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Rural valuation and loan appraisal

by John Larmer Senior NZ1V Vice President
& New Plymouth based rural practitioner

ural finance is a specialist field but Rmany institutions have recently rediscovered rural lending as the commercial property and corporate downturn continues. Financial deregulation and the consequent strong competition for rural finance business has resulted in some basic safeguards being ignored. The valuation process is often short circuited or avoided. Our profession has aproblem if lending institutions view an independent valuation as cost rather than a benefit. We have all seen poor investments made that could have been avoided or modified with expert property or economic advice. Lenders and borrowers who avoid a valuation or treat it as a "rubber stamp'" are not properly using the expertise available to them.

There is no doubt that members of the Institute who hold rural qualifications and have suitable experience are land economists in the wider sense. The valuation function may be central but members should be able to provide impartial and independent advice on productivity, management, finance and viability. Farmers and rural investors often seek advice from professionals who lack sufficient technical background in agriculture and the land market. Just about everyone considers themselves an expert on property matters. The rural recession inthemid 1980sexposedmany farmers who had financial arrangements that were basically unsound even before the "Rogernomics" period.

We thought that such excesses of over-borrowing backed by incomplete or unsound advice would not be repeated but the same cycle has returned. Farmers have short memories and it is clear that many professionals who provide advice to them do also. There is in general an inability to think longer term and any increase in revenueprices, even from an unsustainably low base, results in increases in land and stock prices. Cash forecasts are regularly prepared without any land professional input and the production assessment is often beyond current capability in a normal year, unless extra inputs are provided for. From the viewpoint of our profession, a full loan appraisal, incorporating independent valuation and carefully prepared income/ expenditure projections, would inform the lender much more adequately. Where a member of the Institute reports on a commercial property, the income earning capacity or rental is of course of paramount interest, the actual market value usually being a function of the income. A banker or lender can therefore more easily consider a client's particular borrowing requirements against the property's income. Even then, rental income prospects can change quickly as evidenced in our central business districts over the past two years. However, the rural land marketoperates in quite adifferentway. With regard to status and locality, the motivation can be similar to a residential property, but ultimately rural purchasers are also usually buying a business. This is commonly owner operated, providing self employment and needing ongoing inputs of management and labour. There is a requirement to make a return on the assets employed, and service any debt involved.

It is the inter-relationship of the assets with the debt/equity position and the management that makes each farming business unique and calls for specialised input from members of our profession. The tightened Security Regulations and Nominee Rules require the valuer to advise on the property's earning capacity. This is a logical extension of the valuation process.

If the rural market does not price properties on an investment approach, and the borrower is to carry out an owner/ operated business on the land, how else can a lender decide on a suitable amount to advance?

We have all seen the problems arising from advances based on asset values alone. Low loan to value ratios may confer a wider margin of security but the mortgage interest obviously cannot be paid without an adequate income. Cashflow is vital in any business and undoubtedly cash profitability is essential in farming. There has been some debate about the definition of income but common sense must prevail.

Clearly, the net cash income from farming is the practical approach and this willbeanoutcomeofthesubjectproperty's normal productive capacity, plus the borrower's managementexpertiseandany further investment in stock and plant. If the personal element and financial position are unknown, and this is the reality of mortgage instructions for many valuers, then the income estimates should be on an "average efficient" basis. The actual viability of the property will then be modified for better or for worse by the borrower's own management and financing.

Members of the Institute with the necessary specialised qualifications and experience should be the best equipped professionals to advise on the valuation, income earning capacity, and management aspects of rural property, in association with registered farm management consultants where necessary.

Continuing professional development and educational programmes must in future offer a stronger economic and business consultancy content. This is because the profession is an integral part of the financial services sector, but with technical or specialist skills particularly relating to land. If valuers do not take up the challenge to widen the expert services available to clients, then other professional groupings will surely move to fill the need.

It is up to us as members of a forward looking profession, to turn a property valuation or loan appraisal into a major benefit that lending institutions and borrowers cannot afford to be without, rather than being seen merely as one of the costs of the financing process. In a market driven economy the perception that the public may hold of valuers will be in our own hands. A

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Hotels Motels & Restaurants

Valuations & Market Studies

by Stephen Rushmore MAI

Another excellent publication from the American Institute of Real Estate Appraisers. The original monograph, the Valuation of Hotels and Motels, was first published by the American Institute of Real Estate Appraisers in 1983 and as the title now indicates, a new chapter dealing specifically with restaurants has been added. As the preface notes, change is always pertinent in the area of hotel/ motel valuations and in the years elapsed since the original publication, "the techniques for quantifying lodging demand have become more sophisticated and refined. Research has led to the development of anindexing procedureto evaluate the competitiveness of various lodging facilities so thattotalroom-nightdemand can be allocated among competing hostelries.

Hotel investors are now projecting income and expenses using inflated, not constant, dollars. Their expenses are estimated with fixed and variable component analysis, which automatically adjusts for changes in occupancy levels. Capitalisation and discounting procedures have advanced considerably and computerisation allows for efficient calculation of interest rates of return".

All of these changes are incorporated into the completely revised publication.

At first glance, one might be excused for putting this text to one side on the assumption that it contains in its charts, tablesandanalyseslittlethatisofrelevance to the New Zealand market. That would be a mistake, for there is much that is of relevance and in its entirety, the text questions the past practices in this specialist ifeld of valuation. The author introduces debate on the proper discounting proce dure and the use of the average weighted cost of capital in the income valuation approach. He briefly probes the area of after tax analysis citing recent changes in income tax laws allowing for shorter depreciable lives as having a definite impact on purchase decisions, a situation which will become evident in the New Zealand market following recent legislative changes.

In all an interesting publication and one which is recommended to all who practice in this area of valuation for in the words of Anthony Reynolds, the 1983 President of the AIREA, "the only thing mole risky than inveutinng in hotels and restaurants is appraising (valuing) them".

G J Horsley FNZIV.

Valuation reports and mortgage recommendations

AsaTrusteeofManchesterUnityFriendly Society, I have the privilege of reading valuationreportsfnomalloverthecountry, mainly for house property lending purposes.

I must say that the standard varies from very good to rather poor, from very long to too short, and from complicated to over simplistic.

Long reports are not appreciated, so please keep to the facts. Short reports must contain main basic details. The popoulation of Tuatapere or Kano are important factors, and where they are would help.

Main difficulty, however, is the lack of a mortgage recommendation under the provisions of the Trustee Act. All Manchester Unityreports must have a Trustee Recommendation and if the dwelling has faults, then special conditions of any loan would be helpful. If the house is still on timber piles, they must be near the end of their life. Require six months to repaint if needed.

Please make it easier for a fellow valuer. I wonder how Solicitors or Owner Clients cope with our reports?

DIM Perry, ANZIV, AREINZ
Registered Valuer, Wellington.

Editor: The New Zealand Institute of Valuers Practice Valuation Standard No 1 for the valuation of residential properties, which beanie effective from 1 January 1992, should result in greater uniformity and higher level of standard for the reports you receive in future.

A Valuer's Role in the Rent Review Process

by G G McKay

Many lawyers and valuers approach the task of re-assessing rents under review clauses with simplicity and arithmetic in mind only, but with a wellintentioned plan of making a few comparisons by way of example to follow current trends and re-assess a figure generally upwards. It is significant that rents on review, as a matter of recent history have been mobile upwardly. That trend is now being reversed.

Notwithstanding the simplicity of the subject matter on the face of it, I have frequently encountered procedures adopted in practice which I consider to be less than legally correct, where there are wrong assumptions or premises resulting in a failure to observe safe procedural steps in the process that may in the event of areview being concluded, contribute to the continuation of an inflationary lie, or at least produce a flawed calculation.

What I hope to achieve in this paper therefore is to canvass the responsibilities of valuers in the rent review process, and consider the options that they are confronted with, and make some suggestions as to how those varying situations can be properly dealt with.

If, at the end of this paper, I have helped you bring your own thinking up to date, then my object will have been served

The valuer's role and obligations in undertaking rent review valuations

It is always useful here to remember fundamentals in terms of your own liabilities.

Without spending too much time on this topic, your responsibilities are generally three-fold. First, to your clients, secondly to other members of your profession, and thirdly at large to members of the public. Naturally, this view is always subject to adequate and well-drafted disclaimers which generally limit the liability of valuers to the person to whom reports are addressed as a commitment for the addressees' eyes only and no one else's.

Subject to the issue of disclaimer however, you enjoy the licensed privilege of a monopoly profession which the public at large, I am sure, considers your registration certificate to practise something akin to a De La Rue licence to print bank notes. Suffice to say, that is the cross to bear of a professional man, but as a professional person you are expected to demonstrate special skill, ability and experience. In contract, you will have a responsibility to your client. A valuer may also be liable in tort even though there is no contract between him and his client, if the information has been passed on to another person who relied on it and suffered a loss, as a result. In these circumstances, the law says you have a duty of care. If you are in breach of that duty of care and a person to whom that duty is owed suffers a loss, then you become liable to compensate for that loss. The position arises in contract as between a valuer and his client and in regard to third parties in tort, if that advice was given in the ordinary course of professional activity and also there is a special relationship which the law says justifies in the particular circumstances the imposition of a duty on the valuer to the person who relies on the advice. This is the principle of negligent mis-statements which matured in the famous case of *Hedley Burn vHeller & Partners* [1963] 2ALLER575.

The point is here that your professional responsibilities give rise to the need for special care. It is not difficult usually to track the quantum of damages in a valuation liability case as, generally speaking, persons who may wish to sue in contract or tort have relied upon the valuation to make a key financial decision, either as a lender or as a buyer or as an owner, and it seems that a mistake in this business can be a very expensive mistake, and consequently the question of liability is one that needs to be kept uppermost in your mind in the rent review business.

As you may appreciate, in making these points, I do so out of a genuine interest in alternative dispute resolution procedures. I have a keen desire to keep people out of litigation and out of the Courts, as I believe there are several dispute resolution techniques which may be applied in most cases. However, from your point of view, whether you are involvedas aclientadviser, whether you are asked to give a written opinion or valuation, whether you are consulted as an independent expert, whether you are asked to act as a-mediator or conciliator, or whether you are asked to act as arbitrator or umpire, always keep in mind the importance of an exclusion clause in respect of any liability, and an indemnity in appropriate cases. Only the arbitrator in the end, with one or two remote exceptions, cannot be sued for negligence. In all the other roles, you can.

If the argument is not completely circular, may I suggest that if you adopt a series of permanent guidelines and standards as a matter of practice and routine, that are commonly shared in your professional group as being appropriate and in accordance with the law, you really can't come to any harm. I am not going to claim that my suggested procedures are perfect, but I trust that you will agree that they are sound.

Recent developments in the law affecting rent reviews

I am one of those lawyers who believe that the law should be capable of much simplification. Some jurisdictions around the world have shunned reliance on precedent in such a complicated legal system as continues to dictate much of Anglo, American and correspondingly Australian and New Zealand rulings and legal

...dramatic change in the NZ property market.. has produced a situation where strong nerves and firmness are essential...

procedures. Even this small topic has received frequent adjustmentas aresult of rulings of the Courts. That is not to say thatl do not have a greatdeal of respect for the quality of dissertation and erudition which is evident in these expertly compiled decisions. In fact, some of the finest English language is found in the record of judicial opinion. The *Jefferies v R C Dimock Ltd* decision illustrates the care and precision given to the resolution of a quite ordinary problem concerning a rental calculation and the review process.

In recent times, the dramatic changes in the property market in New Zealand and the evaporation of the promise of inflation in property values, has produced a situation where strong nerves and firmness are essential parts of the armory in reaching conclusions on valuations, particularly in relation to commercial property. Tenant failures and security enforcement situations are now an everyday feature of our respective disciplines that are providing a whole new set of factors resulting in a re-appraisal of lease documentation, and the lessee and lessor rights and obligations and their respective expectations from the valuation process'

There seems to be far more litigation now between the parties. There are frequent examples of original tenants and guarantors endeavouring to escape liability, and landlords are seeking to recover losses on tenancy situations from prior tenants and guarantors. The position becomes more complex for some landlords who own commercial property and whose own mortgage liabilities will now frequently exceed the value of the property. The absolute decline where frequently one now sees selling prices which are only a fraction of the last Government Valuation marks the seriousness of the shift'.

Advisers therefore need to be fully aware of the precise terms of leases in respect of rent review provisions, particularly where old lease forms are involved. There is a current suspicion that ratchet clauses are a thing of the past. That's all very well if you can get rid of them.

The relative bargaining powers of landlords and tenants have changed. There is a whole question to be considered of the so-called inducements which are offered by lessors to prospective lessees, and the greater bargaining power of the tenant in a buyer's market to negotiate terms of leases against standards which were previously regarded as sacrosanct.

The lord of the manor some years ago was a property management executive for a major property company offering downtown space to a retailer or a professional firm. The particular tenant in buoyant times waspractically on his knees to get adequate space and rarely succeeded in negotiating less than stringent terms of lease. Oh, how the tables have turned.

Today a tenant is well able to negotiate terms which belong on a more level playing field, including rent review clauses, and we are seeing now a quite concerted effort to resist minimum rental clauses and to see more balanced means of resolving disputes, and a more open consideration of the factors which affect a revision upwards or downwards of rental obligations.

One must always remember that a lease is not a standard form. There are as many variations as there are buildings. Two things are always very important in dealing with a rent review process. First, read the rent review clause, but secondly read the whole lease.

I happen to think that property values and rentals are still on the way down.

There is no confidence now in the value of property for investment purposes in general...

Until there is a productive drive from within the economy, that trend will continue. There is no confidence now in the value of property for investment purposes in general, and that what movement there is in commercial property apart from acquisitions by overseas bargain hunters and local investors who can never resist an opportunity of tangible bricks and mortar, I suspect the bulk of transactions relate to firms and organizations acquiring property for their own purpose. In other words, firms are buying factory and commercial premises rather than leasing, becauseof themarketconditions.

The other significant trend in the market is the development of a two tier rental market. I mean by this that rentals being asked by lessors for new tenancies are significantly lower than rentals paid by existing tenants on a rent review. Accordingly, the question that will arise fordetermination in rent review procedures is to what extent is the position under existing leases affected by reference to the current market rent on rent review and on the availability of new and often vacant space. When we come on to discuss the difference between adopting an objective or a subjective test in a particular case to determine what rent calculation is appropriate, it will be seen, I think, that a more liberal trend is developing which is more attractive to tenants, that there is a readiness on the part of the Courts where it is possible, given the terms of the lease, to permit a wider and more liberal interpretation of relevant factors than hitherto may have been the case.

In Australia it has been held that rent review rentals constitute material relevant to the determination of a current market rental. The case r*eferencesa*re*BHPvAMP Society* (1986) ANZ. CONR 658 and*EB Chambers Co op Limited v MLC* (1987) ANZ. CONR 22.

There may be conflicts to be resolved in considering ratchet clauses in relation to current market rentals. The effect of a ratchet clause is to artificially compel payment of a rent which is higher than the rent realistically obtainable in the local market place. There is no doubt that in a two tier market the ratchet clause does operate to create an artificially high level of rentals payable. The natural consequence is that as those leases come to an end and the properties become vacant, they will in future be likely to earn less unless the market dramatically changes. Where the lease calls for the determination of a "current market rental", the only comparable levels so far as review rentals am concerned will be those which satisfy the criteria of being market place rentals. I do not know of a case yet where this argument has been put to the test.

Some examples of tenant inducements and hidden benefits

The hidden agenda limited only by the imagination and in some cases the morality of the lessor, offers such a variety of attractions for unsuspecting tenants to be tempted with long-term leases where, hopefully (for the lessor) the market will catch them out on the first rent review, but in the initial stage offering rent holidays, Fiji holidays, loans for partitions, contributions to removal expenses, lump sums, free cars, and picking up a prospective tenant's lease of existing premises, or taking up a liability to meet rent, or a contribution to rent under an existing lease. Apart from unsuspecting and over-trusting tenants being carefully warned about the short term nature of the so-called inducements, it may prove difficult in the future to track the exact nature of these 0

benefits and to what extent they have affected both the market and the actual rent paid or payable under any given lease. The hush hush engineering which attends such arrangements once the fish has taken the bait, will make future calculations somewhat difficult and are analogous to creditor protection transactions and tax avoidance schemes, where the strictness of the situation may mean in a dispute that the situation is held against the party seeking to obtain some benefit. In other words, if the developers and landlords are found out, it will undoubtedly have a significant effect on future rentals payable as there will need to be an inquiry of the books to determine what the net rent paid under the market truly is, ratchet clause or no ratchet clause.

There is a danger in assessing rental rates on the lease documents that inducement transactions will not be apparent

You have a consequential problem of endeavouring to sort out whether these confidential packages have been entered into. It is almost a certainty that no one will be telling a valuer when instructions are given, certainly not the valuer for the lessor in any event. There is certainly a danger in assessing rental rates on the lease documents that the inducement transactions will simply not be apparent.

It has been suggested that such confidential packages have the effect of distorting the rental market and are devices by unscrupulous landlords. They are devices that have been adopted by all kinds of lessors. Even such an organization as the Development Finance Corporation is reputed to advertise a new concept known as "Lease Write".

In other words, write your own lease and suggest it on the premise that no absurdity in this age will not be given the time of day. Whither thou goest, market rental then? You may consider it desirable that valuers as a matter of routine invite on receiving initial instructions to be informed of the existence of any inducement arrangements. Again, you will need to decide the tactics of this in dealing with lessors and lessees.

In my view, in all cases where there is any suggestion that the fixing ofarental has been the subject of an inducement package, the particulars of which arenot available for the purposes of the rental determination, then that rental must be disregarded by a valuer in making a market place determination. It is particularly dangerous in reviews affecting multi tenancy situations where some lessees have had the advantage of inducements and some not, and possibly different tenants accepting different types of inducements according to their pockets, professions or taste.

For tax purposes, it seems clearly arguable that inducement provisions are accruals for the tenants for tax purposes. Legal engineering has endeavoured to convert benefits into tax-free capital receipts.

Unfortunately, as I have said, leases are not standard documents and even more so within the context of leases there is limited uniformity in New Zealand in the drafting of rent review clauses.

I will go on to say in this argument that it will be important as a practical consideration for valuers to know whether they are acting as an expert or an arbitrator, and secondly whether they are entering to assist to negotiate or to solve a dispute. The necessary condition precedent to the task is that you get your instructions clearly in writing, so that your role is quite certain. Don't ever forget that whatever your task initially, you are potentially always able to end up as a witness. That is apart from perhaps just being asked to act as a witness either before a Court or an arbitrator or umpire.

Some guide to your task will also be evident in the rent review clause itself. It is to that clause which you must look to determine the standard against which the new rent is to be fixed, so that the results of your work will correctly reflect the intention of the parties to the lease as it was originally drawn. There are numerous legal decisions on a variety of wording including the following:

rent to be agreed
fair market rent.
open market rent
reasonable rent
best rent
full market rent
reasonable rent for the demised premises
and so it goes on.

Essentially however most rent review clauses can be reduced for practical purposes to two situations:-

The first is the subjective rent review clause or what is now known as the *Bates v Wyndham* [1981] IAER 1077; or

Secondly an objective rent review clause or *a Ponsford v HMS Aerosol* clause.

The differencebetween subjective and objective rent review clauses has been judicially considered in recent times in New Zealand, and I think not only is it important to understand the distinction between the two approaches, but also have a feeling of how the Judge has discussed these various important distinctions, and to see the examples that he has given.

In the *Jefferies vDimockdecision* you will have the pleasure of reading an example of clarity and depth by a master of the English language in an example that is not too long and taxing to peruse. Back to the subject matter.

1: In Thomas Bates and *Sons Ltd v Wyndham's (Lingerie) Limited* [1981] 1 AER 1077 the lease referred to the rent upon review as being "a rent to be agreed between the lessor and the lessee". It was held that as the clause, referred to rent *agreed between the parties an*d not the rent agreed *for the demised premises* the rent to be fixed was to be the rent which would be reasonable for the particular parties to agree having regard to all relevant circumstances including tenant expenditure on tenant improvements. The arbitrator was not to fix the rent assessed objectively on the basis of the market rent for the premises. SeealsoLear *vBlizzard* {1983] 3 AER 662.

2: In *Ponsford v HMS Aerosols Ltd* [1979]AC63 the rent review clause referred to a rent that was "reasonable for the demised premises for the appropriate period".

In that case the majority of the House of Lords held that the words pointed unambiguously to areasonablerentassessed on an objective basis for the premises without reference to the particular tenant or a particular landlord or the history of the premises.

3: The significance of the subjective/ objective issues in relation to rent reviews has been illustrated in a number of recent New Zealand situations, in some cases rather dramatically.

Perhaps the bestexample is *inJefferies v Dimock* [1987]1 NZLR 419. In that case the rent review clause provided that rent would be reviewed to "such rental as is agreed upon by the landlord and the tenant and if they cannot agree to be determined by arbitration.."

The landlord Dimock had purchased land and negotiated with the tenant to take a lease of the property and modify it for the tenant's use. The tenant required extensive alterations and the landlord and

tenant agreed upon the improvements to be carried out. The landlord was not liable for alterations above a limit of $200,000. The landlord's responsibility for alterations amounting to $200,000 was to be repaid by the tenant over a three year period after the fourth year of the tenancy had elapsed.

The dispute arose because the tenant's expenditure on reconstruction amounted to $479,000 or $279,000 above the $200,000 limit the landlord agreed to pay.

The issue that arose was whether in fixing the rent the arbitrator should take into account:

(a) The fact that the tenant had spent $279,000 on landlord improvements for which the tenant would receive no reimbursement; and
(b) The fact that the tenant had paid for major improvements to the landlord's land but would in effect be paying rent on those improvements.

As a matter of fact, the arbitrator found that if the tenant's expenditure was to be ignored the annual rent for the relevant review period was $199,400.

However, if the tenant's contention was correct the annual rent would be $162,900. The rent differential was therefore significant over a three year period.

The arbitrator referred the legal issue to the High Court by way of case stated and it was held by Barker J. that the clause was indistinguishable in any material respect from *theBates v Wyndham andLear v Blizzard* cases. The rent review clause was subjective and required what was reasonable between the parties to be taken into account, i.e. the excess expenditure paid by the tenant. The rent was accordingly fixed at $162,900 per annum for the relevant period.

4: See also *Fel texlnternational Ltd v JBL Consolidated Ltd* [1988] NZLR 668 where the rent review clause provided for an "annual rent" to be reviewed every five (5) years by agreement between the parties and failing agreement to be fixed by arbitration. It was held in that case:

1. That it was proper to imply the word "fair" into the words "annual rent" to give the clause business efficacy.
2 To determine the fair annual rent the "prudent lessee" test should be applied i.e. what would a prudent lessee pay for the premises.
3. That it was proper for the valuer to make an appropriate allowance for the five (5) yearly rental period when comparing rentals for three (3) yearly rental periods.

5 See also *Mahoney v Modick* (Eichelbaum CJ HC Auckland CL 65/89) where a subjective test was applied.

6 Note also the dangers of restrictive user clauses. A restriction on use that is very narrowly drafted may have serious consequences from a rent review aspect. See *Plinth vMottMay&Anderson* [1979] 249 EG 1167 where a user covenant restricted the use of premises to that of offices in connection with the tenant's business of "consulting engineers".

This restriction had the effect of reducing the rent to take account of the very limited use as engineers' offices. The position may be different where the rent is to be a market rent determined with vacant possession *Land Law Company v Consumers Association* [1980] 255 EG 617.

See also *Burns Philp Hardware v Howard Chia* [1987] ANZ Con R 185 where it was held "the then current annual market rent for the premises" had to be fixed having regard to the obligation for use contained in the lease.

7: New Zealand Railways Corporations and Roadmaster Arbitration 9/3/89 involved the assessment of rent on a review of ground rentals in respect of the Roadmaster, Caltex, Turners and Growers and Market Gardeners 21 year perpetually renewable leases in Wakefield Street, Wellington.

The lease requirement was to determine the "fair annual rent of the land" disregarding improvements. A contest took place between the parties as to the fair percentage return that could be applied to the land value to determine the rent.

