



How Online Sales and In-Store Pick-Up Can Muddy the Waters on Calculating Percentage Rent

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In today's internet-reliant economy, retailers are expanding their online presence to stay relevant among customers that are increasingly looking to the internet for their shopping experience. Many customers prefer to shop from the comfort of their own homes and are visiting brick and mortar stores less and less frequently. Not only are retailers offering their same in-store products online, but also many retailers are allowing their customers to either place online orders in their stores or, alternatively, customers can place orders from the internet and arrange for an in-store pickup. Naturally, and of great consequence to the workings of many retail leases, these new internet-era options can dramatically affect the amount of sales consummated from a given retail store.

This trend is a real issue for retail landlords, especially in leases with tenants containing percentage rent as a part of the rent structure. In percentage rent leases, the tenant's rent payable to the landlord is partially (or wholly, in some instances) based upon a percentage of the tenant's sales from its premises. Percentage rent is typically beneficial for both landlords and tenants, as it allows landlords to benefit from higher rent when their tenants are doing well, and tenants are able to pay less overhead in base rent if sales are lower than expected. As such, it is important to make sure that the definition of gross sales and exclusions from gross sales are finely tuned in every retail lease with a percentage rent component.

Most leases do not adequately address the issues of sales kiosks, in-store pickup, and showrooming, as these sales methods have only recently gained such popularity. Sophisticated tenants will ensure that their leases contain a laundry list of items that are excluded from the definition of gross sales. But this will always depend on the particular tenant's bargaining power, or lack thereof. In leases which are more landlord-friendly and which allow for a broader definition of gross sales, it will likely be found that internet sales should be included in gross sales.

How narrow or broad a gross sales definition should be will depend upon the negotiator's position. Landlords want to ensure that these sales are included in tenant's gross sales because tenants are more likely to owe percentage rent. Tenants will fight for these types of sales to be excluded to lower their percentage rent payable. There are several possible solutions, with the key being to try to determine what is properly attributable to that particular store, as opposed to the general operations of such retailer as a whole.

One solution is allowing a certain amount of internet sales to be excluded, usually seen as a percentage, sometimes as high as ten percent (but also, perhaps, as low as two percent). Another possible solution is only excluding those orders that were not placed at the premises, and including the Dollar amount of the sales that were placed in the store. However, this can be tricky when trying to determine if a particular purchase was, in fact, made from the store. How does a retailer characterize purchases made on the phone from the company's distribution center when the store is out of a customer's size? It can be argued that this transaction should be excluded from the tenant's gross sales, as that store location will likely not receive any credit for originating that sale transaction. But many landlords would argue that, regardless of where the goods are delivered to or from, that particular customer used the shopping center's resources and amenities in visiting the store to place its order. It quickly becomes easy to see why these concepts must be thoughtfully fleshed out in individual leases, often on a retailer-by-retailer basis depending upon the retailer's operational model.

In the coming years, it is possible that many stores will switch to exclusively online shopping or online fulfillment, a concept that several stores have already adopted. The men's clothing retailer Bonobos, for example, simply allows for customers to come in and try on items in their store, but purchases are made exclusively online and shipped to the purchaser's home. Whichever camp you fall in, whether you are on the tenant side or landlord side, the parties will need to determine how they want this addressed in their leases, with sufficient flexibility to endure operational shifts and technological advances over the many years typically covered by a lease term. Landlords, especially, need to be wary, as deals underwritten based upon an expectation of percentage rent, may end up becoming less than originally bargained for.

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