Rental arbitration - Whether to set aside umpire's award - Whether the umpire made errors in law - Determination of "current market rental" - Whether objective or subjective assessment required - Whether consideration of comparable lease terms required.

In The High Court Of New Zealand
Wellington Registry

C.P. 740/91

In The Matter of the Arbitration Act 1908

Between Continieau Investments Limited
Plaintiff

And Telecom Corporation Of N.Z. Limited
Defendant

Hearing: 7 October 1993

Counsels: J.O. Upton Q.C. for plaintiff
I.D.R. Cameron and P.W. Michalik for defendant

Judgment: 20 October 1993

Judgment 0f Barker ACJ

This is an application under the Arbitration Act 1908 ('the Act') to set aside or alternatively to remit the award of an Umpire delivered in a rental arbitration.

The defendant entered into an agreement dated 14 March1988 to lease an office building in Lower Hutt for a term of 12 years from 17 July 1987 with a right of renewal for12 years. The then landlord was Chase Wellington Properties Limited. The present plaintiff is that company's successor in title.

The lease is a very comprehensive document. It provides for an annual base rental for the first three years with rent reviews due on 17 July 1990, 1993 and 1996. The base rent may then be increased in accordance with the provisions of the lease. A "ratchet" clause provides that the rental for a renewed term is not to be less than the rental currently being paid. The lessee has to pay the operating expenses of the building.

The document sets out an elaborate procedure for rent reviews; the goal of the procedure is to ascertain the 'current market rent" - an expression found several times. Disregarding provisions about time limits, the procedure can be summarised thus. The lessor must first notify the lessee of the lessor's assessment of the current market rent for the purpose of any forthcoming review. If the lessee does not agree with that assessment, then the lessee may make a counter-offer. If that is not accepted by the lessor, the parties are required to enter into negotiations to resolve the dispute. If these negotiations are unsuccessful, then the parties have to appoint valuers "to jointly determine the current market rent of the premises".

Before proceeding to make their determination, the valuers are to agree upon and appoint an umpire. There are machinery provisions for selecting an umpire in case the valuers do not do so. If the valuers are unable to agree on their determination, then "the current market rent" shall be determined by the umpire, whose determination shall be final and binding on the parties hereto. The umpire is required to have due regard to any evidence submitted by the valuers as to their assessment of the current market rent of the premises and shall give his determination and the reasons therefore in writing.

The following provision states matters which shall be both disregarded and regarded by the valuers and the umpire -

"(1) In determining the current market rent, the valuers or umpire shall:

(i) be deemed to be acting as expert(s) and not as arbitrator(s).

(ii) disregard:

(aa) the value of any goodwill attributable to the Lessee's business and the value of the Lessee's fixtures and fittings in the Premises

(bb) any interest in the Premises created by this Lease;

(cc) any deleterious condition of the Premises if such condition results from any breach of any term of this Lease by the Lessee;

(dd) any rent abatement, allowance for fit out or any such allowance or payment (if any; made by the Lessor to the Lessee by or at the commencement of or during the term of this Lease.

(iii) have regard:

(aa) to the terms and conditions of this Lease and in particular to the period of time until the next Review Date and to the Lessee's obligation to pay a contribution to the Operating Expenses of the Building PROVIDED THAT in determining the Base Rent payable the valuers or umpire as appropriate, shall not take into account or make any allowance for any deduction or discount for any increases in contribution to the Operating Expenses of the Building payable by the Lessee between the relevant Review Date and the next following Review Date or date of termination as the case may be;

(bb) to the rental value of comparable premises.

(iv) consider the Premises as used for commercial office purposes or any other use to which the Premises may be lawfully put;

(v) regard the Premises on a floor by floor basis without a discount or premium where the current market rent is to be determined for more than one floor;

(vi) assume that all covenants on the part of the Lessee and the Lessor

contained in this Lease have been fully performed and observed;

(vii) make no deduction on account of any concession otherwise required to secure a tenant

(viii) take into account the general condition and quality of the Premises and of the Building other than any deleterious condition caused by the Lessee."

For assessment of rental for the 3 year period beginning 17 July 1990, the procedure stipulated in the lease went full circle. The valuers nominated by each party having been unable to agree, the rental fell to be determined by the designated umpire, Mr R.L. Jefferies, Registered Valuer of Auckland. After hearing counsel and witnesses and the submissions of the arbitrators over some three sitting days, the umpire issued a written award on 10 May 1991. The umpire also "took a view" in that he inspected the subject premises and the comparable premises referred to in submissions. Annexed to his formal award is a comprehensive document, lucidly expressed, setting out the basis of and the reasons for his decision. The umpire concluded that the base rent for the new three year term, from 17 July 1990 was to be $763,595, exclusive of GST.

The plaintiff's claim that the umpire made errors of law on the face of the record in that: (a) as a matter of construction of the lease, a subjective assessment of the rent was required and not an objective one; (b) the umpire was not entitled to take account of allegedly restrictive or onerous lease terms or conditions in the lease; (c) as an alternative, he did not identify such clauses or give reasons as to why he regarded them as restrictive or onerous. The plaintiff submitted that the award should be remitted back to the umpire.