Various comparable investment returns were considered and consideration was given to inflation rates and other factors. The umpire `held that the fair return to be applied in these leases at the time of review was 8% on the land value. This was a reduction from the peak rate previously obtained on similar leases of 8.5%.

See also *WCC and Equity Portfolio Investment Co Ltd Arbitration* 1/2/90 where, after very full consideration of the authorities, a return of 8% was assessed for the particular 21 year ground lease.

See also *Wellington City Council v National Bank of New Zealand Properties Limited* [1970] NZLR 660.

These cases illustrate that in the current leasing environment there is some scope for re-assessing some of the fundamental assumptions that were previously accepted during the boom period.

...in the current leasing environment there is some scope for re-assessing some fundamental assumptions accepted during the boom period..

In the *Mahoney v Modick* decision of the current Chief Justice in the High Court at Auckland on December 1989, explains the factors which an arbitrator should take into account in assessing a reviewed rent. The particular rent review clause was the subject of the decision in the *Jefferies v Dimock case* where it was held that the rent review clause called for the subjective approach, namely that it took into account the particular business operations of the tenant.

In the Mahoney case the chief Justice proceeded to consider what factors an arbitrator should consider when following this subjective approach. The issue now was whether on that approach the profitability of the tenant'sbusiness should be a factor.

The judgment extensively reviewed the authorities and cited with approval the proposition that the issue turns on the construction and commercial purpose of a rent review clause. The judgment notes that "notwithstanding the approach is a subjective one the factors which may be taken into account are limited to those which a reasonable person would regard as bearing on the rent of the premises between the particular parties. The Chief justice warns that this subjective approach does not justify the infiltration of fanciful considerations orones idiosyncratic to the personalities of the respective parties".

The factors to be taken into account are limited to those having a connection with the leased premises. The judgment concluded that on a rent review where the subjective approach is appropriate, the profitability or otherwise of the business which the tenant proposes to carry on in the premises during the currency of the rental period, cannot be excluded when fixing the appropriate new rent.

8: Current Market Rent

Where the rent review criteria in a lease calls for "a current market rental", this means the rent should reflect the rent that would be obtained in the open market 0

for the particular property, taking account of all the terms of the original lease and reflecting a bargain between parties, each of whom was willing to proceed. The essence of the current market rental is that it need not be reasonable for the tenant, but only reasonable for the premises *(Lear v Blizzard)* [1983] 3AER 662.

If it is intended that the words produce an open market rental, then you fall into the difficulties of the Ponsford case where a reference to reasonable rents can produce a quite different result.

Insertion of a ratchet clause is one of the more contentious issues facing members of the legal profession

9: The ratchet clause

The insertion of a ratchet clause is one of the more contentious issues currently exercising the minds of members of the legal profession dealing with property transactions. To achieve a level playing field for the lessor and lessee, a rent review clause should make an allowance for downward movements as well as upward in an open market rental value. That however does not have a lot of appeal with a highly-geared developer. There is no good reason why rent should always go up and never down.

That is fine in theory however but it doesn't yet seem to be significant in the review of leases which have run for some time and still have a few years to go. The unfortunate thing is that New Zealand lessors have recently been in stronger bargaining positions, and have simply refused to allow tenants to have protection against deflationary pressures to counter the protection lessors build in against inflation in the first place.

Therefore a ratchet clause is still there but I am sure that quite frequently it is going to be the subject of a deletion. The practical result of not including such a provision is that a lessor will probably resist exercising a right to review the rent unless he is sure he can get an increase. Think what this does to the market. Your services may not be so widely needed if lessors become disinclinedtopursuerental increases, although the boot may be on the other foot with tenants seeking such reviews in order to obtain decreases or reductions.

Something to watch in practice is the lease which directs valuers to either regard or disregard certain factors. All I can say here is you should be careful, and if the effect of disregarding some otherwise increasing factors may on the face of it reduce a base rental, turnover or market conditions to be taken into account may increase operating expenses with a consequence that a tenant in the end is actually paying more not less.

Arbitrators or Experts

The rent review clause should speak for itself in determining whether in the first instance you are acting as expert or arbitrator.

It is true that the arbitration process has been criticised as cumbersome and unduly expensive. That depends of course upon the submission and terms of reference to arbitration. They should avoid involving the parties in a cumbersome procedure.

One cannot speak for the cost. In my experience, arbitration is just as expensive as litigation, although the parties may get to the point far more quickly and may be able to choose their own judge. If the terms of reference are drawn carefully, it should be possible to considerably reduce expense however.

It is generally accepted in practice however that in all situations where the assessment of a new rent is likely to be a simple exercise and the premises do.not contain any unusual features and the criteria of value does not give rise to any special difficulties or involve features that on an objective test require considerable judgment in assessing, then the determination of the rent by expert valuers is appropriate.

Where, however. the dispute determination will involve difficult questions concerning the basic principles to be adopted or analysis of business turnover or performance, then it is unlikely that the parties will be satisfied fully by reference to you as an expert. Only arbitration ensures the parties have the right to legal representation, that they can obtain discovery of documents and call evidence. The arbitrator is, of course, immune from prosecution or suit, and must follow the rules of natural justice and conduct the hearing like any other hearing of a legal dispute, fully and fairly. If complex points of law arise, the arbitrator has power to seek professional legal advice.

It is possible to appeal from the decision of an umpire acting as an expert provided reasons have been given for an Award, and this is what is normally called "a speaking award". In the absence, however, of the speak there would be no reason to attack and therefore there would be no right of appeal.

As a general principle, one could only recommend to tenants not to forego the right to have rental determined by arbitration, although it may be preferable in the first instance by agreement to do this by way of reference to an expert, and only resort to arbitration where all else fails.

Having said that, I am an advocate of arbitration but I believe there are steps in the process of moving from negotiation through to a dispute which involves discussion, negotiation, conciliation and mediation, further negotiation, finally statement of dispute and reference to arbitration. I will move to later in the paper suggest words which cover these options.

Rent Review Clauses

Let us quote some of the problems spoken about. I set out hereafter three different versions of rent review clauses I have picked at random:

"2.0 Rent Review:

2.1 THE annual rent may be reviewed by the Landlord as follows:

(a) the Landlord shall commence areview by not earlier than three (3) months prior to a review date or at any time up to the next following review date giving written notice to the Tenant specifying the annual rent considered by the Landlord to be the current market rent as at that review date;

(b) if, by written notice to the Landlord within twenty-eight (28) days after receipt of the Landlord's notice, the Tenant disputes that theproposed new annual rental is the current market rent, then the new rent shall be determined in accordance with Clause 2.2 BUT the new rent shall not be less than the annual rent payable during the period of twelve (12) months immediately preceding the relevant review date;

(c) if the Tenant fails to give such notice (time being of the essence) the Tenant shall be deemed to have accepted the rent;

(d) the annual rent so determined or accepted shall be the annual rent from the review date or the date of the Landlord's notice if such notice is given later than three (3) months after the review date;

(e) pending the determination of the new rent, the Tenant shall pay the rent specified in the Landlord's notice provided that the rent is substantiated by

a registered valuer's report. Upon determination of the new rent an appropriate adjustment shall be made;

(f) the rent review at the option of either party may be recorded in a Deed, the cost of which and the stamp duty thereon shall be payable by the Tenant "

"2.2 IMMEDIATELY following receipt by the Landlord of the Tenant's notice, the parties shall endeavour to agree the new rent, butif agreementis notreached within fourteen (14) days then the new rent may be determined either:

(a) by one party giving written notice to the other requiring the new rent to be determined by arbitration; or

(b) if the parties so agree by registered valuers acting as experts and not as arbitrators as follows:

(i) each party shall appoint a valuer and give written notice of the appointment to the other party within fourteen (14) days of the parties agreeing to so determine the new rent;

(ii) if the party receiving a notice fails to appoint a valuer within the' fourteen (14) day period, then the valuer appointed by the (otherparty shall determine the new rent and such determination shall be binding on both parties;

(iii)the valuers appointed before commencing their determination shall appoint an umpire who need not be a registered valuer;

(iv)the valuers shall determine the currentmarketrentof thepremises and if they fail to agree then the rent shall be determined by the umpire; .

(v) each party shall be given the opportunity to make written or verbal representations to the valuers or the umpire subject to such reasonable time and other limits as the valuers or the umpire may prescribe and they shall have regard to any such representations but not be bound thereby.

When the new rent has been determined the arbitrators or the valuers shall give written notice thereof to the parties. The notice shall provide as to how the costs of the determination shall be borne and such provision shall be binding on the parties."

"28 THAT if the Tenant shall have duly and punctually and faithfully observed and performed and kept all and singular the covenants conditions and agreements (on his part herein expressed or implied, he shall have the right on the expiration of the term hereby granted to a further lease for a further period of years as specified in the Fourth Schedule hereto provided:-

(a) That the rent for such further term shall be fixed by agreement between the parties or in default by arbitration in the manner in these presents provided but in no case shall such rent be fixed at less than the rent payable at the end of the immediately preceding term;

(b) Such further lease shall be otherwise on the same terms as herein expressed or implied, but excepting this present right of renewal;

(c) If the Tenant shall desire to avail himself of the right of renewal hereby created, he shall give to the Landlord at least three (3) calendar months' written notice of his intention in that behalf, such notice to expirebefore

WANTED!

Rural Topics in Search of Authors and Authors in Search of Topics.

The NZIV Editorial Board is conscious of a need for greater rural content in the New Zealand Valuers' Journal and the assistance of all members to identify suitable topics and for potential authors would be appreciated. Suggestions as to authors or further topics should be forwarded to The Editor or to the General Secretary, New Zealand Institute of Valuers.

1. Rural/urban "Rurban" Valuations the methodology and techniques to value lifestyle and urban fringe agricultural properties.
2. The Valuation of Proposed and existing Dairy Properties the use of DOT and Soil Science as part of the process and consideration of effluents produced.
3. Crown Institute Valuation Methodologies- accounting and valuation standards and practice in motion.
4. The Implications and Impact of the Resource Management Act on Valuations in the Rural Sector.
5 Considerations, Assumptions and Methodologies of Water Rights in the Valuation of Grazing a nd Cropping Farms how to treat existing water rights and their remaining term, transferability, and the new Resource Management Act.
6. Bed and Breakfast/Farm Stays as Unique Valuation Assignments in the rural scene.
7. Geographic Information System (GIS) practical commercial applications and demonstration project.
8. The Problems and Challenges of Valuing River Beds for Regional Councils.
9. The Consideration of Environmental Factors in Rural Valuations T.B., pesticide build ups, noxious weeds, etc.,

the expiration of the term hereby created

"33 RENT REVIEW:

(a) The annual rental for the time being payable hereunder maybe reviewed by the Lessor on the dates stated in the Schedule (each such date being herein called "a date of review") in the manner hereinafter set forth.

(b) At any time but in each case being not earlier than three (3) months prior to a date of review, the Lessor may give notice in writing to the Lessee specifying the new annual rental proposed by the Lessor which the Lessor considers is or will be the current market rental of the Leased Premises as at the date of review specified in the notice.

(c) The Lessee may by notice in writing to the Lessor within twenty-eight (28) days after receipt of the Lessor's notice, dispute that the proposed new rental is the current market rental of the Leased Premises and require the new rental to be determined by arbitration, whereupon the new rental shall be determined by arbitration.

(d) In the event of the Lessee failing to give notice to the Lessor in accordance with the provisions of the last sub-clause the Lessee shall bedeemed to have accepted the proposed new rental specified in the Lessor's notice.

(e) The new annual rental determined pursuant to the last sub-clause or by way of arbitration as being the current market rental of the Leased Premises (as the case may be) shall be the rental payable by the Lessee as from the date of review specified in the Lessor's notice.

(f) In no circumstances whatsoever shall the amount of any new annual rental determined as aforesaid be less than the annual rental payable by the Lessee during the period of twelve (12) months immediately prior to the date of review specified on the Lessor's notice.

(g) If required by the Lessor the new annual rental determined pursuant to the provisions of this clause shall be evidenced in a Deed or other formal document which shall be executed by the Lessee, and all legal and other expenses relating to such Deed shall be borne by the Lessee."

Expert Advisor or Arbitrator

In most cases it will be clear from the terms of a lease where a valuer is to be called to assist in the process by being asked as an expert or as an arbitrator.

This is not to say, however, as is true with many things, that there is certainty in allcases. Sometimes rentreview clauses in leases are an example of, first an attempt to resolve something by agreement, and secondly the resolution as if there is a dispute where agreement has failed but each party appoints a valuer.

Thirdly, failing those steps a third valuer may be appointed, but the uncertain question then is whether he is in truth an arbitrator or merely another valuer engaged as an expert.

An example of this situation appeared in an Australian case of *AMP Society v Overseas Telecommunication Commission* [1972]2NSWLR8O6. In this case, where the parties have failed to agree as to the rental in a lease, the rental was to be determined by "an arbitrator" appointed by a third party.

Upon failing to agree, the parties signed a further submission requesting the appointment of a valuer to determine a rental. The parties continued to dispute his decision.

The.. Supreme Court in Victoria held that what, in fact, had been called forby the lease was not in truth an arbitrator who would. in the ordinary course have conducted a judicial inquiry, but rather it was merely a reference to a person appointed because of his skill and experience to make a determination, but without all the other trappings of an arbitration.

Perhaps what was quite telling in this case was that one judge said "you can't make a valuer an arbitrator by calling him so or vice versa".

> "you can't make a valuer an arbitrator by calling him so or vice versa"

It really depends upon the purpose of the appointment. Ithas been said in another case "where a person is appointed not to assess or value or calculate simply in accordance with his own skill or knowledge, but to resolve a dispute by considering competing valuations, he is an arbitrator".

What it comes down to is whether you have been asked to make a calculation or whether you have been asked to resolve a difference by hearing both sides.

It is always a matter of construction in a particular case. A mere agreement to accept a valuation need not constitute an arbitration agreement, but it may do so.

A golden rule for you is if you have any doubt about your position as to whether you are an expert for the exercise or you are being asked to act as an arbitrator, make the parties make up their mind and so instruct you in writing.

I am not carrying a candle for the arbitration procedure. I can see that in many instances the task is better carried outby valuers acting as experts and leaving the matter at that. If they need an umpire also to act as expert, then all I ask is that you spell out the rules in advance before you embark on the task.

Speaking generally, if the reference is to a person who is intended to form an opinion between the parties from his own judgment and skill as a valuer, he is still acting as an expert and not an arbitrator, but it is not an absolute test because there can be cases where a dispute has arisen in which the third person is an arbitrator, although by reason of his knowledge of the subject matter or his skill it is not intended that he should not hear evidence or hold a judicial inquiry.

Again, that is very much a matter of the terms of reference. In *Carus Wilson v Green* [1886] I8QBD 7 atpage 9, itis said:

> "If it appears from the terms of the agreement by which a matter is submitted to a person's decision, that the intention of the parties was that he should hold an inquiry in the nature of a judicial inquiry and hear the respective cases of the parties and decide upon the evidence laid before him, then the case is one of an arbitration. The intention in such cases is that there shall be a judicial inquiry worked out in a judicial manner. On the other hand, there are cases in which a person is appointed to ascertain some matter for the purpose of preventing differences from arising, not of settling them when they have arisen, and where the case is not one of arbitration but of mere valuation. There may be cases of an intermediate kind where a person is appointed to settle disputes that have arisen, still it is not intended that he should be bound to hear evidence and arguments. In such cases, it may be difficult to say whether he is intended to be an arbitrator or to exercise some function other than that of an arbitrator. Such cases must be determined each according to its particular circumstances."

One problem that can arise is where

two valuers are to refer a matter to an umpire if they cannot agree. It might have been expected that since the umpire was there to resolve an undoubted disagreement he must necessarily be an arbitrator, but this simple view has not been adopted in the Courts.

In holding that it was a mere valuation, the English Court of Appeal relied on the fact that the umpire had been appointed before the disputes between the valuers arose.

This view does raise difficulties however as it could have happened in another order, but the point is in this case merely because he has to hold the scales evenly, does not make a valuer an arbitrator. It gets back to the terms of reference and probably the submission which gave rise to the dispute.

As to hearing evidence and submissions, a valuer would always be entitled to hear such matters. It is amootpointwhether by so doing he would upgrade himself into an arbitrator.

...remember, an arbitrator can't be sued, but an expert can in respect of a negligent valuation.

My view is that unless the terms of reference make it clear that it is an arbitration because he wishes to perhaps hear evidence and submissions, does not necessarily turn his role as an expert into that of an arbitration. One would have to take into account the question of consent and agreement between the parties, and the particular brief he has been given. While we are talking about these things, remember an arbitrator can't be sued, but an expert can in respect of a negligent valuation.

Any further analysis of the distinction between arbitrator and expert would necessarily go on to discuss forensically the particular cases where breaches of duty of care have arisen, and a question of immunity or otherwise has emerged in protecting or not protecting as the case may be a poor old valuer who has set out to do a job as an arbitrator on a look and sniff view, and has ended up finding himself being treated as an expert with the consequence of personal liability where the task has been found wanting and where allegations of negligence have been proven. At this stage, I cannot do more than isolate in your mind the difference as a key factor in considering your role in this process.

Negotiations or Dispute

It is difficult to pigeon-hole or isolate the various stages in business transactions from commencement to final resolution where a dispute may or may not arise as part of the proceedings. The circumstances are often dynamic and involve a full range of business and commercial affairs.

For that reason, the enlightened professional approaches the circumstances with a range of fixes and bandages to be applied depending upon whether a disease is only potential, or whether a wound has been opened and blood is running all over the lease. For that reason, I suggest that one recognises a graduated scale of the various resolution procedures, some of which will involve the recognition of dispute.

Before I move into the topic further, may I say that I am a serious advocate in all matters, commercial and legal, of the various alternative dispute resolution techniques which are promoted and recommended by the New Zealand Institute of Arbitrators.

This programme is still only in its infancy. It requires a concerted effort by all professionals and to help preserve the sanity and sanctity of the Courts in dealing with disputes and cases which ultimately are incapable of being dealt with by anybody else but one of the Queen's judges.

There are many other people capable of resolving and dealing with all sorts of disputes, and in regard to the very matter of rent review procedures, I suggest that the stages of negotiation, valuation, appraisal and assessment, conciliation, mediation, arbitration, and litigation, cover the various ranges.

Again, for that reason, it is my view that in all matters legal, and agreements where a reference to arbitration appears, then in respect of every dispute it is my thesis that it should always be subject to an enforced negotiation period. It should always be subject to the reference of an expert.

If property is concerned, the appropriate expert is a valuer. I believe also that the situation should be subject to independent appraisal and assessment by independent experts in the same field. At that point, again if the matter is not proceeded, I believe it is important that conciliation plays its part. A conciliator is not necessarily impartial and he may have to get alongside each party one at a time. For that reason, it is often unwise for a nominated arbitrator to adopt the role of conciliator and then try and salvage the job in his role as arbitrator.

Conciliation is a particular task in itself. Mediation is different again, the subtle difference of which is the interposition of a third party with a view to persuading the parties in difference to adjust their position and settle their dispute.

The mediator relies on assistance and persuasion rather than the power to make binding decisions, but is a person who is more at arms length than the conciliator and certainly should be impartial. Arbitration involves the determination by a third party acting judicially of differences which have arisen between the parties concerning their legal rights, and who must according to the rule of law, give the parties a hearing and come up with a written decision known as an Award. I am an advocate of abandoning all presently drawn arbitration clauses in standard legal documents, and replacing those with a heading:

"Dispute and Issue Resolution"

In case an issue contest claim or difference should arise between the parties to this contract, the parties may not resort to litigation to resolve such dispute issue or matter without first observing the following alternative dispute resolution procedures:

(1) Negotiation 28 days
(2) Valuation of subject property by one valuer if parties can both agree upon one, failing that two. The valuers may appoint an umpire in all instances acting as experts 28 days.
(3) Appraisal: if either of the parties is not satisfied as a result of the valuation or negotiation procedure, an independent appraisal by a party agreed upon between the parties or failing agreement as nominated by the Institute of Arbitrators 7 days.
(4) Conciliation 14 days, by a conciliator agreed upon between both parties, or appointed by the Institute of Arbitrators.
(5) Mediation - within 14 days a mediation meeting by a mediator independently appointed by agreement, failing agreement by the Institute of Arbitrators, meeting with both parties and/or counsel or other representative, seeking to summarise the issues and resolve the issue matter or difference.
(6) Arbitration if all other dispute resolutions fail, then the parties may refer the matter thing or issue or differ- 0

ence to arbitration to one arbitrator if both can agree, failing agreement then to determination by the appointment of two arbitrators, one by each party who shall appoint an umpire and otherwise subject to the terms of this agreement to conduct such arbitration pursuant to the Arbitration Act 1908".

I believe that these standards would make the cogs of dispute turn more smoothly and resolve matters more effectively according to the scale, priority and importance in a more orderly fashion than currently takes place. This is an enormous topic and this articlerepresents only a hint of my views,so that its appropriateness in rent review procedures can be discussed from the point of view of the relevant disciplines.

Experts' Procedures

There is not a great deal that can be said that is not very much a matter of common sense, and experts must remember to simply follow their own professional disciplines; obtain waivers, disclaimers, and indemnities.

You are free to conduct some aspects of a hearing, perhaps to call evidence or see the parties. However, just remember to adopt the rule of law standard in so doing. In other words, adopt those procedures by consent and make sure that both parties fully understand and agree with what you are doing.

Commit instructions to writing as soon as received, be clear in so doing that you are acting as expert and not arbitrator. Make sure also that clients understand the subtle difference.

In conclusion, present a report or finding on the subject matter that has been referred to you, again making it clear that your finding or subject matter is given as an expert and ensure that you have read the entire contract, whether it be a lease, a building agreement, or otherwise, and finally, if in doubt about a matter of interpretation, take advice. If it is necessary, reserve that right together with the right to recover the cost of doing same in your initial instructions.

Arbitration and Arbitration Procedures

This again can be a very lengthy topic. As a valuer, you will come into an arbitration on a rent review dispute either on the reference as arbitrator or in the proceedings as a witness. 'As' an arbitrator, you are appointed by contract between the parties, or you may have the job arising from a Court order. In either event, you can't be sued for negligence.

The standard procedure for dealing with arbitrations involves the following:

(1) Anagreementinwritingwhichiscalled "the reference" signed by both parties.
(2) An acceptance to act on the reference by the arbitrator again in writing at which time he must consider the terms (the cost) of accepting the appointment and whether security for that cost is warranted. He should also ensure that he has an indemnity in the reference, and that he is entirely satisfied with the terms of the reference.
(3) A preliminary meeting is held with the parties or their counsel to determine matters of procedure. The golden rule is do everything by consent. If you have to make an order, make sure you are legally correct.
(4) Following the preliminary meeting at which a timetable is fixed between the parties, the claimant and respondent will each submit and file their particulars of claim, and in due course normally theirevidencein writingprior to the hearing. A hearing is fixed at which either party presents their submissions to the arbitrator, and any evidence to be called. The other side is entitled to cross-examine. Proceedings are conducted formally and witnesses may be excluded. Evidence is taken on oath. When the arbitrator retires or reserves his decision, it will be final and binding on the parties unless the arbitrator makes an error of law in his decision which would entitle a disappointed party to go to the High Court to move to set aside the Award, which means cancelling it for some technical failure, or remission, because he has made a fundamental mistake of law, but where it is capable of being corrected. Technically, an Award can be set aside for misconduct of the arbitration. That does not mean the arbitrator has misbehaved but simply that he hasn't followed the rules correctly in the conduct of an arbitration. An arbitrator is entitled to take legal advice and normally in the terms of reference there will be the ability for him to consult with experts on particular matters, or take advice in order to come to a proper decision. The Award is a decision in writing with reasons attached and which is normally uplifted when it is paid for.

As to the appropriateness of an arbitrator, independence is important. If there is no other mode of reference provided, the reference will be to a single arbitrator. If the reference is to two or more arbitrators, they must appoint an umpire immediately after they are themselves appointed. If the arbitrators can't agree, then the umpire may enter on the reference in their place.

