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Peer to Peer 7

Gross Sales Exclusions: What Is a Sale Anyway?

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Introduction

Percentage rent was introduced to retail leases during the Great Depression in an effort to save struggling retailers by tying the interests of both landlord and tenant to the tenant's success. However, it wasn't until the emergence of shopping centers in the mid-twentieth century that percentage rent became a common provision in retail leases. While the retail landscape continues to change, percentage rent remains an important concept for a few reasons:

- Percentage rent aligns the interests of the landlord and the tenant by creating an incentive to ensure success of the tenant's business. When a tenant's business performs well and generates higher sales, the landlord will benefit from higher rent. Therefore, percentage rent encourages landlords to invest more time and energy into advertising and generating more traffic to their shopping centers. Similarly, it creates an additional incentive for the landlord to properly maintain the center and otherwise ensure the center is an attractive destination for shoppers.
- Percentage rent gives tenants greater flexibility and reduces their risk by connecting their rental payments to their store's success. This is particularly beneficial for newer tenants or tenants in fluctuating markets, since it would reduce rent during lower sales periods.
- Because percentage rent changes with sales, it naturally reflects the current market conditions. For example, if a recession occurs, the tenants would benefit from lower rent in the form of less percentage rent as their sales decline without the need to amend their leases. As noted above, this can also be advantageous in dynamic markets where sales can vary significantly from year to year.

What is Percentage Rent?

Percentage rent is a percentage of the tenant's gross sales in excess of a specified breakpoint. A breakpoint can be a natural breakpoint (see below) or another amount agreed upon by the parties.

- A "breakpoint" is the sales threshold where a tenant begins paying percentage rent. Some leases provide that percentage rent begins the month immediately after the month in which the breakpoint is achieved; however, others provide that percentage rent is paid annually regardless of when the tenant's gross sales exceeded the breakpoint.
- A "natural breakpoint" is the point that the tenant's gross sales reach a level where percentage rent equals the base rent if the tenant had paid percentage rent from the first dollar. The natural breakpoint is calculated by dividing the base rent by the percentage rent rate.
- The percentage rent rate is the percentage used to determine the portion of the tenant's gross sales that is to be paid to the landlord as percentage rent.

For example, if a tenant is paying base rent of \$100,000 per year and the percentage rent rate is 10%, then the natural breakpoint would be \$1,000,000. If Tenant's gross sales for such year were \$1,200,000, the tenant would pay \$100,000 as base rent, plus percentage rent in an amount equal to \$20,000.

Historically, percentage rent was paid in addition to base rent and additional rent; however, in the post-COVID market, it is not unusual to encounter leases where tenants are paying percentage rent only with no breakpoint.

Gross Sales

Gross sales refers to the total revenue generated by a tenant from the sale of goods and services before any deductions. In addition to calculating percentage rent, gross sales is often seen in the context of "kickouts" which allow tenants (and occasionally landlords) to terminate a lease if the tenant is not achieving a certain gross sales threshold, and it is sometimes used to limit the circumstances in which a tenant is entitled to its remedies for an exclusive violation (e.g., the tenant is only entitled to exercise its remedies if its gross sales declined).

From a landlord's perspective, gross sales should be defined as broadly as possible to ensure all revenue is captured. A broad definition is particularly important if a tenant's use includes a mixture of goods and services or the tenant has the ability to change its permitted use.

For example, "Gross Sales" shall mean the entire amount of the actual sales or rental price, whether for cash, credit or otherwise, of all sales or rentals of goods and services and all other income and receipts whatsoever in connection with all business conducted at, on, from or attributable to the Premises, including, without limitation: (i) fees, commissions, catalog sales, and orders by means of electronic, telephonic, video, computer or other technology-based system, whether existing now or developed in the future, that are taken at or made from the Premises; (ii) deposits not refunded to purchasers; (iii) orders taken at the Premises although filled elsewhere; (iv) gross receipts from vending and game machines; (v) sale price of gift and merchandise certificates; (vi) payments from other parties for shelf or advertising space at or respecting the Premises; (vii) the full value of all consideration other than money received in connection with all businesses and operations conducted at, on, from or attributable to the Premises; (viii) all other gross income or receipts from any business or operation at, on or from the Premises; and (ix) Gross Sales by any sublessee, concessionaire or licensee.

Gross Sales Exclusions

While the term "gross sales" is used in percentage rent provisions, percentage rent is rarely based on a tenant's unmodified gross sales. Instead, percentage rent is typically based on the tenant's gross sales minus certain excluded amounts that are expressly stated in the lease. Gross sales exclusions are often negotiated, but many landlords will include common exclusions in their lease form in the hope of streamlining this process.

