g., two (2)] months prior to the Expiration Date. Notwithstanding that the Expiration Date shall not yet have occurred, such initial determination of Market Value Rent shall be final and binding in fixing the Market Value Rent, unless, within [insert #, e.g., fifteen (15)] days after Landlord shall have given MVR Notice to Tenant, Landlord shall receive a written notice from Tenant (the "MVR Objection Notice"):
- (i) Advising Landlord that Tenant disagrees with the initial determination of Market Value Rent set forth in the MVR Notice; and
  - (ii) Proposing a specific alternative Market Value Rent, which shall have been determined in good faith by Tenant.
- c. Arbitration.**
- (i) If Landlord and Tenant shall fail to agree upon a final and binding Market Value Rent within [insert #, e.g., fifteen (15)] days after Landlord shall have received the MVR Objection Notice, then Landlord and Tenant shall mutually designate an arbitrator whose determination of Market Value Rent (which shall be either the Market Value Rent proposed by Landlord in the MVR Notice or the Market Value Rent proposed by Tenant in the MVR Objection Notice, but no other amount) shall be final and binding upon Landlord and Tenant.
  - (ii) If Landlord and Tenant shall fail to agree upon the choice of such arbitrator within [insert #, e.g., thirty (30)] days after Landlord shall have received the MVR Objection Notice, then either party may apply to the American Arbitration Association or any successor thereto having jurisdiction to designate an arbitrator. The arbitrator shall be a real estate broker or consultant who is MAI certified by the Appraisal Institute and who shall have had at least [insert #, e.g., fifteen (15)] years' continuous experience in the business of appraising or managing real estate or acting as a real estate agent or broker in [insert location, e.g., the Borough of Manhattan, City of New York].
  - (iii) The arbitrator shall conduct such hearings and investigations as he may deem appropriate and shall, within [insert #, e.g., thirty (30)] days after his designation, determine which of the two (2) proposals shall be the Market Value Rent, and that choice by the arbitrator shall be binding upon Landlord and Tenant, provided that the arbitrator shall not have the power to add to, modify, or change any of the provisions of this Lease. Each party shall pay its own counsel fees and expenses, if any, in connection with any arbitration under this Clause, and the parties shall share equally all other expenses and fees of any such arbitration.

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## RENEWAL AT MARKET VALUE RENT (CONTINUED)

- d. Arbitration Canceled.** In the event that the determination of the Market Value Rent set forth in the MVR Objection Notice differs from the determination of the Market Value Rent in the MVR Notice by [insert amount, e.g., eight (8)]% or less per rentable square foot per annum for each year during the Renewal Term, then the Market Value Rent shall not be determined by arbitration, but shall instead be set by taking the average of the determinations set forth in the MVR Notice and the MVR Objection Notice. Only if the determinations set forth in the MVR Notice and the MVR Objection Notice shall differ by more than [insert amount, e.g., eight (8)]% per rentable square foot per annum for any year during the Renewal Term shall the actual determination of Market Value Rent be made by an arbitrator as set forth in Paragraph c hereof.
- e. Late Determination.** If for any reason the Market Value Rent shall not have been determined prior to the commencement of the Renewal Term, then, until the Market Value Rent and, accordingly, the Base Rent, shall have been finally determined, the Base Rent payable for and during the Renewal Term shall be equal to the Market Value Rent proposed by Landlord. If, upon final determination of the Market Value Rent, it shall have been determined that the Base Rent payable for and during the Renewal Term shall be equal to the Market Value Rent:
- (i) Proposed by Landlord, then the Base Rent shall continue to be due and payable in the amounts proposed by Landlord; or
  - (ii) Proposed by Tenant, then an appropriate adjustment to the Base Rent shall be made reflecting such final determination, and Landlord shall refund to Tenant any overpayment in Tenant's payment of Base Rent from the commencement of the Renewal Term to the date of such final determination.

### BASEBALL ARBITRATION (continued from p. 1)

**Step #1: You determine fair market rent.** Make it your responsibility, when you get a tenant's notice that it wants to renew its lease, to calculate the initial determination of the fair market rent figure, says Bart. You'll give the tenant your figure in a written notice [Clause, par. b].