A High Court has authority to appoint arbitrators where the parties fail to agree, or the appointed one fails to act or dies, where they have failed to appoint an umpire, or the umpire fails to act or dies. The Court has general authority to make orders in respect of the arbitrator if there is an issue that cannot be resolved by the arbitrator. The arbitrator may also move the Court to assist by stating a case for a legal determination.

The advantage of arbitration is normally that you can choose your judge and choose your own timetable and conduct matters in absolute privacy. Historically, it is a feature of mercantile law arising from the various trade practices.

If there is a notice of appointment issued by one party which under the terms of the Arbitration Act may mean the other party is forced to accept that appointment unless they go to Court and have that appointment set aside. By agreement, arbitrations can be fixed on their documents only as a particular type of arbitration on an order to resolve a dispute. I point this out as it may be appropriate for rent review disputes.

However, anyone who undertakes an arbitration on documents only must make sure that the contract of reference is absolutely clear, so that the rules of natural justice in terms of direction, evidence and fair hearing etc. are not compromised in any way, otherwise the integrity of that arbitration will be at risk.

I take the opportunity of mentioning your rule in an arbitration as a witness. As a valuer, you would be accorded the status of being an expert witness where your qualifications, your experience, the extent to which you have researched the matter in hand, and your familiarity with the evidence are all very important matters.

In New Zealand, valuers being registered under the Valuers Act and, being registered, are required to furnish evidence of having acquired the necessary educational qualifications and experience provided by the Valuers Act, and that he or she has also obtained areasonable standard of professional competence. A registered valuer will normally be accepted by the

Courts as qualifying as an expert witness within the field of expertise of a valuer. Cases presented without expert valuation evidence involving land valuation proceedings can have little hope of success.

It is important that an expert's report to be acceptable requires:

(1) Thatthewitnessisfully andadequately briefed by his client, and that the matter is discussed with the client's legal adviser.
(2) The witness should be thoroughly familiar with the subject matter of the report.
(3) If expert assistance in the form of surveying or engineering or financial evidence is required, then that additional expertise should be incorporated in supplementary reports, and the authors should be available to give evidence. Any doubts about factual matters should be cleared with the client's legal adviser before the report is completed.
(4) The report should be prepared in a clear logical sequence by traversing the facts and then giving the opinion. The final draft report should be discussed with the client's legal adviser. I have touched on this point merely to say that there are particular standards to be observed if you are acting as a professional witness in an arbitration, indeed in any legal proceedings. If I can summarise the whole issue in two or three sentences.

The valuer must know whether he or she is acting as expert or arbitrator or witness. They must know whether they are in negotiation or dispute and, if so, at what point. Finally, they must be able to read clearly the terms of the lease, in particular the review clause, and know what factors are to be taken in to account in fixing the rent upwards or downwards, and whether they are obliged to follow an objective or subjective test in that process.

Do have matters in writing, and do use good precedents no matter what combination of circumstances are being dealt with to ensure that the task is being handled appropriately, and that procedures are followed correctly, and the result recorded in a manner that will not leave you open to criticism.A

APPENDIX

THE VALUER'S ROLE IN THE RENT REVIEW PROCESS

KEY WORDS

Expert Arbitrator, Adviser, Witness
Objective/subjective
Negotiation
Dispute

EXPERT GUIDELINES

1 Instructing letter with copy of lease, copy of rent review clause, and request to act as expert not arbitrator.
2 Acceptance in writing as expertnot arbitrator. Timetable requirements (if any) including any meeting with the parties or party.
3 Written report as expert with disclaimer and indemnity as may be appropriate.

ARBITRATION GUIDELINES

1 Submission.
2 Agreement to arbitrate attach lease and rent review clause.
3 Acceptance by arbitrator in writing and terms.
4 Ifreference to arbitrators and umpires,preliminary negotiations between arbitrators to see if agreement can bereached, in the absence of agreementreference to the umpire for hearing, orby hearing of two arbitrators chaired by the umpire. The options depend upon the terms of reference.

If to one arbitrator only and in all cases:

(a) proceed to preliminary meeting;
(b) timetable for proceedings including dates for points of claim and particulars of claim and affidavits;
(c) provision for interrogatories and discovery; (d) fix hearing date;
(e) exchange briefs of evidence;
(f) hearing;
(g) issue of Award.

Judicial v Practical Rental Valuation : Principles and Methodology

by R L Jefferies

Basic traditional rental methods up to the 1960s had varied little from the first world war era due largely to various forms of economic regulation and rent control in particular which fixed rentals according to set formulae in the statutes applying.

When I studied valuation in the early 1960's, rent was rent. It was simple, almost universally understood, and fixed by demand and supply, except for the vestiges of rent controlled tenancies in New Zealand applying to only a few `protected' tenants. Long leases were generally the vogue and with relatively low inflation rent reviews were rarely less than five-yearly and disputes were generally infrequent or non-contentious. One simply made a `like for like' market comparison with similar space.

Rental valuation methodology concentrated on the various techniques used, such as the principles and applications of rental depth tables, area or zonal methods. This was all on the presumption of dealing with willing lessors and prudent willing lessees *(DIC'* and *F R Evans2* cases). The sophistications to creep in during the 1970's were in response to the need to adjust for physical differences in modem buildings such as variations in quality, finishes, services provided and elevation or view in office buildings.

In the 1970's, with the early booms and busts of a developing property market, adjustments for time and different lengths of rental terms were the issues of the day. With the advent of the net lease, the complications revolved around the need to adjust for differences in recoverable operating expenses so as to make comparisons on a total occupancy cost basis.

It was largely the world of the valuers, and when disputes arose they were expeditiously dealt with by valuers acting as expert advisers, arbitrators or their umpires. Leases were mainly of a simple preprinted kind approved by the local law society. These contracts invariably provided for future rentals simply to be "agreed between the parties or settled by arbitration". In the latter event, the procedures were set out in legislation.

Rental definitions were rarely disputed, the key assumptions being those of an open market consisting of willing lessors and willing lessees, paralleling recognised statutory definitions of market value, and case precedents involving compensation, or rating valuations.

Contemporary controversy

Today, however, it is a different world. Rental disputes are big business, particularly in a depressed market where the professionals involved are making a meal ticket out of diverging opinion, in advising lessors who are desperate for cashflow to buoy up falling property values; while on the other hand, advising lessees who are frequently hard pressed to keep up with present rental payments in a contracting economy let alone pay increases, however justified!

Rental disputes are big business ...

The battleground has therefore turned to the interpretation of the lease and the rental review process, driven in many cases by legal advice and precedent which are directing valuers in terms of legal valuation principles which have tended to take over in importance from technical valuation methodology, opinion and skill. It is a realm of unreality bred by cunningly worded leases or simply worded leases caught up in the web of legal interpretations, tests, regards, disregards, precedents, and other artificialities.

The effect has been to almost remove rental determination from down-to-earth common sense comparisons and into quasi-legal interpretive nightmare for those valuers at the'coal face' of advising lessors and lessees as to what rental should apply in any given circumstance.

This paper seeks to expose the issues in the context of *a joust* between the legal and valuations professions, based on some case precedents and personal experience, and hopefully point to some reformation taking place that may lift us out of the current dark age of legal suffocation. Unfortunately for valuers the lawyers currently have the longer *lances.*

A rental obstacle course

I liken the contemporary formal rental review determination process, (as practised in New Zealand and from reading the commentators in Australia and the United Kingdom), to an obstacle course arising out of a contingency plan to settle possible disputes within a wider pact the lease of premises.

The basic rules are outlined years before in the lease mainly by the lessor's solicitor with the lessee's solicitor casting his eye over it, usually after all the essential points have been agreed between the parties, with scant regard for the future legal or valuation obstacles which could arise in practice over a dispute over the amount of rent.

When disputes at the rent review intervals arise, the contingency plan comes into effect. If not settled amicably before

the contest, the lessor and lessee, with their respective valuers, counsel and arbitrators form their opposing teams and run the set course, the umpire (not infrequently appointed by the valuers' or lawyers' association's President) adding up the point as to how each team gets over or under each obstacle along the way. The winners are not declared there and then butinanaward, `published' attheumpire's convenience sometime later after the parties pay the umpire's fees and costs.

Unfortunately, the contest doesn't end there as the umpire's decision is able to be challenged with the ultimate score being settled by a judge in some remote court well after the eventbased on legal submissions by counsel who, like the judge, have not witnessed the contests. The judge has the power to decide the issue on the legal argument presented, or remit the arbitration back to the umpire to reconsider any of his or her decisions, interpretations or opinions on the basis of the judge's direction formulated on the basis ofprecedents set by other challenges at another time, place or country over different terrain and under differing rules. The umpire, if unable to finalise the matter by a reconsideration of the contest records, may require a replay of the of finding part of the contest!

..an array of different competing legal tests, lease formats, precedents and rental definitions are creating enormous problems for valuers, lessors, lessees, property owners and managers.

This obstacle course is illustrated in the diagrammatic view of judicial versus practical rental valuation(over page), and shows the impact of legal decisions on the disintegration of traditional `like for like' rental valuation methodology. This covers the time period since the 1970's to a point where we now have an array of different competing legal tests, lease formats, precedents and rental definitions which are creating enormous problems for valuers, lessors, lessees, property owners and managers.

Other recent writers and commentators have variously described the modern rental determination scenario as a "hypothetical world', and "impenetrable b og", a "legal minefield"3, or "likened to a game"6.

Not withstanding these scenarios, many rental reviews are achieved between the parties, usually with professional valuation advice, and it is the exception rather than the rule for these disputes to escalate to a formal arbitration hearing and then suffer the challenge of the arbitrator's or umpire's award in the courts. However, for those who, like myself have had their awards challenged in this way and set aside or remitted back for reconsideration, it is a confusing experience.

Intrusion of different lease terms

In the latterpart of the 1970's and the early 1980's it wasbecoming common to shorten the rent review term due largely as a response to rapidly rising property values coupled with unprecedented general inlfation.

It was clear from an empirical study of the market that lessees taking up new long term leases with long rental periods were prepared to pay a higher level of rental than for shorter rental review periods.

Various mathematical formula' were put forward to 'equate' these differences, but generally an element of arbitrary 'rule of thumb' prevailed in use by valuers to make adjustments for various terms. These types of adjustment received the endorsement in principle by the courts, such as in the *U.K. National Westminster'* and *Bracknell'* cases and *theNZFeltex vJBL10* case.

The injection of the objective or subjective test

A further extension of the intrusion of judicial valuation into the rental review process was the imposition of an artificial legal dichotomy in terms of the "objective" or "subjective" test which extends down from the UK authorities in the *Ponsford", Bates`- and Lear v Blizzard* [13] cases. *Ponsford* held that "a reasonable rent for the premises" would be that based on market value without reference to the particular parties or how the premises were built or paid for, i.e. objectively; while in *Bates and Lear & Blizzard " a* rent to be agreed between the parties" should be a fair rent in the circumstances taking into account all the considerations which would have affected the minds of the parties as if they had been negotiating the rent themselves, i.e. subjectively.

The implications are quite serious for the interpretation of older local lease documents prepared by solicitors, adopting standard or `sold over the counter' formats with simple wording, signed by parties totally oblivious to such implications for future rent reviews.

Until the late 1970's, property owners, lessees and their legal advisers drew up simple lease documents with wording which was not intended to be sophisticated nor intended anything other than reaching a fair rent on an objective basis.

These Court cases deal with semantics and fine literal interpretations of the meaning and construction of words almost devoid of any practical thought for the market and how such things are to operate in commercial practice. The basic concept of fairness of an objective assessment is simple enough, but as we will see, even this has now been complicated, also into realms of unreality in some cases. The subjective test, when the parties themselves are in dispute, requires a valuer, arbitrator or umpire to be a sage and mind reader. Fairness has now been turned from being objective to being subjective. t

Judicial versus practical rental valuation

Basic traditional rental valuation methods (up to 1970's)

Based on `like for like' comparisons of similar premises
- the willing lessor-willing lessee assumption *(F R Evans* case)
- normal terms & conditions found in the market
- prudent lessee test (DIC case)

Intrusion of variable lease terms (1970's to 1980's)

Based on comparables (as above) but with adjustments for variable length terms (2,3,5 years etc.)
(National Westminster, Bracknell, Feltex cases)

Injection of the objective or subjective test (late 1970's/early 1980's)

Based primarily on determining the objective or subjective literal meaning of the rent review/renewal clause in the lease

	OBJECTIVE TEST	SUBJECTIVE TEST
	Based on the market rental of the demised premises by comparison to comparable premises *(Ponsford* case)	Based on what the parties would have agreed having regard to the: - intentions of the parties - lessee's cost of improvements *(Bates, Lear v Bilizzard* cases)
Restrictive user clause (since 1979)	Based on above with adeductionforrestricted use or by comparison to other restricted use premises *(Plinth Burns Philp, Basingstoke* cases)	As above but also allowance for restricted use
Strictures of `regards' & `disregards' constraints (from mid 1980's)	As above but validity of objective comparisons affected by having to regard or disregard factors affecting subject premises or rental terms i.e. - use restraints; certain lessee's improvements; condition of premises; incentives etc. *(GREA, Pleasurama, Norwich* cases)	Comparables merely a starting point with further adjustments as above and as for objective considerations for regards and disregards *(Dimock* case)
Claims of a multi-tiered market (from late 1980's)	Open market v review rents: - locked in tenants *(BHP, Edmund Barton, Landsborough* cases)	All as above and as for objective test beside
Relevancy of the affordability test (1990)	All as above together with the possible requirement to take financial evidence as to affordability into account based on relevancy *(Modick* case)	All as above together with the requirement to take financial evidence as to affordability into account based on materiality. *(Modick,* ARC cases)
Inducements (1991)	Problems of confidentiality packages *(Central Plaza, Grosvenor, Trust Bank* cases)	All as above and as for objective test beside

One of the problems that results when *a subjective* assessment is to be made is that the valuer, arbitrator or umpire is required to take into account matters for which there is no clear factual evidence: i.e. what this actual landlord, if reasonable, and his tenant, if reasonable, would come to an agreement on. In practice reasonable landlords and tenants settle their disputes and it is only where they are *unreasonable* that they go to arbitration. The parties at an arbitration are rarely reasonable and often at loggerheads with each other. Making inquiries of, or examining, the parties and their intentions frequently leads nowhere. This is especially so where recollections differ or where irrelevancies and personality differences cloud the issue, and polarise the parties' positions. The testis more what they would have agreed had they not been *unreasonable!*

Even where it is only a matter of the rental value of lessee's improvements which the subjective test requires to be excluded from the rental (in the absence of specific direction in the lease to the contrary) it requires the valuer or arbitrator to make artificial assumptions as to what the premises would be like if the improvements had not been done. In some cases this could reduce the premises to an uninhabitable or unlettable condition for which no comparable rental basis could be found. Making a fair allowance for the cost of the lessee's improvements in such circumstances requires more wisdom than Solomon's and is inevitably arbitrary.

Restrictive user clauses

Restrictive user clauses in leases were introduced conceptually as a protection to both lessor and lessee. In retail situations they were introduced to protect the lessee from competition from similar uses in the same development. With specialised premises, especially where special town planning or development consents or licenses could be lost by a non-complying change of use, they were a protection for the lessor and lessee alike. Frequently a specialised use involved apremium rental compared to otherwise similar premises to reflect the consents obtained or specialised finishes or other design for the tenant's particular use. However, there was a legal sting in the tail of these provisions following the Plinth [14] case where the use was restricted `to offices... in connection with the lessee's business of consulting engineers'.

This seta precedent that restrictive use clauses were generally regarded as detrimental and lead to deductions being made from otherwise comparable rentals because of a perceived more limited demand for such premises.

Other cases have followed these principles in providing deductions from a normal rental for the restrictive use such as the *Duvan Estates 11* and UDS *Tailoring* [16] cases. These have endorsed the interpretation that ordinarily one must assume that the landlord will enforce the restriction, even if there is a clause allowing a change of use which the landlord cannot unreasonably withhold consent to, unless it has already been relaxed before the date at which the rent is being reviewed or the landlord has indicated an intention of doing so, such as in the *Burns Philp17* case.

However, the Courts have recently been reluctant to allow a literal interpretation which produces an injustice between the parties or offends business common sense such as in the leading *British* Gas1e case, or offends natural justice as in the recent *Glofields19* case, or where the tenant would pay for something which the tenant was not getting, such as in the *Basingstoke'°- and British Home Stores21* cases.

Restrictive use clauses, however, do not always lead to reduction in rental value such as in the recent NZ Court of Appeal *Fencible Courts* case involving a ground rental in which I was the umpire. The Court held that it needs to be shown that the restricted use in fact causes an influence on value. Though I had made an error of law in my interpretation of the lease, in not taking the restriction on use into account, it had not materially affected my valuation. The Court of Appeal allowed the appeal to the Supreme Court's decision setting aside my award, thus upholding my ground rental determination.

Very recently, the New South Wales Supreme Court in *Horwitz73* case, where a arbitrator had been in error in his assumptions and had relied on wrong legal advice in respect of the effect of restrictive user clause, the Court held that the error was not of such a nature that justified the setting aside of the award.

This principle of allowing for restrictive use clauses has also been extended to other restrictive clauses in leases which have been considered onerous compared to 'normal' terms and conditions found in leases of comparable properties, eg onerous repair or replacement provisions, as in the *British Craft"`* case and *Norwich Union Life '3* cases.

I was recently umpiring a dispute over the rental of an office building where deductions were being claimed by the lessee's valuer, from the level of rentals set by comparable space, for a restrictive assignment clause; restrictive time-of-the-essence responses to rent review advices from the landlord; an onerous air-conditioning and external maintenance obligation on the lessee because of plant failure and that the building was leaking, despite the lessor's efforts to mitigate the damage; a specified method of floor area measurement which included normally common space; and other onerous terms and conditions. After being supplied with and perusing of all the leases of the comparables I agreed the lease contained a combination of clauses more onerous to a greater or lesser degree, than found in all of the comparable rent reviews. I accordingly made varying deductions when comparing the subject space and its lease terms to each of the comparables.

Other examples include the *G R E A26* case where the tenant had taken possession of an unfinished office building and completed it, which illustrates the valuation difficulty of imagining it as still a shell; or the *Pleasurama27* case where the tenant had to reinstate a dolphinarium at the end of the term; or the *Norwich Union Life* case where the lessee covenanted to "...where necessary to rebuild, reconstruct or replace.." the lessor's building.

The strictures of the 'regards and disregards' constraints

Flowing from the *Ponsford* decision, solicitors preparing leases, particularly acting for landlords, started to look more closely at the rent review clauses and in an attempt to provide for their client's interests and avoid future disputes began to set out various regards and disregards which the valuers, arbitrators or umpire in an arbitration should take into account. Unfortunately some of these lead to ambiguities, impracticalities, and instead of solving future problems have caused legal valuation problems at review. This is especially so where these have the effect of negating past legal precedents, ignoring normal valuation comparisons or requiring hypothetical assumptions not found in the market, or having to envisage the premises in a totally different state to the actual, or the lease not containing the terms the tenancy does have, or imagining it had different ones.

A New Zealand example is the *Dimock2s* case, where as umpire I stated a case to the High Court seeking directions where the lease required a subjective "rent to be agreed" but subject to a specific 0

requirement that the lessee partially demolish the existing building and reconstruct it to make it suitable for a car sales showroom.

There was a specific formula in the rent review clause to provide for the lessor to refund the cost of improvements paid for by the lessee up to a certain maximum amount. The lessee had spent an excess over the maximum and was claiming a reduction in the rent on account of the excess expenditure.The Court held that I had been wrong at law in an interim award that no allowance should be made for the lessee's excess improvements cost, despite the existence of the specific formula provision in the lease limiting thereimbursement. Although fair, this decision results in the rental being further reduced, effectively reimbursing the lessee above the maximum agreed in the contract.

Another recent arbitration I was umpiring, involved prominent retail prem ises occupied by a bank. The lease restricted the use to banking premises and the valuer for the lessor sought to show that banks were paying premium rentals compared to otherretail uses and that the rent should therefore include a premium. The lease required the "current market rent" to be fixed "by comparison to comparable premises" but also, as part of the regards and disregards in the rental definition, required the umpireto "consider any other use to which premises may be lawfully put". The legal issue was whether the *Plinth* decision must be taken into account or whether the "regard" clause negated the user clause restriction in fixing the rent.

The lessor's counsel relied on the *United Sharebrokers* 29 case where Tipping J, referring to an identical subclause, stated

"The umpire is certainly entitled to take particular heed of comparability, both in respect of the premises themselves and in respect of similarity of tenure".

He therefore argued that I was bound to rely on applying premium rentals paid by banks in the market. the lessee's counsel argued that the "regard" was designed to overcome the *Plinth* Wile and I was required to only take into account those uses not forbidden by zoning or otherwise illegal and to leave out of account, whether as a factor increasing or reducing the rental, the effect of the restrictive user clause. I sought a senior counsel's opinion who, relying also on the *Basingstoke* case, advised me that though the "regard" did effectively negate Plinth, there was nothing which authorised me to disregard the fact that banking premises command premium rentals (if any). In other words the clauses gave the landlord the best of both worlds. In the event I found the evidence did not support any premium, but had it done so I would have allowed for it.

Two very recent Australian Supreme Court cases involving the *Central Plaza One30* in Brisbane, and *GrosvenorPlace31* in Sydney, illustrate the confusion and ambiguity that arises in seeking to determine "open market rental" or "market rental value" when the valuer has to "disregard" vital matters, such as incentives, rent-free periods etc (also affected by confidentiality clauses see later heading) which apply to comparable premises which are intrinsic in interpreting such rentals to find true rental value.

In interpreting the similar lease review clauses involved, the New South Wales judge in the second case held that non-cash incentives could be said to be "paid or payable" and thus, incentives were not to be considered by the valuers, being an opposite view to the Queensland judge in the first case who held that the open market rental applicable would have to take into account the incentives being paid to other tenants in the market. (The Queensland case is under appeal). If the legal profession can't sort out a sensible solution what hope is there for the confused valuer!

Two-tier market claims

During the ups and downs of the recent property cycles, especially in Australian and New Zealand, there have been claims of the existence of a "two-tiere(f" or "multi-tiered" market particularly in office space.The claim has arisen with the review of space occupied by "locked in" tenants who claim that frequently other tenants accept rentals at levels above the open market for various reasons, and that market rentals should be solely based on new lettings. (This also involves the thorny problems of incentives, rent free periods, free fitouts and confidentiality packages.)

Dr Whipple raised the issue in 19803 and since then34 the Australi[an] *BHP* [35] and *Edmund Barton* 36 cases have held that the valuer is entitled to look at all facets of the market but then seems to suggest that the valuer should ignore special discounts, such as incentives.

In New Zealand there has been one appeal to the high Court on this point, being the *United Sharebrokers* case, which dealt with an appeal against the umpire's award in respect of an arbitration of office space in Christchurch. The judge, by way of *obiter dicta,* gives the profession some disquiet in that he gave judicial recognition to the existence of a multi-tier market, namely new leasings, renewals of existing leases, and rent review within existing leases, based on evidence placed by the lessor's valuer before the umpire. The lessor's valuer relied on the evidence of rent reviews. The lessee's valuer submitted it was the umpire's duty to consider all evidence.

This was a case in which the lessee sought to have the umpire's award set aside for misconduct and error of law, on the basis of the umpire failing to give sufficient weight to all the evidence including new leasings, but was unsuccessful.

Empirical research undertaken by Tay37 of the Auckland CBD office market in 1990 identified five classes of office rentals.

1. Ratchet clauses: rentals maintained upon review in pursuance of a 'ratchet clause'.
2. Contract rentals: for new lettings before discounting for incentives.
3. Effective rentals: for new lettings after discounting for incentives.
4. Reviewed rentals: determined on a comparative objective basis.
5. Subjective rentals: determined on a subjective basis.

Tay found that subjective rentals are not likely to form a `tier' of their own due to their subjective and individual nature. Ratchet clause rentals are likely to be the highest of all in a declining or stagnant market followed by contract rentals for new leases. The empirical data of Auckland CBD office rentals showed no distinct disparity between effective rentals for new lettings and reviewed rentals.

