

PERCENTAGE RENT AND ONLINE SALES

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INTRODUCTION

- The treatment of Internet sales in commercial leases is receiving an increasing amount of attention
- More than half of consumers now research their retail purchases online¹
- It is estimated that most retailers will generate about 40 to 50 percent of their sales online within the next five years
- In the United States, Sears closed almost 200 stores in 2013; Walmart's new stores are about a third smaller than they were five years ago²
- This phenomenon is not limited to apparel retailers and department stores
 - Many fast food and fast casual restaurants allow customers to purchase menu items online for home delivery or in-store pick-up
- The traditional function of the physical store is changing

THE IMPACT OF INCREASED INTERNET SALES ON COMMERCIAL RETAIL LEASES

1. *Reduction in percentage rent*

- This issue is especially relevant when a commercial lease requires the tenant to pay percentage rent
- Percentage rent is a form of rent which is based upon a percentage of a tenant's gross revenue and is almost exclusively reserved for retail tenants
- Percentage rent provisions are typically found in large shopping centre leases
- The idea behind percentage rent flows from the fact that a shopping centre is a natural draw for customers and the landlord, who has created an "advantage" for retailers, by selecting which businesses are placed within the same space, can negotiate a percentage of sales for its efforts
- The following is an example of how percentage rent is calculated:
 - a tenant pays minimum rent of \$10/square foot for 4,500 square feet of space, and thus would pay \$45,000 in annual minimum rent (or \$3,750 per month)
 - the percentage rent would kick in after a certain amount of gross revenue is achieved

¹ Louise Herring, Tobias Wachinger, and Chris Wigley. "Making stores matter in a multichannel world." McKinsey & Co., December 2014; page 1.

² *Ibid.*

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- the point at which the payment of percentage rent is triggered is called a “breakpoint” and can either be *natural* or *artificial* (if the breakpoint is never met, the tenant is only obligated to pay the minimum rent)
- an *artificial* breakpoint is simply a dollar amount of sales both parties agree upon
 - for example, a landlord might negotiate that 5% of gross revenue over \$800,000 should be paid in percentage rent (if the gross revenue is \$1,000,000 then the tenant pays 5% of \$200,000 or \$10,000 in percentage rent)
- to calculate the *natural* breakpoint, minimum rent is divided by the established percentage (in the above example, that would mean dividing the \$45,000 annual minimum rent figure by 5%, which equals \$900,000 in gross revenue as the *natural* breakpoint)
- the logic behind the *natural* breakpoint is that a retailer should only pay the percentage rent on sales over and above what is required to pay the minimum rent
 - in other words, taking 5% of \$900,000 in sales would equal the minimum rent payment of \$45,000, so it makes sense that the percentage rent requirement would only kick in after this minimum rent breakpoint is achieved
- Minimum rent and percentage rent are heavily negotiated points, and will vary depending on the nature of the business in question
- When evaluating percentage rent provisions, tenants should be aware of what types of revenue items are typically included and excluded from the gross revenue total; a few typically excluded gross revenue items include:
 - merchandise returned by the purchaser and refunded by the tenant;
 - the selling or rental price of merchandise returned by customers for exchange;
 - delivery charges (where they are a mere incidental part of the tenant’s business operations);
 - charges for repair or alterations made by the tenant at no profit (where they are a mere incidental part of the tenant’s business operations);
 - interest, finance or carrying charges separately charged by the tenant above the tenant’s selling price to the tenant’s customers (where they are a mere incidental part of the tenant’s business operations);
 - transfers of goods or merchandise between the stores of the tenant where such exchange of goods or merchandise is made solely for the convenient operation of the business of tenant not for consummating a sale which has been made at, in, from or upon the premises;
 - discount on sales given to a tenant’s employees;
 - the amount of returns to shippers or to manufacturers; and