I proceed on the basis that the annexure to the actual award, stating the umpire's reasons, is to be construed as part of the award. That seems to have been his intention bearing in mind the requirement for reasons in the lease. See *Max Cooper & Sons Pty Ltd v. University of New South Wales*, [1979] 2 NSWLR 257 and *Manukau city v. Fletcher Mainline Ltd*, [1982] 2 NZLR 142, 160.

I approach the assessment of the plaintiff's submissions, in the light of the following dicta of Cooke P in *Manukau City Council v. Fencible Court Howick Ltd* (1991), 1 NZ Conv C 190,871 at 190,872-3

(a) "Where the parties have agreed to arbitration the Court should not allow the finality of the award to be destroyed except for truly compelling reasons".

(b) "Post-arbitral litigation is not to be encouraged".

(c) "At the present day there is a strong judicial respect for arbitration as a valuable mode of dispute resolution. When an expert arbitrator or umpire has acted impartially (and here the challenge to the umpire's conduct has not been renewed on appeal) the Court should be slow to be persuaded to strike down the decision. The mere possibility of a different result should not normally be enough to justify judicial "intervention". There should be no assumption that an error in expounding the meaning of the contract was or may have been material. The onus should be the other way. In my opinion the Court should not set aside an arbitral award on the ground of error of law unless satisfied affirmatively that the error made a difference to the decision or at least probably did so."

Moreover, the law is clear that it is not "misconduct" (in the technical sense) for an arbitrator to come to an erroneous decision on fact or law. See *Russell on Arbitration* (20th ed.) 422 and *Manukau City v Fletcher Mainline Ltd* (supra) at 146.

Here the umpire stated in his award that he had applied his experience and expertise to the interpretation of the facts; he referred to the submissions made by both arbitrators. He inspected the relevant premises. Counsel for the parties addressed him and witnesses gave evidence. Although the umpire acknowledges that he was required by the terms of the lease to be a valuer/umpire and not a legal umpire, he considered the various legal references, few of which were new to him.

It is clear from reading the award as a whole, that the umpire proceeded on the objective basis of rental assessment; i.e. what a hypothetical prudent lessee would pay in rental for this particular building, taking into account such restrictive or onerous lease terms and conditions which the hypothetical lessee would take into account.

The first argument for the lessor was that, as a matter of construction, the rent review clause required the rent to be assessed on a subjective basis as opposed to the objective basis used by the arbitrator. In other words, the umpire had to take into account all the considerations that would have affected the minds of the particular parties had they been negotiating for the rent themselves within the framework and terms and conditions of the existing lease. This type of assessment is typified in the line of cases of which *Thomas Bates & Son Limited v Wyndham's (Lingerie) Ltd* [1981] 1 A11 ER 1077; *Lear & Anor v Blizzard* [1983] 3 A11 ER 662 and *Jefferies v Dimock* [1987] 1 NZLR 419 are the frequently-cited examples.

In *Bates*, the lease referred to "such rents as shall have been agreed by the lessor and the lessee" and in *Lear* to "a rent to be agreed between the parties hereto or in default of agreement at a rent to be determined by a single arbitrator".

The distinction between the two tests is well known and has recently been discussed by the Court of Appeal in an unreported decision, *Sextant Holdings Limited v New Zealand Railways Corporation* (judgment 19 March 1993).

In the words of Richardson J in that case, the objective test requires "valuers to enter the world of notional markets populated by hypothetical lessors and lessees and assumes a notional letting on the same terms as the subject lease except for the amount of the rent". The subjective test (according to the same learned Judge) "looks to what the particular lessor and lessee would consider a reasonable rent in their circumstances. Although requiring an objective assessment, it may call for consideration of circumstances not relevant to a pure market test such as who paid for the improvements and the profitability of the business carried on by the lessee."

McKay J saw the distinction as being between clauses which require a rent to be fixed for the premises by valuation and clauses which focus on the parties as, for example, by referring to a rent to be agreed between the parties or, in default, by arbitration.

Tipping J saw the objective clause as looking at the premises and what they would reasonably command by way of rent in the market; the subjective clause looked to what would be a fair or reasonable rent as between the particular parties. Tipping J also pointed out that, in a long-term lease, it is inherently unlikely that a lessor would have intended a rent-review clause which would leave the lessor vulnerable to the particular economics of the current lessee's business.

In the *Sextant* case, the Court of Appeal upholder Neazor J's view at first instance that the valuation of "the fair annual rent of the land hereby demised" fell to be

"assessed" on the objective standard. A prohibition against taking into account improvements was found in that lease as it is in the present.