However, a two-tier structure did exist between the latter and contract rentals, the latter being about 15% higher than reviewed rentals. Both new lettings and reviewed rentals were considered relevant to marketrental valuations and arbitrations provided adjustments are made to discount concessions enjoyed by new tenants. Thus consistency between adjusted and reviewed rentals shows that new lettings and reviews can be reconciled in practice.

Parker3s comes to the conclusion, from an Australian and international perspective, that incentives will always be associated with initial lettings of new developments, but as a general market phenomenon is largely a symptom of over-supply

which with an increment in demand will become irrelevant.

The problem of a two-tier market (if it really existed) is more apparent than real and may be relatively short lived as the office market re-adjusts to a change in demand and supply, with new leasings being entered into without ratchet clauses, and as incentives fall out of favour. The taxation offices on both sides of the Tasman, such as in the Australian Full Federal Court *Cooling'ss* case being looked at by Inland Revenue in New Zealand, may be more effective in curbing this latter device to fudge the market, by taxing these incentives for first lettings.

The implications for both valuers and accountants are complex, however, and open the way for further controversy and seeking legal ways of circumventing the tax liability, as had drawn considerable comment in *The Val uer* journal. (See also later heading on *inducements* and the *public interest).*

Relevancy of the profitability test - the lessee's ability to pay

This curly legal and valuation problem has been around in various guises for some time, but as a result of the *Ponsford* case and where a subjective test is to be applied it raises a new test of relevancy and materiality. The issue has somewhat captivated the property industry in New Zealand in following the litigation over the rental review of the property involved in the *Dimock* case, in a subsequent review (with a change of lessee's name) in the *Modick'0* case being a case stated to the High Court by the umpire. The decision of the Chief Justice, Sir Thomas Eichelbaum was appealed" the issue being as to whether regard had to be taken of the profitability or otherwise of the actual business conducted on the leased premises, and if so to what extent the financial situation of the actual lessee was relevant.

In the Court of Appeal, Cooke P summarised the position as :

"The essence of the judgment of the Chief Justice was that the so called subjective approach was appropriate and that the profitability or unprofitability of the tenant's business would be relevant if reasonable persons in the shoes of the parties would have taken it into account. It wasfor the arbitrator to determine whether or not they would have done so and, if Yes, with what effect on the agreed rent... Inevitably it follows, as the Chief Justice held, that the arbitrator should have taken the tenant's trading results into account if he found (the question being for him) that a reasonable landlord and a reasonable tenant would have done so in their negotiations. The arbitrator does not appear to have *addressed himself to that question. Accordingly the award was rightly remitted to him for reconsideration."*

The Chief Justice, in his judgment, had added two further conclusions:

"It may be surprising to many landlords and tenants to learn that the financial accounts of the business carried on by the tenants in the demised premises are of any relevance .....That it must be said is largely a function of the form of the present rent review clause, one which may well have been chosen deliberately in view of the building clause in the lease. I say 'largely' because from the references to case law in this judgment it will become apparent that such financial evidence may *be relevant even with an 'objective' review. Secondly, counsel for the lessee accepted that sauce for the goose would have to be sauce for the gander too. If the tenant's use of the premises appeared to be especially profitable, no doubt landlords would be interested in exploring the tenant's accounts."*

This concluding part of the Chief Justice's decision in particular, had sent a "shock wave" through the profession in New Zealand, simply adding to the problems and confusion over rent reviews in the property market and especially amongst valuers who are at the "coal face" of making these rental determinations.

The Court of Appeal decision, however, contains some helpful interpretive directions, especially the test of relevancy as it impacts on the practical resolution of these matters.

Cooke P stated in his judgment that:

"the question must be what rent should fairly be paid for the premises during the relevant period by a reasonable motor vehicle dealer. Presumably a reasonable motor vehicle dealer would give prominence to potential profitability... Even where rent is expressly required to be fixed on an open market basis, evidence of the trading results that have been or can be achieved in the particular premises is relevant unless there is enough other evidence to establish the figure satisfactorily... Each case must turn on its own facts and there certainly should be no general practice of requiring accounts. But in cases where there is real doubt as to whether a fair economic rent can be otherwise be ascertained, such accounts are likely to be relevant. It will be for the arbitrator to decide whether or not his is one of those cases."

Gault J in his judgment added:

"it is for the arbitrator to determine also whether particular evidence of accounts is helpful. It is to be emphasised, however, that the relevance of such accounts is not to establish what the lessee can afford to pay, but to bear upon what would be a reasonable rent over the period for which the rent is to be fixed in all the circumstances and in light of the use restriction in the lease."

HardieBoysJin hisjudgment added: "The profitability of a business for which the site is suitable, and even more the profitability of a business of the only kind that is able to be carried on the site, may well have a bearing on the value of the property and the rental to be obtained from it. The valuer or arbitrator is unlikely to be an accountant or an *expert in business management, and so is likely to look to true, ie. contemporary, market rentals of real comparability as a better guide than the lessee's own accounts, for they may reflect factors peculiar to business rather than factors relevant to the rental value of the property. But in so far as they bear on the latter, they will be relevant ..... The relevancy of evidence as to profitability must necessarily be limited. the importantdistinctionisbetweenevidence that is related to the rental value of the property as between lessor and lessee on the one hand, and evidence as to the ability or the willingness or reluctance of the lessee to pay a particular rent on the other.*

The judgements are well worth reading in full as the above extracts omit much of the reasoning and references to other precedents.(See December 1991 NZVJ.)

Practical applications

The plethora of cases have created a hypothetical "legal" maze through which the valuer has to twist and turn to reach a determination of a "rental" not really relfected in the common real world or market place.

Basic valuation methodology of a "like for like" comparison based on similar premises (as shown at the top of the diagram) has almost been totally overcome by the legal complexities due largely to the implications of these court cases. Lessors' solicitors have written more and more complex, and often ambiguous 0

"regards" and "disregards" clauses in rental definitions in leases to try and counteract the effect of those legal precedents. Even the Courts are having difficulty in bringing about a sensible construction to these commercial contracts, such as in the cases involving the *Central Plaza One and Grosvenor Place.*

In a hard market with boom conditions lessors tend to have the upper hand and be able to get their solicitors to write very favourable leases which lessees can often do little to reject or amend substantially in negotiations, especially in the rush to take up the space or accept a deal when other prospective lessees are competing for the space. The soft current market has tended to reverse that position with less onerous clauses only being acceptable in a lessee's market, and even some leases are being written without ratchet clauses, and fewer regards and disregards that favour the landlord.

The practical problem is that when valuers get to the point where they are unable to make like for like comparisons, the tools of valuation no longer apply. The problem escalates as the dispute between valuers becomes the dispute between lessors and lessees who are unable to resolve the legal issues to each parties' satisfaction.

Legal opinion is sought and the law has been so open for different interpretations that the dispute escalates into a legal one. This forces the determination before the arbitrators or their umpire incurring significant extensions of the time and costs including the evidence of accountants, economists, solicitors and Counsel representing the parties.

Even then, such evidence is often totally confusing and contrary between the parties. Even a case stated to the courts for a ruling or interpretation may still be unsatisfactory, or at worse further complicate the practical solutions to these rental determinations.

In practice, *m*any valuer arbitrators or umpires faced with such a situation, particularly when struggling with the relevancy of the actual financial accounts of the lessee would find it impossible to translate these into what a hypothetical set of accounts would be for the likely 'reasonable' business that could be carried on in the premises. The evidence would have to be overwhelming, clear, concise and well supported for an umpire to be able to take the financial accounts into the situations on a subjective basis, let alone under an objective test which Sir Thomas Eichelbaum CH says "...that such financial evidence may be relevant even with an "objective view" (note word "evidence" as distinct from "accounts" used in previous para in the judgment). The Court of Appeal decision still leaves open this requirement to consider the relevancy of the financial evidence relating to a typical lessee even under an "objective"test.

The tempting solution for the valuer, arbitrator or umpire is simply to come to the conclusion that it really makes no difference whether it is a subjective or objective test or whether to take into account the financial affairs of the lessee, having considered all that information, placing no weight on such things and make judgments on the traditional or arbitrary methods.

If the umpire does such an Award without explanation, then he or she can get away with it, but the modern trend is for arbitrators and umpires to give explanations in 'speaking' awards or by an annexe which are not final when the Courts can overturn them on a point of law.

Specific practical applications of the Modick decision requires clear identification of the lessee/occupier and the analysis of the lessee's financial accounts in all situations. This requires the exclusion of aspects of the business not actually carried out on the premises which may involve only being a branch of a large organisation or a business which operates not solely in the subject premises but elsewhere as well. Such accounts, if they can be so prepared, and be reliable, still disregards any alternative uses or other businesses which could operate more efficiently in the premises.

As a general practical application, any valuer or arbitrator/umpire who does not consider (even to reject or place no weight on) such financial accounts could run the risk of having misconducted the proceedings, and/or having the award remitted back just for thatconsideration to be made, as in the *Modick* case. However, the *Fencible Court* case is only partly helpful here, in that for an appeal to succeed it is a requirement to show that the answer would have been materially different. How this can be determined by the Court without re-hearing the evidence, or in case of doubt remitting the award for re-hearing

..it seems..quite impractical to.. take into account the financial accounts of the business.. but to exclude the lessee's ability to pay

by the arbitrator/umpire, leaves an impracticality that needs to be clarified.

In summary, it seems to me quite impractical to be required to take into account the financial accounts of the business operated in the premises but to exclude the lessee's ability to pay. The latter must logically follow from the former. If one cannot consider the latter then there is no point in analysing the former.

In many cases, a typical business activity will involve assets other than the real estate such as chattels, plant, stock and working capital and depend very highly upon the business efficiency, management, skill, expertise or entrepreneurial flare of the lessee. How one then relates that to a fair rental will depend on accounting evidence as to the relationship of rentals for typical businesses to their profitability. If that evidence comes from other businesses where their lease rentals have been determined on an objective basis, or where based on a different scale of operations, or size or qualityof premises, then there is no validity in showing these ratios reflect an ability to pay that can be applied to the subject premises. Thus the whole exercise is futile.

If one has to carry out a broader inquiry into what the normal profitability would be of a typical or hypothetical business in thepremises this would involve the multiple analysis of business or industry accounts, and is well beyond the expertise of most normal valuers as well as involving usually unjustifiable cost and expense in relationship to the amount in dispute. It is totally impractical.

This type of enquiry goes far beyond a practical valuation exercise and well away from the traditional concepts of like for like premises comparisons.

Statutory reform

In my view, but it is probably impossible to achieve, the law (The Property Law Act 1952 is currently being revised in New Zealand) should provide for implied covenants in leases and state categorically that all property rentals should be based *objectively* on the property's physical characteristics (howeverdefined therental is in the lease contract). This should be based upon like for like comparisons subject *onl y* to specific limited use clauses, restrictive covenants, or specific and unambiguous regards and disregards when found in the leases. Thus only where the lease provides for specific reference for the rental to be based *upon* or have regard to lessee's improvements, other specific considerations or the profitability of the

allowable business(es) in the premises, can it then be a subjective determination. The parties' intention should be clearly stated in the lease if other specific *subjective* factors must be taken into account.

Inducements, confidentiality packages and the public interest

The matter of inducements or incentives and how to handle them is a current contentious valuation issue 42 and not without its variations of treatment amongst valuers. In both the recent Australian cases involving the *Central Plaza* One and the *Grosvenor Place* buildings, the problem of confidentiality packages was discussed and recognition given to the problems valuers have in determining a marketrental due to the inability of obtaining essential factual data on inducements.

The Australian Institute of Valuers and Land Economists have very recently issued a policy statement on the effect of lease incentives43 with the tendency to secrecy clauses being deplored and encouraging full disclosure, as these are against the operation of an informed market, as well as warning of the serious repercussions for valuers who use information which due to non-disclosure may distort valuations.

This deadlock has recently been broken in New Zealand by the Court of Appeal in a decision involving an arbitration todetermine the headrentof *theTrustBank* Centre in Wellington [4]. The Court of Appeal upheld the High Court's refusal to set aside the lessee's right to serve subpoenas on third parties, being lessees of other buildings, whose comparable office space rental details and inducements were protected by confidentiality clauses in the agreements to lease with their lessors. This action has forced the disclosure of these details before the arbitration hearing so that the valuers and their umpire can be fully informed on the comparables used and can give them whatever weight is relevant and material in determining current market rental son review. Cooke Pin giving the Appeal Court's reason stated that notwithstanding that the lease required the umpire to act as an "expert" it was nevertheless an arbitration and the power existed to serve subpoenas. The right to set aside the subpoenas was overridden by the public interest, and the need for the umpire to get at the truth as to allegedly comparable rentals where available, so that genuine market rental levels could be fixed.(See *Legal Decisions* this issue.)

Though Australian (and other Commonwealth) jurisprudence may differ, especially as to the role of an "expert" or an "arbitrator" and their powers in rental determinations, the Australian Courts (and others) may well take note of the New Zealand judiciary's search for social justice to be achieved in the name of the public interest, and the implied responsibilities of professional valuers, arbitrators/umpires to find the truth behind new leasing deals in the market place. The issues should not go unnoticed also by the advocates of consumer affairs and fair trading.

This is a breath of fresh air for those involved in arbitration disputes and prepared to serve subpoenas thick and fast, but does not help the valuer in the general market place in advising lessors or lessees where access to such confidential information remains inaccessible. If the valuer knows about it by due legal process in another matter, he or she cannot disclose it or use that knowledge (however hard it is in practice to put such knowledge out of consideration). In the *Trust Bank Centre* arbitration, the arbitrator heard this evidence in camera but the resulting rental determination will reflect thatknowledge, and eventually the benefits of such secrecy packages which are designed to usurp free market knowledge and fairness in rental determinations will be unlocked, through the legal process of similar arbit a tions and the affect of their awards on other determinations. Use of this precedent is curerntlybeingconsidez dinothercasesinvolving property transactions (compensation, breach of contract, damages etc) in New Zealand to obtain information protected by secrecy or confidentiality arrangements, the success of which is yet to be known.

The re-ascendency of market rental

In the *Modick* case, the Court of Appeal also stressed the importance of the ability of valuers or umpires to be able to refer to genuine marketrents-that is rents freely arrived at in negotiation between the parties for new leases. Cooke P described the expression of "objective" and "subjective" as "not truly helpful", as under the second test to determine what reasonable parties would have agreed "itself poses an objective test of reasonableness" and later describes the inquiry as "a manifestation of the familiar willing vendor willing purchaser test".

Hardie Boys J considered the legal dichotomy as "Describing the former as an objective approach and the latter as subjective confuses rather than clarifies, for the second is objective too. .. It may well be that there is, or ought to be, no difference in the result between the two approaches". The difference emerges as being real rather than apparent in such circumstances (as in Ponsford) when the lessee is to pay rent for improvements effected by himself.

In the case concerning the *Trust Bank Centre,* the President of the Court of Appeal stressed again the importance of market rents: "that is to say rents freely arrived at in negotiations between the parties, by contrast to those arrived at in the captive circumstances of rent fixations." Gault J says "we emphasised the importance of establishing true comparisons" in referring to their previous decision in *Modick,* and ..."that will be facilitated by access to relevant information. There is a public interest in an open market unless special circumstances exist. In my view, it is important to get to the truth of comparable rentals where available so that proper rent levels are fixed"

In referring to the other landlord's detriment resulting from disclosure, he said "..(the plaintiff) no doubt will be seeking to establish new rents by reference to comparable market rentals and that, on my assessment, reflects the importance of an open market in the longer teem."

A glimmer of hope

Fortunately, news soon spread that the *Modick* decision had been appealed and the Court of Appeal's view was eagerly awaited, and it was of some relief to read the unanimous decisions of Court of Appeal judges in June of 1991. Though not reversing the lower court's decision or completely making the problems go away, it at least brings something of a breath of fresh air into a situation which had the makings of being intolerable, if notbeginning to roll back the tide of judicial interference in the sensible open market-based workings of the rental determination process.

> For justice to be done the law, which constrains valuers arbitrators and umpires in making rental valuation determinations must not only be clear but also seen to be fair...

In the New Zealand *Fencible Court* case and the New South Wales *Horwitz* case, the Courts have shown their 0

reluctance to interfere with the findings of an arbitrator or umpire and emphasised the need to encourage arbitration and respect arbitral awards unless a truly significant error of law with material consequences has occurred.

Having now been followedby the case in respect of the *Trust Bank Centre,* another of the impediments to achieve realistic market-based rental review determinations has been removed. These three New Zealand judgments have put the current problems involved in the judicial versus practical rental review determination process under the microscope of the law. In the process, they have brought fresh hope that the legal system is able to assist in solving rather than complicating the practical problems in a refreshing way that gives hope to the further unravelling of the legacies of *Ponsford, Bates, Plinth* and other cases which require valuers to make unfair or unrealistic assumptions.

For justice to be done the law which constrains valuers, arbitrators and umpires in making rental valuation and determinations must not only be clear but also seen to be fair, practical and have regard to the underlying commercial purposes of rent reviews. There are two ways this may be achieved:

1. by pressing for statutory reform to our property law and tenancy legislation to impose constraints on unfair practices, and to provide clear unambiguous presumed covenants applying to all leases; or
2. to have enlightened Court judgments which swing the pendulum away from literal interpretations creating legal straitjackets for those involved in the rental determination process, on the basis of relevancy, materiality and commercial common sense.

The latter is most welcome, appreciated and more of the same is hoped for.

Footnotes:

1. Drapery and importing Co of NZ v Wellington City Corporation [1912] 31 NZLR 598
2 F R Evans (Leeds) Ltd v English Electric Co Ltd [1977] 36 P & CR 185 [1977]245 EG 657
3 P Clark, The Hypothetical world of rent review [1989] 9/2 RRLR
4 M D Howe, Interpreting rent review clauses: A way through the bog? [1990] 10/4 RRLR
5 J Marshall Commercial rent reviews - a lawyer's perspective [1991] NZVJ June p.14
6 R M McGough Commercial rent reviews avaluer's perspective [1991] NZVJJunep 27
7 Such as that devised by Jack Rose [1979], see A Baum & G Sams, Statutory Valuations (1990) 2nd edn. Routledge, London at p 26; and W A Penman Rent Reviews [1985] NZ Val. 26/1 March p17
8 National Westminster Bank Ltd v B S C Footwear Ltd [1981] 257 EG 277
9 Bracknell Development Corporation v Greenlees Lennards Ltd [1981] 260 EG 500
10 Felten International Ltd v JBL Consolidated (in receivership) [1988] 1 NZLR 668
11 Ponsford and others v HMS Aerosols Ltd [1977] 1 WLR 1029 [1978] 2 All ER 837 [1979] AC 63,243 EG 743
12 Thomas Bates & Son Ltd v Wyndham's (Lingerie) Ltd, [1981] 1 All ER 1077
13 Lear and another v Blizzard [1983] 3 All ER 662
14 Plinth Property Investments Ltd v Mott, Hay and Anderson, [1979] 38 P&CR 361 [1979] 249 EG 1167
15 Duvan Estates Ltd v Rossette Sunshine Savories Ltd [1981] 261 EG 364
16 UDS Tailoring v BL Holdings Ltd [1982] 261 EG 49
17 Bums Philp Hardware Ltd v Howard Chia Pty Ltd [1987] 8 NSWLR 642
18 British Gas Company v Universities Superannuation Scheme Ltd [1986] 1 WLR 398, [1986] 277 EG 980
19 Glofield Properties Ltd v Morley (no.2) [1989] 32 EG49
20 Basingstoke & Deane Borough Council v Host Group Ltd [1988] 1 All ER 824, [1988] 1 WLR 348
21 British Home Stores Plc v Ransbrook Properties Ltd [1988] 16 EG 80
22 Manukau City Council v Fencible Court Howick Ltd CA 192/89;[1991] NZVJ September 37
23 Horwitz Grahame Books Pty Ltd v Mid City Centre Pty Ltd [1990] The Valuer 3l/ 4 November p281
24 James v British Craft Centre (1986) 277 EG 976
25 Norwich Union Life Insurance Society v British Railways Board [1987] EG 846
26 GREA Real Property Investments Ltd v Williams [1979] 250 EG 651
27 Pleasurama Properties Ltd v Leisure Investments (West End) Ltd [1986] 278 EG 732
28 R LJefferies v RC DimockLtd, andGiltrap Group Holdings Ltd [1987] 1 NZLR 419
29 United Sharebrokers Ltd v Landsborough Estates Ltd & JNB Wall HC Christchurch, N.Z. (Judgment 18/5/90) C.P. 298/89; [1990] NZVJ December p 40.
30 In the matter of the Rules of the Supreme Court of Queensland and in the matter of a lease from ANZ Executors & Trustees Company Ltd and/or Queensland Treasury Corporation and the National Mutual Life Association of Australasia Ltd [1991] The Valuer 31.7 August 1991 p 512
31 RopartPty Ltdv KernCorporationLtdand Superannuation Fund Investment Trust & Another [1991] The Valuer 31/1 August p 515.
32 G C McNamara, "Rent reviews and determinations" [1991] The Valuer 31/6 May p 399.
33 RTMWhipple(1986)CommercialRent Reviews: Law and Valuation Practice Law Book Co Ltd Sydney Chapter 1 ..Disputations and Definitions
34 R T M Whipple, Valuations for Commercial Rent Review Purposes: Procedural guidelines and other commentary [1990] NZVJMarch 10; also The Valuer 31/3 August 1990 p 179
35 Broken Hill Proprietary v Australian Mutual Provident Society [1986] ANZ Con R 658; [1986] The Valuer 29/4 October p 340.
36 EdmundBartonChambers(level44)Co-operative Ltd v Mutual Life & Citizens' Assurance Co Ltd [1987] ANZ Con R22; The Valuer 31.2 129
37 Tay Yong Chin "Two Tiered Rental Structure for Offices" [1991] NZVJ December 1991 p 11
38 D RR Parker, "How should a valuer approach incentives?" [1991] The Valuer 31/5 February p354
39 Federal Commissioner of Taxation v Cooling [1990] 44 ALR 121
40 Mahoney v Modick R *C Ltd* (formerly R C Dimock Ltd) and Giltrap Group Holdings Ltd [1990] NZVJ June p 54.
41 Modick R C Ltd (formerly R C Dimock Ltd) v Mahoney & *Giltrap Group HoldingsLtd* [1991] NZVJDecember 1991 p 34.
42 See Whipple (supra) (1990) at p 18 and 188 respectively; Marshall (supra) at p 18; SM Locke, "Rental Valuation with Inducements", Property Management (NZ) July 1991 at p2 also a topic at this conference; and Parker (supra); P Mora & D Hastings, Lease Incentives... after Cooling's case, The Valuer 31/5 February 1991 p 322; I M Muir Lease incentives and their impact on property values - the valuer's challenge, The Valuer 31/ 7 August 1991 p452; A T Cocks, "How to treat rental incentives in rental valuations and determinations", The Valuer 31.7 August 1991 p 454; L Somerville, "The taxation of lease incentives after the Commissioner's ruling", The Valuer 31.7 August 1991 p459
43 "The effectof leasing incentives onrental and capital values", prepared by the National Valuation and Land Economy Professional Boards and from the Victorian Division's Incentive Discussion Group, [1991] The Valuer 31/8 November p 532.
44 Dickinson & Others v Watpat Nominees Ltd, National Provident Fund & Others v Dickinson & Others, CA Wellington, NZ (judgment 24.9.91) C.A. 268./91,C.A. 269/91.

Definitions

TheAppraisal ofReal Estate (1987) 9th Edn Chicago, American Institute of Real Estate Appraisers p 437:

Market rent is the rental income that a property would most probably $

Mortgage Recommendations

by Wei Kim Teoh & Cedric Croft

U nder the Land Transfer System of Registration, a mortgage is viewed as a charge upon land by way of security for the acknowledgement of a debt. It is represented by a legal document which pledges land as security for a loan. The owner of the property who has been granted the loan is referred to as the mortgagor.

The person or institution that advances the money or loan is called the mortgagee (or the investor). The valuer's role is to report on the property, the applicantmortgagor and the proposal, and to make a recommendation.