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- the selling price of gift certificates or coupons (provided that such amounts are included upon redemption).
- In scenarios where percentage rent is charged, landlords will typically require tenants to:
 - provide regular sales reports;
 - allow audits of gross revenue; and
 - not open additional locations within the same market area.
- As shown above, percentage rent is based upon the gross revenue generated within a particular store; if we assume that increased online sales do not simply supplement in-store purchases, but rather detract from them, then this translates into a reduction in gross revenue and therefore, a reduction (or total elimination) of percentage rent that is payable to the landlord

a. **The Landlord's Perspective**

- The landlord's first position will be to insist that Internet sales having any association with the physical store be included in the calculation of its gross revenue, regardless of whether:
 - payment for the item was made online, and **NOT** run through the post-of-sale system within the store
 - the customer completed the transaction from their home, and **NOT** from a terminal or telephone located within the store or through an in-store sales associate
 - the sale was fulfilled from a centralized warehouse, and **NOT** from the store's inventory
 - **Example:**
 - Molly buys a t-shirt from Gap.com, using her home computer
 - She pays for the item online
 - The t-shirt is shipped to the Eaton Centre location from a central distribution centre in Mississauga
 - Molly picks-up the t-shirt from the Eaton Centre after receiving an online notification that it has arrived

In this example, is it reasonable for the landlord to require that the sale be accounted for in the same manner as an ordinary in-store sale?

b. **The Tenant's Perspective**

- The tenant's first position will be to insist that **all** Internet sales, even those having an association with the physical store, be excluded in its calculation of gross revenue, regardless of whether:
 - payment for the item was run through the point-of-sale system within the store
 - the customer completed the transaction from a terminal or telephone located within the store or through an in-store sales associate
 - the sale was fulfilled from the store's inventory

- **Example:**
- Molly buys a t-shirt from Gap.com, using an in-store computer terminal at the Eaton Centre location and with the help of a sales associate
- The sale is not run through the cash register in the store
- The t-shirt is shipped to the Eaton Centre location from a central distribution centre in Mississauga
- Molly picks-up the t-shirt from the Eaton Centre after receiving a phone call from the sales associate that it has arrived

In the example above, it would be difficult for the tenant to argue that the facilities of the store in no way contributed to Molly's purchase.

Would your opinion change if the sale was in fact run through the point-of-sale system or cash register within the Eaton Centre store?

c. **The Compromise**

- In most lease negotiations, the landlord will allow for the exclusion of Internet sales from gross revenue **so long as certain conditions are met:**
 - the item is paid for online, not run through the store's point-of-sale system
 - the sale is not fulfilled from in-store inventory
 - the online purchase was not completed from within the store (i.e. through an in-store terminal)
- **Example:** "Internet or catalogue sales, in either case to the extent: (a) payment for the items purchased does not occur at the Premises; and, (b) any such sale is properly accounted for in the ordinary course of business as having occurred at a location other than the Premises and not for the purpose of depriving Landlord of a sale which would otherwise have been made at, in, on or from the Premises."

2. ***Death of the "brick and mortar" store?***

- It is too simplistic to assume that growing Internet sales will lead to the complete demise of the "brick and mortar" retail concept
- Instead, retail strategies will need to evolve and progress:
 - Enhance the shopping experience and the atmosphere of the store:
 - ***Examples:***
 - J. Crew invites popular online bloggers to interact with customers, while attendees enjoy snacks and champagne

- the Apple store allows for hands-on testing of electronic devices; each store has a “Genius Bar” which allows customers to make reservations for repair of Apple products and to receive in-store support from experts
- William Sonoma conducts in-store product demonstrations and sampling
- Fewer, more useful physical locations: eventually, retailers may close a number of their existing locations, and may instead focus on “flagship” stores which serve to promote the online business; may be supported by smaller, less prominent locations³
- Internet sales will have little impact on service-based operations such as hair salons, medical offices and health clubs
 - Landlords may wish to pursue these types of tenants more aggressively, as they are better posed for longevity and for attracting customers to the shopping centre

A COMPLEX ISSUE

- The compromise position proposed above will be suitable for most traditional retail concepts, but a “one size fits all” solution does not exist
- The “showroom” retail concept
 - Limited quantities of products are displayed within the store for customers to peruse
 - Purchases are then made online or from kiosks located within the store
 - Depending on where the order takes place, landlords may forgo percentage rent and propose an increased base rent figure in its place
 - *Example*: Restoration Hardware
- Single store operations
 - Some tenants have only one retail location and no distribution warehouse
 - It will be difficult to argue that Internet sales have no nexus to the store, especially given that the sale must be fulfilled from in-store inventory
 - The tenant will argue that an order that is made from outside the store and only picked-up from the store should still be excluded from gross revenue

CONCLUSION

- In the near future, most successful retailers will generate a significant part of their gross revenue from online sales
- When negotiating exclusions from gross revenue in a commercial lease, the parties will need to compromise with respect to the treatment of Internet sales
- Parties should be aware of the nuances of a particular business so that a realistic solution is achieved

³ *Ibid.*