When should you give the tenant your figure? If the tenant requests the fair market rent figure in its renewal notice, give it that figure by a set date that's one month after the tenant's deadline to exercise its renewal option, says Bart. For example, if the tenant must exercise its renewal option by Dec. 31, 2005 (which is six months before the lease's expiration date), you must give the tenant the fair market rent figure by Jan. 31, 2006. If the tenant doesn't request the fair market rent figure in its renewal notice, then give the fair market rent figure to the tenant at least two months before the lease's expiration date, he adds. In the above example, you must give the tenant the fair market rent figure by April 30, 2006.

**Step #2: Tenant accepts or rejects your figure.** Allow the tenant only a short set time—say, 15 days—after it gets your fair market rent notice to accept or challenge your fair market rent figure, advises Bart. The shorter the period you set, the greater the chances that the tenant won't make its challenge in time. If the tenant doesn't challenge your fair market rent figure, that figure becomes “final and binding.”

To challenge the figure, require the tenant to give you a written objection notice, saying that the tenant disagrees with your fair market rent figure and proposing an alternative figure. To prevent a spiteful tenant from proposing a ridiculously low figure, require the tenant to determine

its fair market rent figure in “good faith,” advises Bart [Clause, par. b].

**Step #3: You and tenant agree or baseball arbitration begins.** You and the tenant may agree quickly—say, within 15 days after you get the tenant's objection notice—to use the tenant's fair market rent figure or some other fair market rent figure. Then that figure will be final and binding. But if you and the tenant can't agree on a figure, have the baseball arbitration process start—by having you and the tenant appoint an arbitrator to determine the fair market rent figure [Clause, par. c(i)].

**Step #4: Arbitrator is appointed.** If you and the tenant agree on the arbitrator quickly within a set period—say, within 30 days after you get the tenant's objection notice—the process moves on to Step #5. But if you and the tenant can't agree on an arbitrator within that time, say in the lease that you or the tenant can ask the American Arbitration Association to designate an arbitrator. To protect your interests, you'll want an arbitrator who's experienced in real estate matters. So require either a real estate broker or consultant who has an MAI membership certified by the Appraisal Institute (meaning that the broker or consultant is experienced in the valuation and evaluation of commercial properties) and has at least a certain amount of continuous experience—say, 15 years—in appraising or managing real estate in your area, suggests Bart [Clause, par. c(ii)].

**Step #5: Arbitrator issues decision.** To keep the process moving quickly, require the arbitrator to issue a decision on the fair market rent quickly—say, within 30 days after being designated the arbitrator, advises Bart.

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## BASEBALL ARBITRATION (continued from p. 3)

Make it clear that the arbitrator's decision is final and binding on you and the tenant, so neither of you can try to change the chosen fair market rent figure. To be fair, you and the tenant should pay your own attorneys and split the other arbitration costs, he says [Clause, par. c(iii)].

**PRACTICAL POINTER:** If, for some reason, the fair market rent figure isn't set before the renewal term begins, require the tenant to pay the fair market rent figure that you proposed, advises Bart. If the fair market rent figure is finally determined as the figure that you proposed, the tenant will continue to pay that amount. But if the tenant's proposed fair market rent figure becomes the final figure, you'll have to refund any overpayment to the tenant, he says [Clause, par. e].

### Alternative: Resolve Dispute Yourself

Baseball arbitration can work so well that it may eliminate the need for an arbitrator, notes Bart. It disposes you and the tenant to try to pick reasonable renewal rent figures from the start. So the difference between the two figures often will be very small. Bart recommends dispensing

with baseball arbitration if that happens. Instead, require that you and the tenant automatically split any difference if the tenant's figure differs by, say, 8 percent or less from yours, he says [Clause par. d]. For example, you propose \$32.50 per square foot and the tenant proposes \$30 per square foot, \$2.50 less than your proposal. That's a difference of 7.7% (\$2.50 divided by \$32.50). You split the dollar difference (\$2.50 divided by 2 = \$1.25). The tenant pays \$31.25 per square foot.

Although this may seem like the same kind of compromise that turned owners off arbitration in the first place, it's only a small compromise, Bart says, and it's one reached by you and the tenant, not by an arbitrator. The time and money you both save by resolving the dispute yourselves without an arbitrator should go a long way toward making up for the small amount you each may give up, he notes. Plus, there's no guarantee for either of you that an arbitrator would have chosen your figure. s

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**Jacob Bart, Esq.:** Member, Stroock & Stroock & Lavan LLP, 180 Maiden Ln., New York, NY 10038-4982; (212) 806-5400; JBART@stroock.com.