In New Zealand, the practice of mortgage lending is governed by a number of Acts of Parliament. In brief, the Land Transfer Act 1952 requires the registration of a mortgage. Under the Act, a mortgage operates only as a charge against the land. Therefore, the legal ownership remains vested in the mortgagor. The Property Law Act 1952 sets out the implied covenants in all mortgages. The implied covenants can only be negatedby expressed terms in the mortgage contract. The Trustee Amendment Act 1988, provides the powers and the liabiliti es of a trustee in mortgage lending. One important provision in the Act is that a trustee cannot be charged with breach of trust if the trustee acted on the advice of an independent registered valuer. [1] Finally, the Securities Act (Contributory Mortgage) Regulations 1988 observes mortgages which secure money owing to more than two people or their nominee. These Acts, together with the legal precedence, strongly influence the current practice of mortgage lending in New Zealand.

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This paper focuses on the role of the valuer in the valuation of mortgage security in the present day's environment In addition, current issue surrounding valuation of the security in the present legal system and uncertain business climate, are discussed.

To this end, this paper is divided into four sections. Part 11 considers the role of the valuer in mortgage security valuation. Part 111 evaluates the effect of the Trustee Amendment Act 1988 and the Security Act (Contributory Mortgage) Regulation 1988 on the valuer's role. The Solicitors' Nominee Companies Rule 1988 and the New Zealand Institute of Valuers' efforts in providing guidelines for the valuers are also examined. Part N provides a discussion on the various criticisms aimed at valuers, and the cred- 0

1. See section 13N of the Trustee Amendment Act 1988.

Continued from previous page

command in the open market; it is indicated by the current rents paid and asked for comparable space as of the date of appraisal.

Principles and Practice of Modern Urban Valuation in NewZealand, (1959) Wellington , New Zealand Institute of Valuers p187:

Rental is assessed by comparison with other up-to-date market rentals.

J FN Murray, *Principles and Practice of Valuation* (1973) 5th edn. Sydney, Commonwealth Instituteof Valuers p 109:

The simplest and most accurate method of imputing rentals is by direct comparison with let properties.

RLJefferies, *Urban Valuation in New Zealand* - Volume 1 (1991) 2nd edn, Wellington, New Zealand, New Zealand Institute of Valuersp16-8;also (1978)1st edn.pl6-6:

The rental which could reasonably be expected to be paid by a typical lessee for the space occupied by the tenant on the terms and conditions normally prevailing in the market if the space was available in the open real estate market to be leased at the time of valuation. It is determined by comparison with the current rentals being paid for comparable space and on comparable terms. Adjustments would need to be made where the terms of the leasefor the subject premises differ from those typically found in the market.

A more recent definition based on the proposed international asset valuation standards and being recommended by the NZIV in the property law reform process currently proposed in New Zealand is:

Current market rental is the estimated annual amount that the property if available for occupation at the date of valuation should rent for between a knowledgeable willing lessor and a knowledgeable willing lessee wherein the parties each act prudentl y taking into account the terms and conditions of the lease. A

ibility crisis they face, followed by the concluding remarks to this essay.

II: The Valuer's role in the valuation of the security

It is circumstantial that in applying for a mortgage loan, the loan applicant would have the self-interest and the tendency to project anoptimistic forecast with regards to the proposed investment. However, it is equally probable that the lending party would be inclined to view the proposal much more conservatively. To facilitate the negotiation between the loan applicant and the lender, an independent party's opinion is often an important criteria. The valuer enters into the negotiation scene to provide an independent and expert assessment of the proposal.

While the valuer is required to provide arealistic judgmentbetween the optimistic extreme of the mortgagor and the pessimistic extreme of the mortgagee, the valuer'sprimary duty is to the mortgagee.2. The valuer's role is to advise the prospective mortgagee on the current market value of the property at the date of inspection, the suitability of the property as security for a loan, and also any related matters which might affect the decision of a lender in making any mortgage advance. Where the valuer is requested to provide a valuation for the purpose of the Trustee Amendment Act 1988, the Securities Act (Contributory Mortgage) Regulations 1988, or the Solicitors' Nominee Company Rules 1988, a recommendation is to be provided as to the maximum amount of loan which the valuer considers prudent to lend on the property.

However, generally speaking, there is no obligation upon a valuer to make recommendation as to the quantum of an advance unless specifically so instructed [Christiansen (1991) p 236]

For this purpose, impartiality, independence, technical ability, and experience are essential attributes that the valuers should have. The valuer is expected to provide unbiased, specialised investment advice to the investor. Hence, the valuer is seen as the mortgagee's collator and interpreter of relevant facts 3. In advising property as security for a loan, the valuer is required to assess the fair market value of security offered. The security is given to protect the lender in case of the borrower's default. The mortgagee usually restricts the amount of loan to a certain proportion of the market value of the security.

The prospective mortgagee is entitled to a genuine valuation which enables the mortgagee to make informed business decisions

Alternatively, the mortgagee instructs the valuer to provide a recommendation as to the amount of loan that is prudent to lend. Based on the findings of the valuaiton, the valuer would estimate a lending margin (also called a security margin), which is the difference between the amount of loan and the fair market value oftheproperty. Thevaluermustbecareful that the mortgage valuation conveys the realistic open market value of the proposed security. The prospective mortgagee is entitled to a genuine valuation which enables the mortgagee to make informed business decisions. It is equally important that the prospective mortgagor should not be disadvantaged by an unnecessarily depressed or overly conservative value.

The valuer begins the property valuation by searching the title of the security to determine the estate in land which the loan applicant holds. The valuer must be careful in differentiating the chattels from the fixtures to ensure that only fixtures are considered in the valuation of the security. In addition, the valueris expected to comment on the availability of the property under various market conditions and also state, wherever appropriate, the details relating to other security required (eg collateral land security, personal covenant in case of companies, etc.).

Hence, the assessment of the security inevitably results in an element of prediction of the future. The requirement of a mortgage recommendation to the prospective mortgagee makes the report and valuation an even more onerous task. Therefore, the valuer must be aware of the possibility of a drop in value or a forced sale, although it is not normally appropriate to value the security on a forced sale value basis. The valuer should collect as much up-to-date information as possible to be able to have reasonable predictive confidence.

Apart from considering the sensitivity of the security towards adverse conditions and its flexibility in adapting to these conditions, the valuer should identify various risk factors to the property itself and its location. In relation to the property, the building and improvements should be assessed for deterioration and reversion orpossibleobsolescence. Town planning changes as well as alternative uses of the property should also be taken into consideration. In relation to the location, the assessment should cover even broader matters like neighbourhood growth or stagnancy, technological advances, inflationary factors, populations drifts, etc.

From the review of the valuer's role above, it is obvious that the duties of the valuer are wide. The valuer should take every step in the valuation of the security positively and with tact [Rothwell (1982) p87]. Most importantly, the valuer should be free of influence from all parties in providing expert investment advice to the mortgagee.

111. The acts of parliament and the New Zealand Institute of Valuers' standards

The enactment of the Trustee Amendment Act 1988, the Contributory Mortgage Regulations 1988, and the Solicitors Nominee Company Rules 1988 have a number of important implications on the valuer's role in mortgage valuation. One significant change is the replacement of Section 10 of the Trustee Act 1956 with Section 13N. Under Section ON, a trustee cannot be charged with breach of trust if lending on security of property and lends "too much" if:

a. he or she has acted on the report of a competent valuer who was employed and instructed independently of any owner of the property; and
b. the amount lent does not exceed that stated in the report; and
c. the loan was made on advice expressed by the valuer as written in the report.

In effect, the two-thirds safety margin rule for freehold properties is abolished. 4 The abolishment of the two-thirds rule appears justified in the face of the present day's uncertainty. New Zealand's property market has been volatile over the last few years. Hence, setting a rigid percentage relationship between the market values of the properties and the mortgage advances seems illogical. S Furthermore, it is more appropriate for each mortgage

2. See, for example, Frizell (1979) at p211
3. Ibid
4. Traditionally, lenders were legally chargeable with breach of trust if financing more than two-thirds or 66.6% of the valuation of the property.
5. See, for example, Halstead (1989) at p40.

application or valuation to be assessed based on the merits of each case.

On the other hand, some writers comment that the replacement of Section 10 with Section 13N has in fact increased the valuer's responsibility. For example, Halstead [(1989)]p40] questions whether the deletion of the two-thirds rule was wise. Banks and other institutions are currently lending 79% to 90% on house mortgages. He also comments that if valuers start making recommendations up to those levels, losses on forced sales could be more prevalent. As a consequence, the valuer's liability would increase accordingly.

However, it should be noted that such a comment is based on the assumption that a valuer is motivated to recommend high lending rates merely because of competitiveness in the market. The assumption fails to recognise the fact that the valuer must be independent and professional. Independent in the sense that the valuer must not be influenced by his or her client or other lending institutions. Professional means that the valuer should make decisions based on his/her own findings and analyses during the process of valuation rather than depending on the current lending trends in the market.

From the valuer'sperspective, the new Trustee Amendment Act has indeed increased the valuer's liability towards the investor. Under the new Act, the onus is on the valuer to state the maximum proportion that is prudent to lend. In arriving at the "prudent" amount, the valuer inevitably has to predict the future market value of the investment.

The unwillingness of the valuer in certain cases to predict the future value of the security is understandable because of the vulnerability of property value to changes. The volatility of the property market increases the uncertainty of future prediction. Property values fluctuate with technology, inflation, use changes and possible obsolescence, to name afew. The valuer only has his or her experience and analytical powers (or even intuition) to depend on in using past records and current conditions to predict the future.

However, it is equally important to note that valuers are the only professionals capable of giving such specialist advice. Their experience, knowledge, and understanding of the property market puts them in the best position to make such recommendations.

From the investor's point of view,the recommendation is often of critical importance to their investment decision making. In addition, it is clear that the new ruling (Section 13N) has effectively improved the investor-trustee's position. Without the strict requirement of the two-thirds rule, the trustee now has increased lfexibility to raise lending levels. The only restraint on lending is thus between the prospective mortgagor and the trustee. This argu men t brings us back to Halstead's (1989) reservation with regards to the current high lending rates.

As long as the valuer is convinced or satisfied with the proposed security and makes a good recommendation, the trustee may be persuaded to grant a higher level of loan. Furthermore, the trustee is protected under Section 13N if the trustee was acting upon an independent valuer's report as discussed above. In short, the trustee could not only reap the benefits of increased flexibility in lending, but also possibly escape liability of breach of trust, if acting on the valuer' advice.

The Securities Act (Contributory Mortgage) Regulations 1988 also brings some interesting rules affecting valuers. The Act was introduced by the Securities Commission to govern contributory mortgage lending in the commercial sector. Section 2 of the Act defines contributory mortgage as "a mortgage of land that secures money to two or morepersons or to a nominee on behalf of two or more persons".

The regulations also include important definitions which directly affect the valuer in mortgage valuation. For example, Clause 5(1) provides clear definition of "valuation report". One important requirement is that the report must be prepared and signed by an independent registered valuer. Clause 5(2) sets strict rules with regard to the meaning of "independent registered valuer" by providing a list of factors which would negate the independence of the valuer. Clause 5 also refers to the Third Schedule of the regulations, which sets out various items that should be contained in the valuation report. Under Clause 13 to the Third Schedule, the valuer is required to make recommendation as to the amount for which the land provides adequate security for a loan on first mortgage free of encumbrances.

The requirements set out in the regulations clearly show the intentions of the Securities Commission to regulate the practice of mortgage valuation. To safeguard the interests of the parties involved (particularly the mortgagees), the independence of the value is carefully observed.

As required by the Trustee Amendment Act 1988, the Securities Act (Contributory Mortgages) Regulation 1988 also require the valuer to make recommendation as to the level of loan advance. Most importantly,the regulations provide the valuer with definite and useful guidelines on the reporting of mortgage valuation.

Apart from the Acts of Parliament, there are private bodies and institutions which regulate the practice of mortgage lending and mortgage valuation. The New Zealand Law Society issued the Solicitors' Nominee Company Rules 1988 to observe and to guide solicitors who wish to establish and operate a solicitors nominee company.

The requirements in the Solicitors' Nominee Company Rules 1988 correlate well with that of the Securities Act (Contributory Mortgage) Regulations 1988. For instance, Appendix 1 to the rules is exactly the same as the Third Schedule of the regulations. To this end, both the regulation and the rule can be seen as the reinforcement of each other.

Another body which helps in the regulating process is the New Zealand Institute of Valuers. The Institute has recently released exposure drafts of Proposed Standard No 2, *"Valuation of Residential Properties for Mortgage Purposes"* which applies to the valuation of residential properties for mortgage purposes. It is foreseeable that such a standard would provide some insights into the Institute's yet-to-beproposed standard for the valuation of commercial properties for mortgage purposes.

The proposed Standard No 2 is divided into six sections namely, "residential standards", "valuation report", "work in progress", and "variation of instruction". The standard refers to the Trustee Act 1956, the Solicitors Nominee Company Rules 1988, and the Securities Act (contributory Mortgages) Regulation 1988 and specifically states that the valuation report should be in compliance with their requirements.

It is interesting that the New Zealand Institute of Valuers does not attempt to provide a more detailed set of rules or guidelines for its members. In its current form, the standard is unfortunately brief and hence, fails to provide adequate and useful guidance to valuers. As a result, the practitioner is left with no choice other than to look to the statute and other related parties (solicitors rules) for direction. It is unfortunate that such a professional body should be under the direction and authority of the government (through the Trustee Act 1956 and its amendments, and

the Securities Act 1988) and another professional body (i.e. the New Zealand Law Society through the Solicitors Nominee Company Rules 1988).

It is only appropriate that the profession itself has its own set of clearly defined standards, which may not necessarily be different from the existing rules and regulations, but provides additional and useful guidelines for its members.

In addition, the profession should be aware that the government, the Securities Commission, and the New Zealand Law Society have a certain degree of advocacy for the people they serve or their clients. Therefore, unless a detailed and all-encompassing standard is issued by the valuation profession, its members would continue to depend on other bodies for guidance.

IV: The investor's viewpoint

For many years, property valuers have been subjected to various criticisms with regard to their professionalism. As Rothwell ((1982) p 81) comments, "as valuers we are selling a service. I do not believe that any other trade or professional group has failed so dismally as our own to identify and service the needs of its client".

One group of critics, which has frequently questioned the ability of the valuer, is the bankers. They are generally dissatisfied with the present service that they get from their valuers. This dissatisfaction has led to a number of submissions which recommend to the profession attributes that a valuer should possess.

For example, Connell (1990) an Auckland banker, criticises the quality of the valuer's report. He says that the valuations are outdated and are "not reflecting changed conditions in the market" (p35).

He also indicates that unless valuers are willing to provide more up-to-date valuation reports that assist the bankers in handling the present day's environment in a more efficient and effective way, the profession would face serious credibility crisis.

It is submitted that "non-professional" reports not only damage the valuer concerned but also do a great disservice to the entire profession.

It is accepted that the nature of the task for valuers may lead to minor variations in the assumptions or recommendations. However, gross errors of fact and approach can result in the valuer facing legal proceedings.

Furthermore, valuers have been criticised with regard to the quality and content of information in their reports. The report must not only be accurate but also show all the relevant factual detail. Frequently, the valuer would have to provide further interpretation of the information to give it qualitative and quantitative meaning.

"non-professional" reports not only damage the valuer concerned but also do a great disservice to the entire profession

The inclusion of information interpretation should not be sacrificed in the effort to shorten the valuer's report. An opinion without substantiation of factual, detailed and useful information is equally unacceptable.

Last, but not least, some valuers have even been accused of engaging in less than professional behaviour, ignoring the very basic requirement of independence. The valuers are among the first to be blamed when a mortgage investment fails. Clearly, a credibility gap exists between valuers and their clients and the challenge is there for the valuers to close that gap.

In summary, unless the individual members in the profession make an effort to improve their valuation and reporting skills and their relationship with their clients, it is likely that the already tarnished reputation of valuers would be further impaired.

It is, however, unfair that the entire valuation profession would have to suffer for the mistakes and incompetence of a very small number of individual valuers in the market. The majority of loan reports and valuations do provide highly skilled and professional advice to mortgagee investors.

The very nature of this type of investment means that where a valuation report is provided and the investment endures (or naturally terminates) with no losses, neither the public nor the valuer are ever made aware of that success.

Only in the case of a loss or failure is valuer's report closely scrutinised in the hunt for a scapegoat.

Nevertheless, it is obvious that the reputation of the profession lies solely in the hands of its members. In this respect, the New Zealand Institute of Valuers must play an active role in providing detailed and useful guidelines to its members, from the initial stage of the valuation procedures to the final stage of reporting. A

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Accounting for Properties: Which Standard?

by Sonja Newby

With the release of SSAP-28 *Accounting for Fixed Assets*, we now have two standards dealing with properties. The other, of course is SSAP-17, *Accounting for Investment Properties and Properties Intended for Sale.*

The purpose of this article is to clarify the scope of SSAP-28 and SSAP-17 in terms of which standard deals with what types of property; to compare their specific requirements; to highlight similarities and differences between them, and as an adjunct, to ask whether SSAP-28 brings the demise of historical cost accounting in New Zealand. SSAP-28 in fact covers most types of fixed assets, but the focus in this article is on its application to properties.

Set out in Table 1 (over page) is a summary of the requirements of both standards in respect of key issues.

Classes of property

Paragraph 4.1 of SSAP-17 discusses in general terms the nature of different classes of property.

The usual case is land and/or buildings utilised as an integral part of an entity's normal activities such as production, manufacturing, administration and trading. In other situations, property may be regarded primarily as an investment for capital gain or rental income.

Alternatively, an entity may hold or develop property mainly for the purpose of on-selling it, much like inventory.

A key concern in classifying property is its relative importance to the entity's result (profit or loss) for the period.

In the usual case described above, an entity's result is determined largely by its normal activities, so any property utilised as part of those activities is regarded as a fixed asset and falls within the scope of SSAP-28.

On the other hand, change in the value of property regarded as an investment may be highly relevant in assessing an entity's performance and thus should be taken into account when considering its result. Likewise, realisation of properties intended for sale may be critical to an entity's performance.

These two types of properties aredealt with by SSAP-17, which was issued to reduce the diversity of accounting reporting and practice by entities whose earnings are affected significantly by interests in properties.

Investment property is defined by SSAP-17 as "property which is held, or development property intended to be held, primarily for capital growth or rental or similar income" (paragraph 3.2).

Property intended for sale is defined as "all property, other than investment property, held with the intention of realisation in the ordinary course of business" (paragraph 3.3).

SSAP-17 also covers both of the above types of properties while they are under development, as indicated in the definition of investment property. Property as defined in SSAP-17 does not however include properties occupied substantially by the reporting entity or its "group".

This is provided for in paragraph 3.1 which states, "Property is, for the purposes of this Statement, an interest in land or buildings in which the reporting entity, or any of the members of a group, singly or in combination, does not occupy or intend to occupy more than 20% of the area of the land or buildings."

This 20% occupancy limit means SSAP-17 is not applicable to many entities.

SSAP-28 is a catch-all for other land and buildings utilised on a continuing basis by the reporting entity. Property interests in land and buildings are not defined specifically in SSAP-28, but it is obvious they are covered because of references to them in the standard.

For example, paragraph 1.2 states that, "many businesses revalue fixed assets, especially land and buildings...", and paragraph 4.17 talks about government valuation and interests in property. Thus we have two standards operating side by side but applying to different types of properties.

They do not overlap because SSAP-28 specifically excludes "investment properties" (paragraph 1.45(e)), and effectively omits properties intended for sale. This conclusion is reached by way of the definition given in the standard for fixed assets - these are "non current tangible assets that... are not intended for sale in the ordinary course of business" (paragraph 3.3(c))

This does not mean the entity cannot have fixed assets for sale when they are surplus to requirements, for example. The important distinction with fixed asset properties for sale is that normally they are not for sale as part of an entity's operating activities.

Balance sheet classification

Both investment properties and fixed asset properties are classified as non-current assets in the balance sheet.

Properties intended for sale are treated as inventory. Although SSAP-4, *Accounting for Inventories* (1986) specifically excludes inventories accumulated under construction contracts (paragraph 1.2), the general principles set out in $

that standard provide useful concepts for distinguishing properties intended for sale from other properties.

In the discussion section of SSAP-4 (paragraphs 4.2 to 4.4), one important difference identified between fixed assets and inventory is the basis of matching cost with related revenues.

For fixed assets, matching is considered achieved best by depreciation, whereas for inventories, cost is carried forward into the period when the inventory is sold. This is designed so its cost can be matched against specific revenue generated, enabling a profit or loss on sale to be determined. The different matching concepts reflect in part the relative importance of various activities on an entity's result (see "Classes of Property", above).

Another concept discussed in SSAP-4 is that inventories may be held for either the short or long term. Hence under SSAP-17 (paragraphs 4.6 and 5.1), properties intended for sale may be classified as current ornon-current assets.

When such property is readily realis-

Table 1: SSAP-17 Compared With SSAP-28

	SSAP-17		*SSAP-18*
	nIvestment Properties (pares)	*Properties Intended for Sate (Para)*	*Fixed Asset Properties (pars,)*
Classification	Non-current (4.10)	Current or non-current (4.6, 5.1)	Non-current (3.3)
Valuation of Completed Properties	Net current value	Lower of cost and net realisable value or lower of carrying amount and NRV when previously an investment property.. (4.6, 4.26)	Cost or net current value provided net carrying amount not greaterthan recoverable amount (5.6)
Valuation of Development Properties	Cost plus percntage of completion increments when development margins can be recognised; otherwise lower of cost and NRV (4.15, 4.16,5.4,5.5)	Cost plus percentage of completion increments when development margins can be recognised; otherwise lower of cost and NRV (4.8,4.9,5.2, 5.3)	Cost including financing costs provided net carrying amount not greater than recoverable amount (4.5-4.12)
Depreciate?	No (4,11,4.12,5.4(b))	No not "depreciable' (SSAP-3,3.3)	Yes (4.25, 4.26, 5.10)
Revaluation Frequency	Annually (4.13,5.4(a))	Only writedowns when NRV is less than cost or carrying amount (see above)	'Systematically', preferably annually (4.14, 5.5)
Reporting valuations	Unrealised - either in income statement following profit after extraordinaries or transferred direct to an investment property revaluation reserve - any debit balance revaluation reserve should be charged as part of operating results. (4.20, 5.6)	Writedowns should be charged in the income statement as part of the operating results (5.8)	Debit or credit to asset revaluation reserve for that asset class -anydebit balance revaluation reserve should be expensed to the profit-and-loss or operating statement. Any subsequent revaluation credit for same class should be accounted for so as to reverse the previous charge (4.19, 4.20, 5.8, 5.9)
Reporting Development Margins	As for 'Revaluations', above	Included in the operating result (4.8,5.2)	Not recognised
Disposal Gain/Loss	Difference between net sale proceeds and carrying amount - included in operating result (4.23,5.7)	Difference between net sale proceeds and carrying amount - included in operating result (4.23, 5.7)	Difference between net disposal proceeds and carrying amount - disclosed separately in the profit-and-loss or operating statement (could be abnormal or extraordinary) (4.21, 5.12)
Disposal Transfer of Reserve	If revaluations disclosed in incomes statement on disposal, transfer any balance of revaluation reserve directly to retained earnings. (4.23, 5.7) If revaluations transferred direct to reserves, on disposal transfer any balance of revaluation reserve to operating statement (4.23, 5.7)	No revaluation reserve so not applicable	Transfer any balance of revaluation reserve to retained earnings (4.23, 5.11) Adjust reserve for any bonus issues (4.24)

able and intended to be held for not more than one year, and there is evidence of intent to sell (such as authorisation by directors and listing for sale), then it is regarded as appropriate to classify the property as a current asset.

When the current asset conditions are not met, the property for sale is classified as non-current. Classification obviously has implications for ratio analysis.

Valuation of properties

Properties intended for sale, whether classified as current or non-current assets, generally are valued like inventory, at the lower of cost and net realisable value.

If the property previously was accounted for as an investment property, it continues to be recorded at its carrying amount rather than at cost, and the valuation rule becomes the lower of carrying value and net realisable value (paragraphs 4.6 and 4.26).

