von Briesen
von Briesen & Roper, s.c. | Attorneys at Law

Jun 03 2013

Posted By: William R. West & Chris A. Jenny

Practice Area: Retail Real Estate

The recent rise in retail sales made over the Internet has thrown retail landlords and tenants alike for a loop. Not only with regard to changes in brick-and-mortar retail traffic and purchasing patterns generally, but also with respect to retail leasing arrangements, especially those that require payments of rent based on a percentage of the tenant's sales. This changing landscape has created a need for landlords and tenants to carefully examine their existing lease terms to ensure their current and future business methods are accurately captured or excluded, as the case may be, in their lease language.

The concept of percentage rent has been familiar to retail tenants and their landlords for many years. Landlords benefit from these arrangements by capturing higher rent when their tenants' businesses are doing well, rewarding the landlords for efforts to increase traffic to their shopping centers or properties; tenants benefit from lower rent payments in times when business may be sluggish.

While it has been generally accepted that items such as sales taxes and returns should be excluded from the percentage rent calculation, e-commerce sales are the subject of much negotiation. Landlords will typically want to capture as many Internet sales as possible in the calculation of sales upon which percentage rent is based, while tenants will want to exclude such sales to the extent their negotiating power permits. This Update is not intended to advocate for one position or the other, but rather, merely to highlight the terms parties on each side of the table should consider in their negotiations.

Percentage rent calculations typically include sales "made from the store," or perhaps may exclude Internet sales except for those "made from the store." Defining what constitutes a sale being "made from the store" can be a difficult task when considering various types of transactions. Landlords and tenants will want to consider variations on the typical transaction and determine if their existing or proposed lease language appropriately includes or excludes that type of transaction from the sales calculation upon which percentage rent is based. Some common scenarios to address include the following:

- Items ordered by a retail staff member on behalf of a customer, to be delivered directly to the customer's home because, for example, the item is out of stock or not available in a particular size or color;
- Purchases made by the customer at a kiosk or computer located in the store and made available to the customer for their own personal use;
- Purchases made by the customer by phone or on the retailer's website, to be picked up from the store and fulfilled from the store's existing inventory; and
- Purchases made by the customer by phone or on the retailer's website, to be shipped directly to the customer's home and fulfilled from the store's existing inventory without the customer ever setting foot in the store.

Some of these sales are more clearly attributable to the brick-and-mortar tenant, while others are more appropriately excluded from the percentage rent calculation; landlords and tenants may have room to negotiate over specific types of transactions. The key is to decide what constitutes a sale properly attributable to the tenant, and determine whether the existing lease language supports the landlord's or tenant's understanding of what should be considered in tenant's sales for the purposes of calculating percentage rent, or whether a revision is needed in order to clarify which sales will or will not be counted. Landlords and tenants with existing lease arrangements should review their existing language to ensure that existing or future plans to utilize one of the Internet sale methods discussed above are accurately expressed in the lease.

It is unclear how a court might interpret customary percentage rent language with regard to Internet sales. For this reason, in the interest of avoiding a dispute or potential event of default during the term of the lease, landlords and tenants should carefully consider the expression of their intent with respect to Internet sales and percentage rent. Because retail leases may span a number of years, both landlords and tenants would also benefit from taking the time to consider potential types of transactions that may be introduced in the future, in order to ensure that the language chosen at lease commencement or renewal encompasses new technologies, new means of fulfillment or inventory structures, or other new ways that customers may be purchasing at retail in the not-so-distant future. Careful consideration of percentage rent definitions will allow both landlords and tenants alike to deal with the rapid increase in online sales and the resulting impact that those online sales have on the brick and mortar retail business.