Both McKay J and Tipping J in *Sextant*, discussed the decision of the Full Court of the Supreme Court of Western Australia in *Ricciardello v Caltex Oil Australia*, [1991] A.N.Z. Conv. Reports 445. There Malcolm CJ drew a distinction between the expression "market rent", where the rent is determined on the open market basis having regard to rents for comparable premises, and the expression "fair rent" where the rent is determined on the basis of what it would be fair for the particular parties to have agreed under their lease, having regard to all the circumstances relevant to any negotiations between them of a new rent from the review date. The case is authority for the proposition that the words " market rent" provide an indicator of the objective approach.

Counsel for the plaintiff, in submitting that the lease in this case called for the subjective assessment, stressed the provisions in the lease requiring negotiations; only if they broke down, then and only then, were valuers jointly to determine and agree the current market rental, having regard to the terms and conditions of the existing lease.

I am unable to accept this submission. The reference to "current market rental" occurring several times in the lease is a clear indication that the hypothetical lessor/lessee objective standard of rental assessment is appropriate. In *Sextant*, "fair rental" was held to come within the objective test. I think the present case is a stronger instance of the objective standard being required. The umpire correctly embarked upon his task which was to assess the market rental which term predicts the objective approach.

As was pointed out by Richardson J in the *Sextant* case, there can often be little difference between the two approaches. It was not demonstrated to me that there would have been any marked difference had the umpire approached his task on the *Bates* subjective basis. Applying the *Manukau v Fencible* approach mentioned earlier, I should find it hard to be satisfied affirmatively that any error of law of this description would probably have made a difference to the umpire's assessment. I am satisfied that the umpire's approach was correct and the first ground of challenge must fail.

Dealing next with the plaintiff's remaining submissions; the umpire records that, in coming to his decision, he had considered comparable properties which had been mentioned in submissions. These properties are tabulated in an annexure to the lease with abundant detail. The umpire carefully assessed each comparable lease document to see to what extent the subject lease differed. He made some allowance in assessing the comparable rentals by reference to what he considered onerous clauses in the subject lease.

The plaintiff submitted that the umpire should not have compared lease conditions but should only have had regard to rental value of comparable premises. According to this argument, if lease terms were meant to have been compared then there should not have been a valuer/arbitrator but a lawyer/umpire.

The umpire found that some aspects of the subject lease were more restrictive than the comparable and that this fact would affect the mind of the hypothetical prudent lessee. He was entitled to use his knowledge and judgment in coming to his assessment.

The umpire said at p.5 of his award -

> "If an adjustment is to be made, and I conclude some should be, it can only properly be made in the valuation process of comparable by comparable adjustment, along with other differences, so as to compare "like with like". Only where all the comparables have identical lease terms and the subject only was different, could an adjustment (if warranted) be made at the end of the process (on a single percentage or other uniform basis). In practice this would be most unlikely to be the situation - though for restricted use or absolute prohibition of assignment clauses (rarely encountered) it could arise. I therefore reject the uniform and overall 7½% deduction made by Miss Jansen, but accept that in principle adjustment for any different terms and conditions needs to be made, as appropriate, where such differences would materially affect the rental that would be agreed between a (willing and prudent) lessee and lessor.
>
> My approach has been to examine the lease for each comparable in turn, and where particularly material clauses are present or absent, by comparison, to make a judgment whether this would affect the mind of a prudent lessee, and if so make an appropriate percentage (or per m2 per annum) adjustment in arriving at the indicated rental for the subject premises. Such allowances can only be subjective in the absence of empirical evidence, and I have exercised my own "expert" judgment in this regard in these comparisons between the comparable leases and the subject premises lease. The effect of the allowances, should, however, be reasonable, especially when taken along with other adjustments between comparable for physical differences in the location, quality, presence or absence of building services and the like."

In my view, the umpire was not obliged to give further reasons for his adjustment. Even had he been more specific regarding the terms he felt were onerous, there is no affirmative indication that such identification would have made any difference to his award. See *Manukau v Fencible* and *Sextant*. In the words of Tipping J in *United Sharebrokers Ltd v Landsborough Estates Ltd & Anor* (unreported Christchurch, C.P.298/89, 18 May 1990) at p.17 -

> "No doubt what constitutes current market rental is not an easy matter to determine in those circumstances, but I do not regard that essential question as being simply a question of law. It is in reality a mixed question of fact and law. The key point for present purposes is that the umpire is not shown to have misdirected himself in law or to have overlooked any relevant principle of law in coming to his assessment of current market rent. Indeed the matters which an expert umpire is obligated to take into account in a case of this kind are essentially a question for his expert assessment after having listened carefully to the evidence and representations that the parties wish to put to him."

Bearing in mind the cautions of the *Manukau City* case, I consider there are no grounds for upsetting this award or for ordering it to be remitted to the arbitrator for further final consideration. The parties got what they bargained for - an impartial and expert assessment by an umpire who took into account all relevant matters and approached the determination of the current market rental on an appropriate basis.

The application is therefore dismissed with costs to the defendant of $1,000 and disbursements.

Solicitors:

Jacobs Florentine & Partners, Palmerston North, for plaintiff

Morrison Morpeth, Wellington, for defendant