SSAP-17 does not define net realisable value, but it is defined in SSAP-4 as "the estimated selling price in the ordinary course of business less costs of completion and less costs necessarily to be incurred in order to make the sale".

Except for development properties (discussed below), properties intended for sale should not be revalued other than downwards when net realisable value falls below cost or carrying amount.

Investment properties, other than development properties, are required to be recorded in the balance sheet at their net current value (SSAP-17, paragraph 5.4).

Net current value in essence is open-market selling price less costs of disposal Its meaning therefore seems to be equivalent to net realisable value.

For fixed assets, there is a general requirement to show gross carrying amount and related accumulated depreciation for each class of asset, together with separate disclosure of the aggregate amounts for any revalued assets within each class to distinguish them from assets which have not been revalued (SSAP-28, paragraph 5.14).

The gross carrying amount is defined as either the initial cost of revalued amount adjusted for additions, improvements and disposals in both cases (paragraph 3.4).

The general principle appears to be that investment properties must be shown at their revalued amount, whereas fixed asset properties can be shown at either their revalued amount or at cost.

Net current value in essence is open-market selling price less costs of disposal Its meaning therefore seems to be equivalent to net realisable value.

There is, however, some question as to whether the wording used in the SSAP-28 definition of "gross carrying amount" effectively eliminates "cost" as a basis of valuation. This point is discussed below.

Revaluation of fixed asset properties is done on a basis similar to the revaluation of investment properties that is, both are revalued to net current value.

SSAP-28 does not however allow the net carrying amount to be greater than recoverable amount (paragraphs 5.3). Net carrying amount is defined as the gross carrying amount less amounts written off to date (paragraph 3.7). Recoverable amount is the amount of net cash inflows expected from either the asset's continued use and ultimate disposal, or from its immediate disposal (paragraph 3.9).

Revaluation for both types of properties should be prepared in accordance with the New Zealand Institute of Valuers Asset Valuation Standards. The valuer should hold a recognised professional qualification and have experience in the location and category of property being valued.

SSAP-17 requires the valuer to be independent, but SSAP-28 also permits internal valuation when the valuer is qualified (as above) and the basis of valuation has been subject to review by an independent valuer (paragraph 4.15).

In addition, SSAP-28 specifies that the valuation will be on an existing use basis or disclosure should be given of an alternative use value (paragraph 4.16).

Frequency of revaluation is more flexible under SSAP-28, which permits revaluation on a "systematic" basis (although preferably annually), whereas SSAP-17 requires annual revaluation.

There is some question as to whether the SSAP-28 definition of "gross carrying amount" effectively eliminates "cost" as a basis of valuation

"Systematically" is not defined, but presumably refers to some notion of consistent timeliness such as revaluation every two years.

SSAP-28 states that normally assets within a class should all be revalued at the same time, but it does permit revaluation "on a cyclical basis in a systematic manner, subject to no individual ifxed asset being included at a valuation undertaken more than three years previously" (paragraph 4.14).

Properties under development

According to SSAP-17, development margins may be recognised on both development properties intended to be sold and those intended to be held provided certain conditions are met. The presumption is that conditions ensure the required degree of reliability is achieved for financial reporting purposes.

On this basis, qualifying development properties are recorded on the balance sheet at cost plus accumulated increments to date, determined on a percentage of completion basis. The stage of completion should be determined in accordance with SSAP- 14 *Accountingfor Profits on Construction Contracts.*

When the conditions are not met, the development property is valued at the lower of cost and net realisable value.

Conditions of development properties intended for sale are:

- an unconditional contract for the sale of the completed property; and
- all costs incurred and expected to be incurred by the reporting entity can be estimated reliably.

Conditions for development properties intended to be held are:

- an unconditional contract pre-letting the property to at least 80% of the anticipated annual rental revenue to be received from external entities; and
- all costs can be estimated reliably (as above).

The annual incremental development margin is recognised in the financial statements as detailed in the section below on "Reporting" (see Table 1 for paragraph references).

Fixed asset properties under development are valued at cost, including applicable financing costs (SSAP-28, paragraphs 4.5 to 4.11). Presumably the provisions of SSAP-28 allowing revaluations and requiring deprecia- 0

tion of fixed assets do not apply until the asset under development has been brought into "the working condition necessary for its intended use".

Until this point, costs are more in the nature of expenses carried forward and have no utility until the asset is ready. Only then can an initial cost for the asset be established (paragraphs 4.1 and 5.1).

Inclusion of financing costs potentially could inflate the initial cost of a property under development above its recoverable amount. SSAP-28 does not address this point directly, butparagraph 4.12 states, "If, at any time, a permanent impairment in the value of a fixed asset causes the recoverable amount to fall below the net carrying amount, the fixed asset should be revalued downwards immediately."

A strict interpretation would hold that any downward revaluation necessary due (for example) to over-capitalisation of financing costs could only be applied once the property was completed and ready for use, and thus came within the definition of a fixed asset. Nevertheless, a liberal interpretation of the above valuation rule is adopted here.

In Table 1, cost is limited to recoverable amount in line with paragraphs 4.12 and 5.3. This interpretation is consistent with the concept of prudence, which requires losses to be recognised as they occur. What is probably needed in S SAP-28 is specific limitation on the extent of cost capitalisation.

Perhaps the unusual wording in the definition of "gross carrying amount" is an attempt to provide such limitation. As paragraph 3.4 states: "Gross carrying amount will be the recoverable amount where this is lower than cost of the revalued amount." The implications of this terminology are discussed below.

Depreciation

Depreciation should not be charged on investment properties (SSAP-17 paragraph 5.4 (b)). The reason given is that "the net current values of investment properties would reflect their age (and hence the depreciation to date)" (paragraph 4.12).

In driect contrast to this view is the SSAP-28 requirement (paragraph 5.10) that "depreciation should be charged even when assets are revalued on a systematic basis".

As SSAP-28 explains, "Most fixed assets have a finite useful life. So that the financial statements properly reflect all the costs of the enterprise, it is necessary to make a charge against income in respect of the use of such assets" (paragraph 4.25).

This is consistent with the requirement in SSAP-3, *Accounting for Depreciation* (paragraph 5.1) that "the depreciable amount (historical cost of revalued amount, less residual value of an asset)... should be allocated on a systematic basis to each accounting period during the useful life of the asset".

Under both SSAP-28 and SSAP-17, revaluation of properties is to net current value, so why should one standard require depreciation and not the other?

In discussing whether or not depreciation ought to be charged, the emphasis in SSAP-17 is on reporting the correct valuation of properties in the balance sheet, whereas SSAP-28 talks about relfecting costs properly, which implies concern with reporting the periodic earnings number correctly in the income statement.

One explanation for the different depreciation treatments could be that the assets concerned are different in nature.

Fixed assets are "used up" in the earnings process so their cost needs to be recognised over their useful life. Most investment properties also have a finite useful life, however, so why should their cost not also be recognised over their useful life?

Another explanation could be that the standards reflect subtle shifts in consensus on the purposes of financial reporting, combined with what is sometimes referred to as "UK balance sheet versus US income statement" biases.

This can occur easily without some sort of conceptual framework.

SSAP-28 is concerned with recognising net current values in the balance sheet as well as reporting costs properly, and therefore may reflect an admirable attempt to report relevant information in both the income statement and the balance sheet. (This attempt falls short, however, in not allowing the next credit revaluation amount ever to be recognised in the operating result, even on *realisation* through disposal of the asset - see below.)

Properties intended for sale are not subject to depreciation because they are not "depreciable assets" within the meaning of SSAP-3, paragraph 3.3: "A depreciable asset is an asset which (a) is expected to be used during more than one accounting period; and ... (c) is held by an enterprise for use in the production or supply of goods and services, or for administrative purposes.".

Depreciation with revaluation

Each time a fixed asset is to be revalued, SSAP-28 requires the balance in the accumulated depreciation account to be credited to the related fixed asset account.

This establishes the net carrying amount for that asset, so it can then be increased or decreased to the amount of the revaluation (paragraphs 4.18 and 5.7).

In an upward revaluation, the above methodology effectively recovers accumulated depreciation already expensed to the operating statement.

Under SSAP-28 the amount of any regulation normally is transferred direct to reserves except when this would put the reserve into a debit balance.

The amount of any debit balance revaluation reserve is required to be expensed to the profit-and-loss or operating statement, but any subsequent revaluation credit for the same class of asset should be accounted for by entries which reverse the prior debit (paragraphs 4.19, 4.20, 5.8 and 5.9).

In the usual situation where a revaluation credit cannot be taken to the operating statement but must be taken direct to reserves, effective recovery of previously charged depreciation simply increases the amount of the revaluation credit in reserves.

It is therefore not treated in a manner consistent with the above provision, which allows reversal revaluation credits to be taken to income. This appears to make the standard inconsistent within itself.

In a downward revaluation situation, the effect of crediting the balance in the accumulated depreciation account to the related fixed asset account is to recognise a smaller revaluation debit.

When the debit can be absorbed by a credit balance revaluation reserve, the debit bypasses the operating statement as it would be transferred directly to the reserve.

This approach gives a different result from that arrived at under traditional conservative accounting, in which losses would be recognised in the operating statement as they occur, on grounds of prudence.

Perhaps in an attempt to achieve more consistent accounting, SSAP-28 states that, "reversals of previous revaluation are, as far as possible, accounted for by entries which are the reverse of those which brought the previous revaluations to account" (paragraph 4.20).

Revaluations and development margins

For investment properties, including those under development, any qualifying development margins and net change in value of investment properties for the period can be disclosed by either of two methods, provided the method chosen is followed consistently for all relevant properties. The method preferred under SSAP-17 is disclosure "in the income statement following profit after extraordinary items and clearly identified as unrealised.." (paragraph 5.6).

This method is viewed as providing highly relevant information which is sufficiently reliable because it is backed up by independent valuations.

S SAP-17 recognises there is a degree of uncertainty in valuing investment properties, so it also permits margins and revaluations to be "transferred direct to an investment property revaluation reserve".

Further, there is a requirement to disclose the property revaluation reserve separately from other reserves, and movements in that reserve during the period.

When the reserve balance "is insufficient to cover a deficit, the amount of the deficit should be charged in the income statement as part of operating results" (paragraph 5.6).

The preferred method results in both gains and losses being reported "below the line" outside the operating statement but still within the income statement as part of total earnings for the period.

The reserve accounting approach keeps gains out of the income statement but can result in an unrealised loss being recognised "above the line" in the operating statement, due to the requirement to charge a deficit reserve to operating. Thus in a period of declining property values, the income statement approach could give a healthier operating result as any losses are reported near the foot of the income statement as unrealised, rather than in the operating statement.

This difference between the two approaches can be important if analysts focus on the reported operating result for an indication of "quality earnings".

Properties intended for sale are not subject to revaluation, other than writedowns (referred to above) which are charged in the operating statement. Qualifying development margins in respect of these properties are recognised in the operating result.

The revaluation debit or credit on fixed asset properties normally is taken directly to reserves, except in the circum stances outlined above. For each class of fixed assets, disclosure of the dates and amounts of valuations is required together with other details concerning the valuations.

In respect of fixed asset properties under development, the amount of financing costs capitalised in a period (if any) should be disclosed. SSAP-28 contains no specific requirements concerning disclosure of reserves or movements in them.

Disposal of assets

Calculation of gain or loss on disposal is similar for all types of properties. It is the difference between net sale or disposal proceeds and carrying amount. Normally it should be included in the operating result, although in practice writedowns and losses on sale of fixed assets frequently are treated as extraordinary items.

SSAP-28 requires the surplus or deficit to be disclosed separately, but unlike SSAP- 17 does not prescribe where, other than within the profit-and-loss or operating statement (paragraphs 4.21 and 5.12). "Profit-and-loss or operating statement" is not defined. Presumably the provisions of SSAP-7 *Extraordinaryltems and Prior Period Adjustments,* continue to apply to fixed assets including properties, so items may be treated as extraordinary when applicable.

There are important differences between types of properties also in the treatment of any balance of related revaluation reserve on disposal. Properties intended for sale are not revalued, so there is no revaluation reserve to deal with on their disposal.

For investment properties, treatment is determined by the method used to report revaluations in the first instance. If the revaluations (and development margins) were disclosed in the income statement under the preferred method, then on disposal of the investment property any balance in the revaluation reserve in respect of that property is transferred directly to retained earnings (SSAP-17, paragraphs 4.23 and 5.7).

The practice in some instances is to leave revaluations reported in income in the residual retained earnings balance for the period without a subsequent transfer into a revaluation reserve, so in these circumstances evidently there is nothing to transfer back on disposal.

When the income statement method is adopted for reporting revaluations, the only amount which will be reported in the operating statement on disposal is the gain or loss on sale (calculated as above).

Revaluation already have been reported in the income statement once (in the period when they were recognised) and thus do not appear there again.

Some entities argue that under this approach, the revaluation portion is only ever reported as an unrealised item in the income statement, even if it is validated subsequently by an external sale.

On the other hand, this approach potentially could result in revaluation losses being reported "below the line" while the asset was held, but a healthy "realised" profit being reported on sale if the asset had been undervalued.

If revaluations (and development margins) were reserve accounted, then on disposal of the investment property any balance in the revaluation reserve in respect of that property is transferred to the operating result (SSAP-17, paragraphs 4.23 and 5.7).

Thus the amount reported in theoperating statement will be the net sum of the gain or loss on sale (calculated as above) together with the related reserve amount.

This approach effectively "undoes" the revaluations in order to report an historical cost gain or loss on sale. The argument here is that the full amount should be recognised on realisation because none of the revaluation has ever been reported in income previously.

For fixed asset properties, SSAP-28 requires any related balance of the asset revaluation reserve to be transferred directly to retained earnings on disposal (SSAP-28, paragraphs 4.23 and 5.11).

Since amounts of revaluations would have been transferred directly to reserves at the time they were recognised initially (except when a revaluation debit was expensed or reversed), the effect of these provisions is that net revaluation losses only can ever be recognised in income.

Generally the only amount which 0

will appear to the operating statement will be the surplus or deficit on disposal based on the *carrying amount.*

Apparently the above approach has been elected on international harmonisation grounds, in order that our standard will be consistent with requirements overseas.

Current practice here is quite different, however - on realisation the revaluation typically is recognised in the income statement, as for investment properties which have been reserve accounted.

The new provisions may serve as a disincentive for entities to engage in upward revaluation of their fixed asset properties, for the two reasons outlined above.

First, since depreciation must be charge on the revalued amount and is expensed in the operating statement but cannot be reversed, there is a permanent "above the line" cost irrespective of a subsequent reversal of previous revaluations.

Secondly, a net revaluation credit can never be recognised "above the line" in the operating result, even on realisation. Both effects reduce the operating result. A refinement added by SSAP-28 is that revaluation increments associated with particular assets should be adjusted when the reserve balance has been utilised for bonus shares or dividends (paragraph 4.24).

End of historical cost?

Gross carrying amount of a fixed asset is defined as, "either the initial cost or the revalued amount adjusted for additions, improvements and disposals in both cases".

The definition given in. SSAP-28 (paragraph 3.4) includes the statement that, "gross carrying amount will be the recoverable amount where this is lower than cost or the revalued amount".

Recoverable amount is defined in paragraph 3.9 as "the amount of the net cash inflows expected to arise: (a) from the asset's continued use and ultimate disposal; or (b) from its disposal (where it is intended to dispose of the asset in the immediate future)".

> Perhaps inconsistencies evident between the standards reflect the fact that standard-setting occurs progressively as issues arise and are dealt with on a somewhat piecemeal basis.

This statement has similarities with the definition of recoverable amount given in S SAP-3, *Accounting forDepreciation.*

What appears to be unusual is the suggestion that the gross carrying amount should be written down in some circumstances - when recoverable amount is lower than cost or the revalued amount.

Under historical cost accounting, the historical cost value of an asset is carried forward from period to period and reported together with the asset's related accumulated depreciation to show a net book value.

Both SSAP-28 and SSAP-3 require that if the recoverable amount of a fixed asset should fall below its net carrying amount, the fixed asset should be revalued downward immediately (SSAP-28 paragraphs 4.12 and 5.3; SSAP-3, paragraphs 4.7 and 5.5).

In terms of historical cost accounting, this would be achieved by debiting a writedown expense which would be charged to income and may or may notbe disclosed as an abnormal orextraordinary item.

The credit would go to accumulated depreciation for the asset so net book value would be at the lower, written-down amount while the asset's historical cost valuation would stand unchanged.

The recoverable amount of an asset - its disposal value or value in use may well be less than its cost.

The inference in the definition that gross carrying amount cost under historical cost accounting will be written down to recoverable amount when this is lower is entirely different from writing down net book value.

It means the asset's historical cost valuation can no longer stand unchanged. This highlights an important difference in the way in which changes of value are accounted for under different bases of accounting.

Under historical cost accounting, values are adjusted by way of provision with historical costs carried forward, whereas under revaluation, values are revised so the base amount recorded changes following revaluation. Although the wording of the definition seems effectively to eliminate use of historical cost as a basis of valuation, I doubt this implication was intended by the standard-setters.

Differences and inconsistencies

The major differences between SSAP-17 and SSAP-28 identified above are in the areas of depreciation, reporting or revaluation amounts in the financial statements, and treatment of the revaluation on disposal.

Perhaps the inconsistencies which are evident between the standards reflect the fact that standard-setting occurs progressively as issues arise and that they are dealt with on a somewhat piecemeal basis.

The standard-setters clearly have a very difficult task which could be made easier by having more guidance on the content and presentation of financial reports, perhaps through developing a framework of concepts. An issue of particular urgency is the matter of recognition of unrealised items A

Compiled by Leonie Freeman

What practicing valuers need to know about regression analysis

by S Locke

IT he application of regression techniques to various aspects of valuation work has gained increasing acceptance within the professional literature. An understanding of regression is expected of most students studying valuation at either University or College in Australasia. It is not surprising that with the increasing availability of personal computers and spreadsheets that technology is making regression more readily available. The major issue orproblem which requires consideration is when should it be used.

As mentioned above, the professional literature in Australasia, the *Australian Valuer and New Zealand Valuers' Journal,* have featured several articles concerned with regression in the last two years.

The individual articles taken as a group cover abroad range of topics relating to regression. While some concentrate on technical issues, the majority cover various applications of regression in valuation work.

These provide useful case studies guiding theprofessional in deciding when regression may be appropriate. Locke (1987) discusses the conceptual problem involved in endeavouring to develop a statistical model of the human valuation process.

Recent Literature

McFarlane and Fibbens (1990a,b) in two papers in this journal discussed the application of both linear and multiple regression analysis to the valuation of rental assessments in shopping malls.

The relationship between rental and three variables, viz. area, frontage and time were explored. Not surprisingly, strong relationship was found between area and rental, indicating this may then provide a sound basis for setting new rentals.

In the September 1990 issue of this Journal, Binnie (1990) provides a more formal statistical explanation of the regression technique. This is the type of material with which most students entering the profession should be familiar. The application of linear, multiple and polynomial regressions in valuation have potential as explained in the examples provided for each technique.

Jackson (1991) discusses the application of regression analysis to rental assessments, illustrating the procedures with data from Dunedin.

Again the major finding reported in the paper is that the technique is applicable, affording significant advantages over the conventional and less mathematically formal approaches currently practised by valuers.

Valuing a regression

It is important not to trivialise complex procedures to cookbook simplicity and a balance must be struck between sophistication and usefulness.

The present literature appearing in the professional journals does not sufficiently relate regression to the output from standard spreadsheet and statistical programs. What is necessary is an understanding of how to interpret the statistics and understand whether the regression is significant or rubbish.

The valuer, when considering the use of regression to investigate a particular assignment, or confronted with the results of a regression, needs to be able to interpret the various statistics, understanding what they mean and do notmean.

The first principle in using regression analysis is to question whether the relationship between the various items, i.e. the variables, makes any economic sense. This is of critical importance.

Valuation is a form of applied land economics. Accordingly, postulated relationships between variables must make economic sense. If sight is lost of this first principle, then all forms of spurious relationships may be investigated and proposed as making some form of valuation sense. Regression is about finding statistical correlations between variables, and as such when applied to valuation must be constrained to those models which are theoretically. acceptable to valuation.

Stuart Locke,
McCarthy. BAgete ;;;;,
t'rofessor of the department of
.operty Studies a' Massey Uni 'ersrty

Consider the recent exploration of the relationship between rent in shopping malls and various measurable explanatory variables in McFarlane and Fibbens (1990b). Area is postulatedasbeinglikely to be significant.

Valuers would readily accept that ren t is almost certainly a function of the area over which the lease rent is calculated. Therefore, fording a useful formula, founded on a strong statistical relationship, will assist the valuer in determining rentals in that market place. The regression results may prove useful at an arbitration hearing into disputed rental levels for a particular site, assuming the sample properties from which the equation is estimated, are truly comparables.

Principle 1 *The regression formula must make economic sense*

Check all the variables in the equation to ensure their inclusion conforms with valuation expectations, especially 0

that the signs are the right way around. Note whether these variables allow for an increase or decrease in the prediction. If the equation is:

Value = 600 x floor area + 20 x locality 30x no. of bathrooms,

then this seems counter intuitive as bathrooms usually increase value.

How good is the regression? *The R'*

The R2, pronounced R squared, is the statistic which explains goodness of fit of the regression. This statistic which has a minimum value of zero and a maximum value of one is indicative of the explanatory power of the regression equation. A value close to zero indicates very low explanatory power and a value close to one indicates high explanatory power. The explanatory power relates to the extent to which variability in the dependent variable, i.e. the variable which we are attempting topredict orforecast, iexplained by variability in the independent variables or variables.

Consider again the rent as a function of area. The dependent variable is rent and the independent variable is area. As area varies so too does rent. The R2 indicates the extent to which the variation in area explains the variation in rent. As the value reported by McFarlane and Fibbens (1990b) is close to one the regression appears to have strong explanatorypower.

The second principle relating to regressions is that the model should have strong explanatory power. A R2 close to one is desirable. How close to one is an open question.

The American Institute of Real Estate Appraisers suggest, in the Handbook [reference] that a R2 of at least .8 is required before accepting the regression as having reasonable explanatory power. Why exactly .8 is chosen cannot be explained. Iftheresult were.77 o'r.79, could this regression model beused? The answer cannot be determined in any hard and fast way. The use of a 0.8 criterion, whilst quite arbitrary is, nevertheless, conven. tional and provides the practicing valuer with a reference point.

Principle 2 A R2> 0.8 is required *Should the included variables be there? The t test*

There may exist a plausible economic relationship between the dependent variable and the independent variables, and the equation may have high explanatory power, but this does not mean that the model is a good statistical model. There may be problems in the statistics which need further testing. The further testing is normally referred to as a series of diagnostic tests. It is necessary to determine that the equation is properly specified, ie that there are no statistical problems resulting from odd distributions in the data , or in the way in which the regression statistics are calculated.

Several statistical problems can arise in using regressions. The practising valuer who is preparing regressions must be aware of these pitfalls. The valuer confronted with regression results must ensure that they are statistically pure, especially if they are being used in evidence against a case at a rental arbitration or a valuation objection. The third principle in using regressions is that they must be statistically defensible and not be subject to any diagnostic failings.

Most regression packages produce the tstatistic for each variable. If the tstatistic is greater than 2, then the conclusion may reasonably be drawn that the variable is significant. There are more formal ways of analysing the t statistic in terms of significance levels but the practising valuer need first obtain a general indication that the variable is significant.

Principle 3- *Ensure the regression is not subject to diagnostic flaws.*

Inclusion of variables with a t statistic > 2 limits the likelihood that closely related variables are included as explanatory variables.

Variables which are closely related multicollinearity

Multiple regressions employ more than one independent variable. The dependent variable is explained by two or more variables. A common example relating to residential valuation is the use of descriptive variables in estimating the market value of the houses. Market value is the dependent variable and independent variables may include, for example, land area, number of bedrooms, cladding, roof cladding and whether off street parking is available.

It is always true that adding additional variables to a regression improves the R2. What must be ascertained is the extent to which the specific variables included in the regression contribute significantly to the overall explanatory power. It is important that only variables which are statistically significant are included in the regression. The test for whether s. variable is statistically significant is relatively simple.

Residuals and Mis specified Regressions

Two further common problems with regression analysis which need to be checked are labelled with the following somewhat daunting names, autocorrelation (also known as serial correlation) and heteroscedasticity.

The concepts are reasonably straight forward and nowhere near as difficult as pronunciation of their names. Both are examined in turn. The importance of testing for these potential diagnostic problems cannot be overstated. When a regression is proposed which is subsequently found to have diagnostic problems then it should be discarded. The importance for practicing valuers in either defending a regression or critiquing a regression should be obvious.

Autocorrelation

Theregressioncalculatesapredictedvalue for the dependent variable for each value of the independent variable(s). This predicted value will normally differ from the actual value of the dependent variable, the extent of the average differences will be reflected in the value of the R2. Subtraction of the predicted value from the actual value gives the difference, which is termed the residual, i.e. the unexplained amount. When the residuals are large, the regression has low explanatory power and the R2 will be closer to 0 than 1.

The residuals may contain additional information. This arises when there is a discernable and definite pattern in the residuals. Knowledge of this pattern in the residuals can be integrated into the regression model, further enhancing the prediction. This may involve using a lagged dependent variable or some form of transformation such as the Cochrane-Orcutt transformation. At this point the problem is becoming complex and expert assistance is probably required.

If there is a pattern in the residuals then this is indicative of autocorrelations and suggest the regression is not well specified. Such patterns may be observed visually when the residuals are plotted as in Figure 1(over page).

A well specified regression has the residuals distributed in a random pattern as shown in Figure 1A. The second pattern shown in Figure 1B is indicative of autocorrelation with a regular pattern emerging.,

Standardised scatterplot of the residuals for a regression equation that predicts the sale price of a Palmerston

Figure 1A

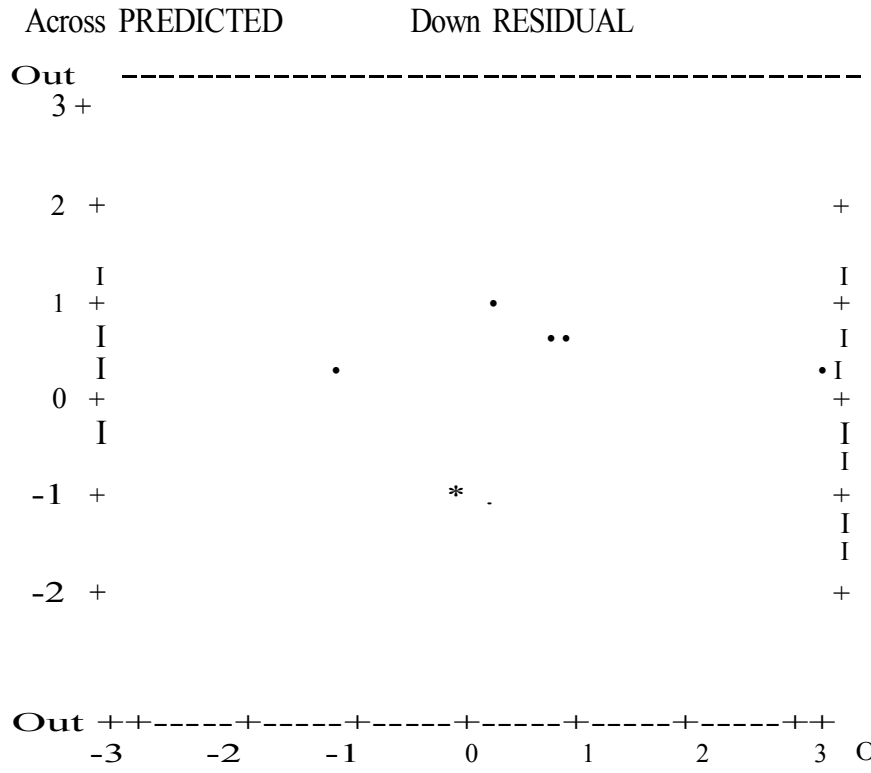
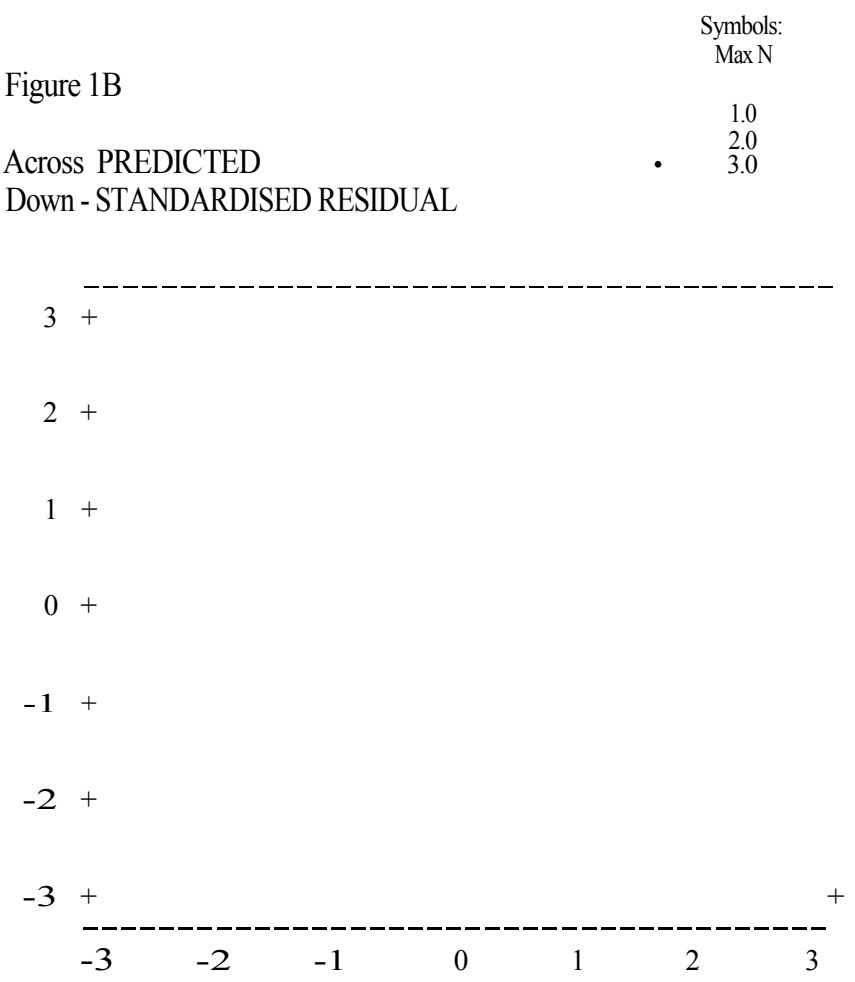


Figure 1B



North dwelling in 1988 within the price range of $80,000 to $180,000. The random pattern of residuals indicates a well specified regression equation.

The regular fluctuation in residuals, as emphasised bythe line superimposed on thegraph,is indicative of fast order autocorrelation. Various summary statistics can be calculated to check whether autocorrelation is present. The most common of these, known as the Burbin-Watson (DW) statistic, indicates whether first order correlation is present. When quarterly data arebeing used fourth order autocorrelation may occur, i.e. a quarterly cycle appears in the residuals. Similarly when monthly data are being used twelfth order autocorrelation may occur revealing an annual pattern in the residuals.

The DW does not provide a good measure of autocorrelation other than for first order and a valuer who recognises that quarterly or monthly data are being used must not be lulled into a false sense of satisfaction by a good DW, which is in fact meaningless in such instances. A visual check of theresiduals orstandardised residuals is safer. Most regression programs provide for a printout of the autocorrelation function and at a minimum will provide aplot for the residuals.

Heteroscedasticily

The problem may most easily be explained by reference to Figure 2. The residuals are increasingly dispersed as the value of the independent variables increases. There is a direct relationship between the size of the independent variable and the size of the prediction error. Accordingly, the accuracy of the model declines with size.

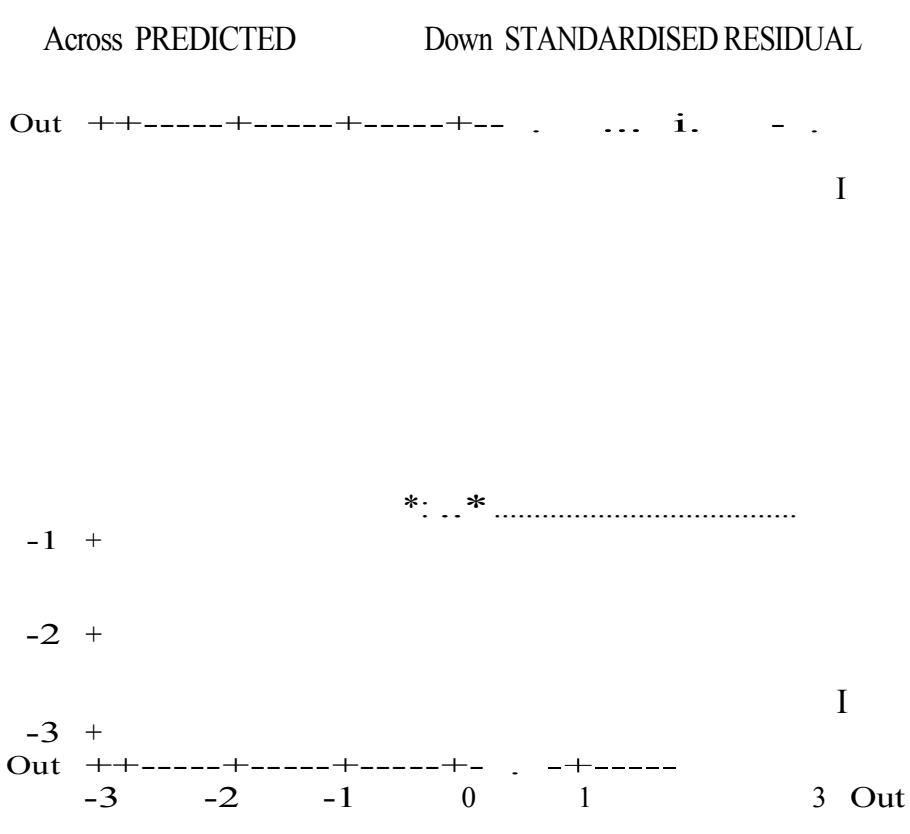
Standardized scatterplot of residuals for a regression equation developed to predict sale price of a Palmerston North dwelling in 1988, with no restriction on price range. Note the increasing inaccuracy of prediction of sale price towards the higher end of the market as emphasised by the diverging lines superimposed on the graph.

Conclusion

Practitioners who know little of the mathematical intricacies of regression analysis can readily acquire sufficient skills and understanding to ensure they are not overwhelmed or swamped by artful dodgers. An understanding of the approach and the relevant statistics is sufficient to ensure that practitioners can reasonably

represent their client's position. The prevailing atmosphere of either exponent or avoidance is not a satisfactory standoff.

New techniques such as regression have their place in valuation and it is importantthatoutcomes of analyses and arbitrations not be limited or slide into error through prejudices. Valuers must have a working understanding of regression analysis, which is in factavery straight forward technique, feeling neither threatened nor exploited by its use. A



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Decision modelling for valuations

by P Ragan

The increasing acceptance by the valuation profession of computerised valuation programmes presents the profession with a unique opportunity to standardise valuation practice on a national and international basis.

This paper draws on an initiative currently being undertaken in Australia to produce a series of standard templates and suggests that suitably modified, these could form the basis of an international standardisation of methodology.

Introduction

Computer use, particularly with spreadsheets such as Lotus, is becoming widespread in the valuation profession. In the space of five years, techniques such as cash flow analysis and IRR measures have moved from the classroom to the field. The catalyst for this was the ready availability of desktop computers and simple programs.

While this is good, there are drawbacks in putting such tools in the hands of largely inexperienced users, in the form of errors and omissions. Sadly, many Australian valuers lack sufficientprofessional experience to construct such valuation models.

GarryRothwell, drawing on his experience both as a valuer and as a senior executive in mortgage lending, condemns the sheer incompetence and lack of professionalism he has encountered in reports prepared all to frequently by some members of the Australian valuation profession.

(Whipple 1984)

This situation, and the opportunity that spreadsheets bring, requires a full con-

sideration of what contribution could be made to professional development.

Today's valuers: Who are they?

There has emerged two groups of persons in real state:

1. Seasoned professionals with a good knowledge of their market, but little formal training in financial analysis techniques, or computing.
2. Younger professionals with a background and knowledge of financial analysis and computing, but perhaps less exposure to the realities of the property market.

A major task in the area of professional training and development for the nineties is to synthesise the best of the knowledge of the two groups to the benefit of the whole profession.

Many university courses are now playing a leading role in this area, with the establishment of computer training rooms and bridging courses.

Using computer models for valuations

Spreadsheets have been the software that is chosen when it comes to setting out valuation tasks. But usage is ahead of formal training, and universities need to reconsider their role in this present day to offer training and courses with direct relevance to the area.

There are no general valuation templates available in Australia to suit normal valuation tasks. Programs that are retailed tend to be either too basic, or too expensive. Most majorreal estate practices have developed their own models, as have many individuals.

This raises problems when it comes to comparing models produced by different bodies. A multitude of techniques and approaches are in use which can result in different valuation answers, given the same facts.

While valuers are entitled to have differences of opinion on values, it is clearly not in the interests of the profession to produce different answers purely due to the mathematics contained within spreadsheets.

There can also be a tendency to accept anything analysed on a computer as correct, since it seems more impressive. But lfaws and errors can regularly be seen in models that can jeopardise their reliability.

In Western Australia, a study group was convened under the Australian Institute of Valuers and Land Economists (AIVLE), to examine the use of valuation templates by the profession.

Members comprised a broad cross-section of valuers, all with good experience in valuations. A survey of the members indicated the following:

- 90% of valuers using computers use spreadsheets primarily.
- 85% of those use, or were familiar with, Lotus 1-2-3.
- For static valuations, three main methodologies were employed.
- Each of those three methodologies had variations, in some cases up to five or six variations.

The fact that spreadsheets have become the software of choice for the valuation profession is supported by past papers in the Journal.

In a paper on using Lotus for Monte Carlo simulation, Mollart concludes that a spreadsheet is adequate for this purpose and can perform a statistical analysis of the results. (Mollart 1988).

In a paper on computer assisted valuations, Hsia and Byrne note that

> *GenericIntegratedSoftware Systems have not been greatly favoured for general business use. The reasons for this are not very obvious, but perhaps the principal one was the relatively late appearance of such packages, at a time when generic packages such asLotus 1-2-3- had taken a firm hold on their market sectors.*
>
> (Hsia and Byrne, 1989)

Testing the spreadsheet models

To test and compare the models in use, the study group set a standard 'textbook' question, calling for the valuation of a simple office block, with most assumptions and facts supplied. Each valuer used their own model to analyse and value the property, and then notes were compared.

The valuations produced had a spread of almost 15%. A supplementary question asked for a five-year IRR to be calculated, again with all facts supplied. The answers ranged from 12% to 18.5% emphasising the continuing difficulty in promoting cash lfow methods as reliable form of valuation.

Where differences appeared, they ware attributable to one of three factors.

- Mathematical errors, rendering the result incorrect.
- Perceptual errors, resulting in the misapplication of techniques.
- Confusion of static and dynamic methodology.

The first category was not a major one. The second category covers misunderstandings in the way the spreadsheet worked.

This is not an error as such, but a matter of perception. One person can write a formula in a spreadsheet, and understand the meaning of the result. Another person can read a different meaning into that result. The general problem here is lack of guidance or documentation to fully explain the workings of formulae.

The last category covers confusions of methods, which are becoming apparent as dynamic cash flow techniques are mixed up with more traditional static methods eg. escalating rents to future values, when current market rents should be analysed.

Improving professional use of spreadsheet models.

The profession can be assisted in two ways.

1. Better training and course facilities
2. Providing standard valuation templates.

Standard valuation templates

In conjunction with the AIVLE in Western Australia, a series of valuation template models have been developed and the first model has now been released to the profession at large, at minimal cost.

The first model covers normal commercial static valuations, while other models will provide for retail valuations, cash flow modelling, project developments, and subdivisions.

The model templates are designed to:

1. Achieve greater consistency in modelling and approach.
2. Provide a level playing field for comparisons of valuations.
3. Reduce the scope for mathematical error.

The initiative has received widespread acceptance by the profession, which will contribute to a harmonisation of valuation approaches over the next decade.

This would then assist university training courses, in that the models could be incorporated as part of the curriculum.

Comparable evidence

A weakness perceived in valuation practice currently is the insufficient analysis of sales evidence for investment properties. Valuers may use different approaches and varying definitions of capitalisation rates, etc. but, in theory, their valuation answer would not differ, provided they analysed their comparables in the same way.

However, if comparables are not so

analysed or evidence of capitalisation rates is taken verbatim from another source, then variations will continue to occur.

The old adage "as you devalue, so you value" still carries weight.

The model template is designed to assist the correct quotations of equivalent yields or capitalisation rates. Eventually, as the models gain common use, it is intended that a capitalisation rate can be quoted as "established in accordance with the standard model".

VP Valuer: A valuation template for static valuations

VPValuer is based on the Lotus format, but compiled using Baler software to prevent users tampering with key formula cells. The program therefore runs as a stand-alone program.

Simple program menus enable the user to move around the various input screens, then move on to the valuation screens where three variations on valuation technique can be employed; a detailed rental analysis of the property can be examined and sensitivity analysis on the capitalisation rates can be used. Printing is a one-touch operation, run directly from the menu.

This program has not been designed to impose a particular valuation methodology on values. Rather, it is to facilitate a standardised approach by valuers, using whatever method they are comfortable with.

This is achieved in a very useful way in the model. While all the usual input pages are there (tenancy schedules, outgoing schedules, etc) three alternative valuation pages are provided.

These enable the valuer to adopt one of three different valuation approaches; namely, the layered income method; the market value lesspresent value of income lost method; the market value less loss of rents method.

These have been identified as the three main methods in use in Australia, and a valuer can use any of these.

In fact, all three methods can be used if a valuer wishes, which also enables the model to be used as a form of training tool in that the logical effect of using any of the methods can be immediately modelled.

While the user cannot "see" the formulas in the program, they are listed in the accompanying manual so that the user can cross-check. This should be done at least once, so that the model is properly understood.

The need, for this was recognised by Byrne. He says of Lotus formulas:

> *the user must appreciate not only the exact routines making up the various functions in the spreadsheet, but also the underlying principles on which the functions are based.*
>
> (Byrne 1988)

The advantages of the compiled approach have been significant. The program looks and feels like a Lotus spreadsheet, enabling anyone familiar with Lotus to use it immediately

However, the security level of the compiled program is such that users cannot accidentally or deliberately erase formulas, or significantly damage the program.

This is a major problem with spreadsheets, and this approach gives rise to a more reliable finished program, while retaining the many advantages of spreadsheets.

A vision for the future

VPValuer is the first step in bringing the valuation profession a readily available set of standard valuation spreadsheets that include normal valuation principles. This will enable all valuers to work on a common basis, and will lift their professional standing throughout the community by reducing errors and making the valuation process more intelligible.

It has become apparent that such programs are greatly needed by the profession, and not just in Australia. Modifications are now being considered to make such aprogram useful on an international basis.

A major advance in this program has been the availability of three different valuation techniques in the one program. It is possible to take this further and imagine a program with a valuation screen available for each country.

Therefore, depending on the country in which the model is being used, tailoring its use for that country would be as simple as selecting the valuation page for, say Australia, New Zealand or America.

An examination of the differences in valuation methodology between the major Western countries suggests that the differences are not that great, and an international model is therefore feasible.

Once such a model is available an widely in use, it may provide valuable stepping stone toward the goal of harmonising international valuation methodologies. A

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IN THE COURT OF APPEAL OF NEW ZEALAND
C.A. 268/91

IN THE MATTER of an Arbitration

AND
IN THE MATTER of the Evidence Amendment Act (No. 2) 1980

AND
IN THE MATTER MARK DAVID DICKINSON
First Appellant

AND
IN THE MATTER of WILLIAM MCLEOD WILSON
Second Appellant

AND
IN THE MATTER BRIAN EDWARDS
Third Appellant
CA 269/91

BETWEEN THE BOARD OF TRUSTEES OF THE NATIONAL PROVIDENT FUND a body corporate constituted under the National Provident Fund Restructuring Act 1990 and
CENTRAL TOWER LIMITED
a duly incorporated company having its registered office at Wellington, property owner
PLAINTIFFS

AND MARK DAVID DICKINSON of 22C Orchard Street, Wadestown, Wellington, Bank Officer, and WILLIAM MCLEOD WILSON of 7 Gloucester Street, Silverstream, Wellington, Solicitor, and BRIAN WILLIAM EDWARDS of 20 Oak Avenue, Paremata Wellington, General Manager
DEFENDANTS

Coram: Cooke P.
Gault J.
McKay J

Hearing 24 September 1991

Counsel: M N Dunning and Sonja Cooper for Appellants, Plaintiffs and Defendants
MR Camp QC for Watpat Nominees Limted

Judgment: 24 September 1991

JUDGMENT OF COOKE P

The Australian Mutual Provident Society as lessor and Watpat Nominees Limited as lessee are engaged in a rent review relating to premises in the Trust Bank Centre in Wellington.

The valuers appointed on each side have disagreed. The umpire has embarked on a hearing pursuant to clauses in the lease which provide that, if the valuers are unable to agree, the current market rent shall be determined by the umpire, whose determination shall be final and binding on the parties. The relevant clause continues:

> *The umpire shall have due regard to any evidence submitted by the valuers as to their assessment of the current market rent of the Premises. The umpire shall give his determination and the reasons therefore in writing.*

The lessee is desirous of tendering before the umpire the evidence of the rents agreed upon for certain other office premises in Wellington said to be comparable. Just as the Trust Bank Centre is a major office building in the city, so is the IBM Centre, and a third building in much the same category is the Majestic Centre. The information sought by the subpoenas is in essence details of there rental and collateral agreements bearing on therental in relation to each of those lettings. Those lettings are subject to confidentiality clauses between the parties, of which an example is Exhibit A to the affidavit of Mr R W Byrne, sworn on 22 September 1991:

> *CONFIDENTIALITY*
> *20.1 This Agreement is strictly confidential to the parties hereto and accordingly no party will disclose or permit to be disclosed any of the terms of this Agreement to any person not being a party to this Agreement without first consulting and agreeing with all other parties as to the terms of that disclosure but the following disclosureswill not be deemed to be a breach of this clause:*
> *a. disclosures made to professional advisors in relation to advice or opinions required pursuant to the terms of provisions of this Agreement for the Lease; or*
> *b. disclosures of information which is public knowledge other* than *as a result of unauthorised disclosures by the parties.*

The lessors of the other two buildings and the lessees in those buildings whose representatives have been served with the subpoenas have sought to have the subpoenas set aside on the ground that the confidentiality clauses should prevail.

The proceedings or sets of proceedings have very recently comebefore Greig J in the High Court. On 20 September 1991 he set aside the subpoena relating to the Majestic Centre on the ground that in that case there is material arising from a compromise of litigation which, in his view, places it in a special category.

That part of Greig J's decision is not in issue now before this Court, although we have been informed by Mr Camp, who appears for Watpat-that is to say for the lessee in the pending review that despite the Judge's decision the Ernst and Young material, as it is called, is in his understanding likely to be made available. We are not called upon to consider Greig J's decision with regard to that material.

As to the material relating to the IBM Centre, the Judge considered that it was not entitled to protection and refused to set aside the relevant subpoenas. From that part of his decision the three lessees concerned have appealed.

There is also now before us another proceeding. The lessor of the IBM Centre is the Board of Trustees of the National Provident Fund. They and an associated company commenced proceedings against the three lessees.seeking an injunction restraining disclosure under subpoena or otherwise of confidential details of the leasing arrangement.

The Judge granted an interim injunction until further order of the Court of Appeal but at the same time ordered that the application be removed into this Court to enable a decision as a question of law whether the interim injunction should be sustained. No procedural point has been taken on either side. In both proceedings or sets of proceedings essentially the same questions arise.

As to the jurisdiction to set aside such subpoenas, there can be no doubt that 0

jurisdiction exists. It would certainly exist at common law on the ground of abuse of process of the Court if that could be made out, and a possible alternative source is s.35 of the Evidence Amendment Act (No.2) 1980.

There is no need to determine whether jurisdiction is available under both heads for the purposes of the present case. The principles to be applied under either head must be substantially the same in a case such as this.

Accepting then that there is jurisdiction, one goes on to consider the contentions raised for the appellants and the plaintiffs in support of the argument that the subpoenas should be set aside.

Mr Dunning first contended that the subpoena procedure was not available in the rent review between the AMP Society and Watpat because the lease there includes a provision that, in determining the current market rent, the valuers or umpire shall be deemed to be acting as experts and not as arbitrators.

It is to be noted that this provision must in any event be read subject to the express requirement `the umpire shall have due regard to any evidence submitted by the valuers as to their assessment...' but, subject to that qualification, the clause appears to me to be designed to ensure that the umpire may act on his own expert knowledge if he sees fit and is not in all circumstances bound to hear evidence. Such a situation is not uncommon and sometimes arises even by implication: see for example *Mediterranean and Eastern Export CoLtdvFortressFabrics (Manchester) Ltd* [1948] 2 All ER 186.

The argument of Mr Dunning is that the effect of the clause is that the Arbitration Act 1908 in general (as I understand it) and s 9 in particular do not apply to the rent review. That argument must fail, bearing in mind that in the New Zealand legislation `submission' is deemed as including a written agreement under which any question or matter is to be decided by one or more persons to be appointed by the contracting parties or by some person named in the agreement; while 'arbitrator' includes referee and valuer.Those definitions appear in s2 of the 1908 Act. Some discussion of their history and significance will befound in *Hunt v Wilson* [1978] 2 NZLR 261, 274.

Here the umpire is conducting a hearing with the assistance of counsel. It is apparent that the parties wish to call evidence. There is a very large sum at stake. It is obviously highly desirable there be an opportunity of calling evidence and cross-examination: that is evidently what the umpire intends. Section 9 should be and, in my opinion, is available for such a case.

The more important point raised by Mr Dunning concerns confidentiality. As to that, again it may be accepted readily enough that, if this were a case in which on balance the public interest required confidentiality to be preserved, the Court would have jurisdiction to set these subpoenas aside on that ground.

The categories of confidentiality to be protected by the law are not closed, as pointed out by Turner J in *Bell v Universi*tyofAuckland [1969] NZLR 1029,1035-37.

More recent illustrations in England of the recognition of the principle and its limits are *Science Research Council v Nasse* [1980] AC 1028, especially at 1067 per Lord Wilberforce; *Campbell v Tameside Metropolitan Borough Council* [1982] QB 1065, where there are helpful explanations by Lord Denning MR and AcknerLJ; and*Brown vMatthews* [1990] 2 All ER 155.

I am disposed to agree with the view expressed by Ralph Gibson LJ in the latter case at 164 that the kind of claim to confidentiality made in this field need not be approached under the head of public interest immunity. It is rather a situation in which, if the claim is to be sustained, it is to be based on the private commercial interests of those objecting to the subpoenas. The interests here are primarily those of the National Provident Fund as lessor, but the three lessees support their lessor, not wishing to be in breach of their obligations of confidentiality.

It may be accepted then that, if the grounds for holding that the private interest in confidentiality should be protected are sufficiently strong, the claim should be upheld. It is a balancing exercise, although as Lord Wilberforce put it in the Science Research Council case:

> *This is a more complex process than merely using the scales: it is an exercise in judicial judgment.*

Mr Camp has argued that there is a heavy onus on those claiming confidentiality to make out their claim. I prefer to approach the matter on the footing that the Court must in the way indicated by Lord Wilberforce weigh the competing considerations and, if in the end satisfied that the interest ought to be protected, uphold it.

Approaching the matter in that way, I have no doubt that Greig J was right to refuse to set aside these subpoenas. It is understandable that an organisation such as the National Provident Fund with very large funds under its care should be anxious to maintain rentals levels in its building as high as reasonably possible. Any commercial lessor is likely to have the same approach.

Perhaps in these times of economic stringency it is not surprising that confidentiality clauses have begun to appear in commercial leases of this kind. But, for very many years, leases of commercial premises in New Zealand cities have to a large extent been fixed by rent review procedures. They are a major or at least a significant element in the New Zealand economy.

Generally speaking , the leases authorising or requiring such procedures speak of market rents or use some similar formula such as fair rent. In *Modick RC v Mahoney* (CA 12/90; judgment 24 June 1991) this Court stressed the importance of the ability of valuers or umpires to be able to refer to genuine market rents: that is to say rents freely arrived at in negotiation between the parties, by contrast with those arrived at in the captive circumstances of rent fixations.

Such genuine market rentals are not always easy to discover, and when discovered they may be of great importance in assisting an umpire in carrying out his difficult task of assessment. It is a fair inference in the present cases that the rents agreed for the IBM Centre may well be of true significance for the umpire concerned with the Trust Bank Centre. Of course one infers as much without any detailed knowledge of the situations and without in any respect seeking to fetter him, but it is desirable that he should be able to get at the truth as to these allegedly comparable rentals. Plainly details will be required such as the terms of collateral contracts offering side benefits and the like.

The contention for the lessor of the IBM Centre really does not withstand analysis. In effect it is an attempt, in the interests of lessors, to prevent true market rents from being ascertained. But in the current economic climate it is plainly in the public interest that fair levels of rent be arrived at in our main cities. One has only to consider the apparently extensive unlet areas in newly constructed buildings to appreciate that unrealistically high levels are not in the public interest. One sympathises, as I have said, with the responsibility of the lessor for the funds in

its care but, in my opinion, the over-riding public interest is in as fair a fixation of market rents as possible. The upholding of the subpoenas will be conducive to that.

It remains to mention that Mr Dunning in his reply placed some reliance on s.21 of the New Zealand Bill of Rights Act 1990, wherein there is confirmation of the right to be secure against unreasonable search and seizure.

Since, for the reasons already given, the issue of the subpoenas cannot in my view be described as unreasonable, that takes the argument for the lessor and the others no further nor is any further discussion necessary in this case of the scope of the Bill of Rights.

With regard to the mechanics of compliance with the subpoenas, Mr Camp has made it clear that, so far as can be foreseen at present, production of the full documents is unnecessary and a summary sheet containing all material information should be enough. That kind of question can be ruled upon by the umpire should any difficulty arise.

Mr Camp also indicated that one particular matter, as to which we permitted Mr Dunning to address us in conditions of some secrecy, does not appear to have sufficient relevance to the rents to make it necessary for him to ask for information about it to be supplied.

For those reasons I would dismiss the appeals. As to the interim injunction, the same reasons lead to the conclusion that it cannot be sustained.

The Court being unanimous, the appeals are dismissed and the interim injunction discharged. Watpat Nominees Ltd will have costs in the sum of $1500 to cover the hearings in both Courts.

Solicitors:
Russell McVeagh, Bartleet & Co, Wellington for Appellants, Plaintiffs and Defendants.

IN THE COURT OF APPEAL OF NEW ZEALAND
C.A. 268/91

BETWEEN Mark David Dickinson
First Appellant
AND William MCLeod Wilson
Second Appellant
AND Brian Edwards
Third Appellant
AND Watpat Nominees Limited
Respondent

C.A.269/91

BETWEEN NATIONAL PROVIDENT FUND
Appellant
AND DICKINSON AND OTHERS
Respondents

Coram: Cooke P
Gault J
McKay J

Hearing: 24 September 1991

Counsel: M N Dunning for Appellants
MR Camp Q C for Watpat Nominees Ltd for respondent

Judgment: 24 September 1991

JUDGMENT OF GAULT J

I agree with the judgment that has just been delivered and will add only brief remarks of my own.

After hearing applications urgently last Friday and yesterday Mr Justice Greig refused to set aside certain subpoenas except for one which he regarded as a special case, granted an interlocutory injunction restraining representatives of three of the lessees of the IBM Centre from disclosing under compulsion of the subpoenas or otherwise confidential details of leasing arrangements with the landlord and removing into this Court for a decision as a question of law whether that injunction should be sustained.

While it is an urgent appeal in the context of an interlocutory application I am satisfied that it is not appropriate to deal with it on the conventional balance of convenience consideration.

If the injunction is discharged and the subpoenas are not set aside the decision effectively will be determinative of the substance of the dispute and, while it may be said that some additional material might become available if more time were allowed, the principal contentions are clear and the matter can be determined now.

As outlined in the President's judgment the lessee of space in the Trust Bank Centre, in a rent review under its lease, seeks from lessees in the IBM Centre in Wellington, said to be comparable rental space, correct details of rentals in their respective leases together with any collateral agreed details pertaining to rent.

In each of the leases there is an obligation of confidence imposed upon the lessee which the appellants perceive would be breached if they were forced to disclose the information sought in evidence given under subpoena. Even though the rent review upon which the evidence is required is being undertaken by an umpire in terms of a submission in a lease in which he is said to be acting as an expert, I am satisfied that there is no basis for setting aside the subpoenas on the ground that they are not properly issued pursuant to s9 of the Arbitration Act 1908. It is clear that the the umpire with the assistance of counsel is to hear evidence and make a determination which willbe imposed upon the parties in the review proceeding submitted to him. Clearly he is acting upon a "submission" as defined more broadly than in at least some overseas countries.

Accepting that in appropriate circumstances there is jurisdiction to set aside a subpoena even where properly issued, I agree that this is not an appropriate case where that course should be followed.

Whether or not protection of confidential information will provide a sufficient ground to allow evidence to be withheld will depend upon the circumstances in each particular case.

Although we have been referred to no decision directly in point the principles are not in dispute on the submissions we have heard from counsel. It is necessary to balance the advantage of maintaining confidentiality against the competing advantageofopennesswhereapublic interest is to be served. That balance is referred to in a number of authorities and in particular *Campbell v Tameside Metropolitan Borough* [1982] 2 All ER 791 in which Akner L J said (p796):

> *The fact that information has been communicated by one person to another in confidence is not , of itself, a sufficient ground for protection from disclosure in a court of law either of the nature of the information of the identity of the informant if either of those matters would assist the court to ascertain facts which are relevant on which it is adjudicating... The private promise of confidentiality must yield to the general public interest, that in the administration of justice truth will out, unless by reason of the character of the information... a more important public interest is served by protecting the information...*
>
> *The proper approach where there is a question of public interest immunity is a weighing, on balance, of the two public interests, that of the nation or the public service in non-disclosure and that of justice in the production of the documents.*

Helpful guidance as to relevantprincipies also is available from *D v The National Societyfor the Prevention of Cruelty to Children* [1978] A C 171, 233 and *Morgan v Morgan* [1977] 2 All ER 515, 518.

There must be good reason to exclude or limit relevant evidence in any proceeding. Here Mr Dunning has advanced two principal reasons. They are first that the information is a matter of confidence between the parties to the lease in which it is embodied and being perceived by those parties as confidential should be respected as such, and secondly that because that confidentiality is the subject of contractual obligations the Court should so far as possible support and enforce those obligations.

The Courts will in appropriate cases protect confidentiality in commercial contexts and frequently do so. Weighed against that, however, is the established approach to the fixing and reviewing of commercial rentals by reference to comparable market rents. We emphasised the importance of establishing true comparisons in ModickR CLtd vMahoney CA 12/90, judgment 24 June 1991. That will be facilitated by access to relevant information.

There is a public interest in an open market unless special circumstances exist. In my view it is important to get to the truth of comparable rentals where available so that proper rent levels are fixed.

So far as concerns detriment from disclosure Mr Dunning was able to refer to no more than what appears to be the short term disadvantage for the landlord in the IBM Centre seeking to let unleased space in that building. He acknowledged, however, thatin the longerterm hisclientitself no doubt will be seeking to establish new rents by reference to comparable market rentals and that, on my assessment, reflects the importance of an open market in the longer term.

Accordingly, I have not been satisfied on the argument presented that there is, or is likely to be, oppressiveness in the disclosure of the information sought in proceeding before the Umpire that justifies setting aside the subpoena or otherwise suppressing the evidence.

One particular matter was mentioned by Mr Dunning. I am not satisfied that that goes directly to market value in an event but if it were shown that it did I would be inclined to protect it. However, Mr Camp indicated that he will be satisfied with less in the context of the rent review proceedings. He seeks simply details of the matters pertaining to the rental of the premises concerned. He will not insist upon production of the lease documents. Should there be any difficulty in that respect I have no doubt that an application to the Umpire and the co-operation of counsel will lead to it being overcome readily.

Accordingly, for these reasons, and those given by the President, I would discharge the interim injunction and dismiss the appeal.

Solicitors

Russell McVeagh McKenzie Bartleet & Co Wellington for Appellants.

IN THE COURT OF APPEAL OF NEW ZEALAND
C.A. 268/91

IN THE MATTER of an Arbitration

AND
IN THE MATTER of the Evidence Amendment Act (No. 2) 1980

AND
IN THE MATTER MARK DAVID DICKINSON
First Appellant

AND
IN THE MATTER of WILLIAM MCLEOD WILSON
Second Appellant

AND
IN THE MATTER BRIAN EDWARDS
Third Appellant
CA 269/91

BETWEEN NATIONAL PROVIDENT FUND and another

AND
BETWEEN MARK DAVID DICKINSON and othesr
DEFENDANTS

Coram: Cooke P.
Gault J.
McKay J

Hearing: 24 September 1991

Counsel: M N Dunning and Sonja Cooper for Appellants, Plaintiffs and Defendants
MR Camp QC for Watpat Nominees Limted

Judgment: 24 September 1991

JUDGMENT OF MCKAY J

I agree with the judgments which have just been delivered by the President and by Gault J.

The subpoenas in question were obtained under section 9 of the Arbitration Act 1908. Their issue was challenged on the ground that the rent review was not an arbitration. The review hearing is being conducted pursuant to a clause under which the valuers or umpire are deemed to be acting as experts and not as arbitrators. The effect of that provision is to permit the valuers and the umpire to reach their respective decisions as expert valuers without the necessity for formal hearing. In this case, however, it is clear that a formal hearing is in progress before the umpire, the valuers having been unable to agree. We were told that counsel is appearing and evidence is being called. I have no doubt, therefore, that the proceeding is an arbitration and subpoenas are available under the Act. As the President has pointed out that would be the result in any event under the New Zealand legislation, because of the definitions in the Arbitration Act 1908. The term "arbitrator" includes a valuer, and the term "submission" has an extended meaning.

The Court has an inherent jurisdiction to set aside a subpoena and will normally do this where it can be shown that the issue of the subpoena is oppressive. That can be done under the general jurisdiction to avoid an abuse of process, as the President has pointed out.

Reference was made in argument to section 35 of the Evidence Amendment Act (No 2) 1980. It is not clear whether that section applies to situations such as the present.

The section appears to be more obviously directed to information received by one person from another in confidence. Here what is in issue is the detail of contractual arrangements made between parties who have mutually agreed to maintain confidence as to those arrangements.

If the section does apply then the matters which it sets out as relevant to the exercise of the Court's discretion appear to me to be the same matters as would be considered under the inherent jurisdiction.

The section requires the Court to consider whether or not the public interest in having the evidence disclosed is outweighed in the particular case by the public interest in the preservation of the confidence.

The Court is to have regard to the likely significance of the evidence to the resolution of the issues to be decided in

the proceeding, to the nature of the confidence, to the special relationship between the parties to it and to the likely effect of the disclosure of the confidence.

I do not think anything turns on whether the matter is dealt with under the sections or under the inherent jurisdiction. As to the relevant principles under that jurisdiction, Mr Camp for Watpat Nominees referred us to the judgment of Ackner LJ in *Campbell v Thameside Metropolitan Borough* [1982] 2 All ER 791. The relevant passage has been included in the judgment of Gault J.

There cannot in my view, be any doubt that the material which is the subject of the subpoenas is of considerable importance and is material to the issues in the rent review proceedings.

The issue in those proceedings is the fixing of rental for space in a central city building at the top portion of the market. The evidence sought to be disclosed by the issue of the subpoenas relates to rentals of space in another such building. There are possibly as few as three buildings in Wellington at that top level of the market which are truly comparable.

The rent review is under a clause which is apparently the standard BOMA clause in general use in Wellington. Such rent review proceedings are commonplace, and have been for many years.

Their effectiveness depends very much on the availability of accurate market information relevant to the particular premises, including details of side agreements providing for rental holidays and the like without which the actual lease may give a false picture.

The system of rent reviews based on assessment of market rentals has existed in this country for probably more than a hundred years, and the system inevitably depends on the availability of accurate market information which can be then analysed and assessed by valuers.

We were told from the bar that the information soughtby the subpoena from the appellants, relating as it does to another lease in a comparable building, relates to a lease which almost certainly has similar rent review provisions contained in it.

Given that situation, there would need to be very strong reasons before one would be inclined to say that the public interest in the disclosure of that information, so that the proceedings can proceed on reliable evidence, would be outweighed by the need for confidentiality pursuant to the agreement.

A number of matters were urged by Mr Dunning in support of the setting aside of the subpoenas.

He submitted that because the umpire was an expert and not bound by the rules of evidence, he could take into account hearsay and other indirect evidence and was, therefore, not dependent on the availability of the information sought. The fact that he may have access to inherently unreliable evidence in a matter of this kind does not appear to me to be any answer.

Then it was submitted that the law will protect confidential information, and will protect contracts and enforce contracts freely made.

That is true. However, the protection which the law will give to valid interests in confidentiality must yield where appropriate to the necessity for evidence to be available in proceedings whether in Court or before other tribunals. It was further submitted that Watpat Nominee's interest in obtaining the information arose from its own commercial interests. That is probably true of all commercial litigation where one party seeks to subpoena witnesses.

I do not regard that as a valid consideration.

It was urged on us that the National Provident Fund is the main beneficiary of the obligations of confidence in the lease agreements of which disclosure is sought.

It was submitted that the National Provident Fund will be likely to suffer economic loss if there is disclosure of the confidential information.

It represents a substantial portion of the public interest, it was said, as it manages 17 separate superannuation schemes with a total of 120,000 members. The only prejudice to the National Provident Fund, however, is that the disclosure of the information may lead to a truer appreciation of the true rental market and therefore may lead to lower rentals being obtained by it in other rent reviews in the future.

Probably because of the recent downturn in the market and the desire of landlords to maximise rents, confidentiality clauses have become popular in recent years. The property market seemed to manage quite well without them up until the recent downturn. Landlords are not necessarily to be blamed for seeking to ensure that conditions are confidential if they perceive that they may thereby be able to obtain better rents.

Likewise, lessees are not to be criticised for endeavouring to achieve lower rents.

It can hardly be said, however, to be in thepublic interest thatbusiness rentals should be based on a false appreciation of the market. There can be no injustice to either lessor or lessee in having reviewed rentals based on correct information as to true market levels.

None of the reasons advanced carry any weight, to me, against the important consideration that proceedings of the kind envisaged in a rent review should be able to proceed with accurate information as to market levels.

Mr Dunning also invoked section 21 of the New Zealand Bill of Rights Act which gives every person the right to be secure against unreasonable search or seizure.

That right applies, but is not limited, to persons, property or correspondence. I do not think there is anything unreasonable in information being required to be made available as evidence to the Court or to a tribunal to ensure that justice can be done asbetween the parties to those proceedings.

For these reasons, and those that have been traversed in the other judgments, I, too, would dismiss the appeal. A

IN THE HIGH COURT OF
NEW ZEALAND
AUCKLAND REGISTRY
CP 997/86

UNDER The Wages Protection and Contractors Liens Act 1939.

BETWEEN DOWNER & COMPANY LIMITED

Plaintiff

A TERRENCE ROY HILLSON and LINDA HILLSON

Defendants

Hearing: 27 August 1991
Counsel: M E Casey for Plaintiff
S C Ennor for Defendants
Judgment: 23 August 1991

JUDGMENT OF ROBERTSON J

On 14 August 1986, a proceeding was commenced in this Court seeking a lien under the Wages Protection and Contractors Liens Act 1939. An amended

statement of claim filed in February 1987 sought specifically a sum in excess of $500,000 and a declaration in respect of the lien as well as ancillary matters.

There has been a variety of amendments to the pleadings and there is a counterclaim which seeks a sum of more than $200,000.

In substance there is a dispute about the construction of a house for the defendant by the plaintiff with all the inevitable permutations and combinations which can arise in that area.

In 1989 there was an application for the appointment of an arbitrator and/or a referee. After a defended hearing the application was dismissed. However, eventually, the parties agreed in 1990 that the matter should be dealt with under s 15 of the Arbitration Act.

That arbitration is due to commence on Monday next, 26 August. It is scheduled to run for about two weeks. I am advised that there has been one preliminary procedural hearing before the arbitrator, but that he has not embarked in substance on the reference to him.

On 22 July 1991, what is described as a "Case stated pursuant to s i 1 of the Arbitration Amendment Act 1938" was filed in this Court. The case stated is signed by the arbitrator. There was provision for it to be countersigned by counsel for each party but that has not occurred. The background of the matter is set out in the case.

It is noted that the issue giving rise to the case stated is whether the building contract between the parties was validly terminated by the defendant on 16 February 1987.

It is acknowledged that certain aspects of this question concerned disputed issues of fact, but that there is one aspect in particular which was able to be determined as a matter of law.

The pivotal issue is whether a notice dated 5 February 1987, which purported to be under clause 40.1 of the NZIA standard conditions was effective in as much as the notice stipulated "five days" and not "five working days" as the period in which rectification was to occur.

Mr Ennor of counsel for the defendants, submits that the document presented to the Court by the arbitrator, was completed by the arbitrator without his having given any notice to the defendants nor having heard them on the issue as to whether it was necessary or appropriate to state a case.

He further submitted that at the time the case was stated, and in fact at the present time, the arbitrator has not yet embarked upon the hearing of the reference. All that has happened is that there has been a formal submission to him, a procedural conference at which counsel for the plaintiff specifically requested that this matter not be considered at all, and that accordingly, the case stated is not properly before the Court.

Section II provides:

"Statement of case by arbitrator or umpire

(1) An arbitrator or umpire may, and shall if so directed by the Court, state

(a) any question of law arising in the course of the reference; or

(b) A special case with respect to an interim award or with respect to a question of law arising in the course of a reference may be stated, or may be directed by the Court to be stated, notwithstanding that proceedings under the reference are still pending."

Mr Casey's submission to response was that once there has been a consensual reference to an arbitrator by the Court, then the course of the reference had begun and that this was an appropriate step to be taken at this stage by the arbitrator.

I am not persuaded of that situation. Although there is undoubtedly an ability to seek from the Court or from a barrister where the parties agree, a ruling on a question of law, in my judgment that should be seen and interpreted within the context of the decision to have the matter dealt with by way of arbitration.

It appears to me that to remove a question of this sort from its factual matrix before there has been any discussion of any sort before the arbitrator on the point, is inappropriate.

I have substantial sympathy with what Mr Case is trying to achieve in curtailing the metes and bounds of this dispute resolution which will go on before the arbitrator.

But in my judgment as a matter of policy where there is a reference to arbitration, then the issue should be considered in the course of the reference, to determine whether in fact it is necessary for a case to be stated. See *In re Arbitration,Roke vStevens* [1951] NZLR375.

If I view this matter in a robust way, it is clear that counsel for the plaintiffs have persuaded the arbitrator that the issue of whether a notice was defective or not is purely a question of law and have persuaded the arbitrator as a preliminary issue to seek the advice of the Court.

In my judgment the more appropriate and prudent course of action is for the arbitrator to hear counsel on this question and if he is then left in a position where he is unable to carry out his task without stating a case or without counsel agreeing to obtaining an opinion from a barrister, then the arbitrator in concert with both parties, should arrange for a case to be stated to this Court.

I accordingly uphold Mr Ennor's preliminary objection and decline to answer what is purported to be a case stated, but in respect of which the necessary preliminaries have not been carried out.

Solicitors

Kensington Swan, Auckland for plaintiff.
Glaister Ennor & Kiff, Auckland for defendants.

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