Common Gross Sales Exclusions

Some gross sales exclusions are so common that they have become customary and market in the industry. A few examples of these are the following:

- Returns to shippers or manufacturers
- Proceeds from the sale of used trade fixtures
- Any cash or credit refunds made upon any sale in or from the Premises where the merchandise is returned by the purchaser
- Any sales or excise tax imposed by any duly constituted governmental authority (provided that no income or franchise tax, capital stock tax, tax based upon gross receipts, assets or net worth, or similar tax shall be deducted from Gross Sales)
- The exchange of merchandise between the stores and warehouses of Tenant, if any, where such exchange of merchandise is made solely for the convenient operation of the business of Tenant and not for the purpose of consummating a sale that has theretofore been made in or from the Premises or for the purpose of depriving Landlord of the benefit of a sale that otherwise would be made in or from the Premises

Less Common Exclusions

Tenants often negotiate additional gross sales exclusion; however, as this impacts percentage rent, landlords will often seek to limit these exclusions. Some exclusions, such as discounted sales to employees and altering when gift cards are included in gross sales, are typically not controversial but the landlords will usually want to impose clear limits on these exclusions. For example:

- The amount of any sales to employees at a discount of at least twenty percent (20%), such excluded amount not to exceed one percent (1%) of Tenant's Gross Sales at the Premises per Lease Year
- All sales of gift certificates or like vouchers, so long as gift certificates and like vouchers are similarly treated in all of the stores of Tenant, its parent, affiliates and subsidiaries, and provided that sales of merchandise made at the Premises and paid for by such gift certificates or vouchers (regardless of where such certificates or vouchers were issued) shall be included as Gross Sales and, further provided, if at any time

Tenant deems the certificates or vouchers forfeited, or if the certificate or vouchers are not redeemed within one (1) year after the end of the Lease Year in which they were sold, the amount of the certificates or vouchers shall at that time be included in Gross Sales under this Lease

Other exclusions, such as bad debts, are often a sticking point for landlords, because these exclusions shift certain business risks which are typically borne solely by the tenant onto the landlord.

As a part of the gross sales exclusions, landlords and tenants often negotiate which online sales should be included in gross sales for the tenants' premises. Fortunately, landlords and tenants generally agree that online sales should be included in gross sales if the premises played a role in the sale; however, they may not agree as to when the premises played a significant enough role to justify including the online sale in gross sales. The role that stores play in online sales varies from retailer to retailer. Therefore, it is important to understand the specific retailer's system when clarifying the definition of gross sales and exclusions from gross sales.

New(er) Terms for the Online Shopping Age

In the past decade, online shopping has grown in popularity. While the COVID-19 pandemic contributed to the rapid growth of online retail, consumers continue to patronize brick and mortar stores, and it is not unusual for shoppers to order something online but pick it up in store. As such, it is important to understand how online shopping and brick and mortar stores often interact.

BOPIS

BOPIS is an acronym for "buy online pickup in-store." It lets shoppers make a purchase via an online channel, such as a mobile app or website, and retrieve their order from a nearby brick-and-mortar store.

Consumers can shop on the retailer's app, mobile site, or website. Once the order is ready for pickup, customers will receive a text or email notification. They can then head to the store and find the online pickup location. There, they'll need to either show identification or open the retailer's app to confirm their order details and get their purchase.

BOPIS gives customers a reason to visit a brick-and-mortar store, where they may spot more enticing items to purchase on a whim. It also reduces shipping costs for retailers and frees up space for new inventory, as brands can more easily move the stock that's already available in their stores.

By using BOPIS, customers can avoid shipping fees – generally one of the biggest draws of the service. The other big perk is the immediacy of retrieving orders without waiting for delivery. Additionally, customers who choose curbside pickup can skip in-store lines and save time by getting their orders dropped off at their cars.

BORIS

BORIS stands for "buy online return in-store." This means that shoppers can purchase items online and later return or exchange them in a brick-and-mortar store.

Consumers can make purchases on the retailer's app, mobile site, or website and select their preferred fulfillment method to receive them. If they receive their items and decide they don't want to keep them, they can either start the returns process on the retailer's mobile app or site, or they can head directly to the store to initiate the return there. If they opt to start on the app or site, the retailer will typically ask why they are returning the items – which can inform future inventory decisions – and provide a QR code that in-store associates can scan to expedite the process.

After shoppers arrive at their nearest brick-and-mortar store, they can head to the designated online pickup counter, customer service counter, or main cashwrap to drop off the items they don't want. The sales associate will process the return and prepare the items to hit the sales floor to be sold again or sent back to the warehouse or distribution center.

BORIS yields many perks for retailers, including increasing foot traffic in stores – which can then boost the potential for impromptu in-store purchases. It also results in a greater likelihood of converting returns into exchanges if

customers see that the item is readily available in another size or color. Additionally, omnichannel returns promote more sustainability due to retailers using less packaging and shipping materials. If items can be added back into the store's inventory for reselling, they may also be kept out of landfills.

BORIS eliminates the hassle associated with paying for return shipping, and it expedites the entire returns process. It also offers customers a more personalized experience, as they can interact with a store associate who can answer any questions for them. This can ultimately result in greater brand affinity.

BOSS

BOSS is an acronym for "buy online ship-to-store." Retailers typically offer BOSS as a fulfillment option if their operations aren't set up to fulfill online orders with store inventory or if the local store is out of the customers' desired items.

If shoppers purchase items online that are not available at their nearest store, retailers can offer BOSS to ship the order to the nearest location from another store, warehouse, or distribution center. While this option gives customers fulfillment choice, it can take several days for their order to arrive at the store for pickup. BOSS is especially useful at promoting omnichannel fulfillment because it effectively means retailers will never have to turn away sales due to being "out of stock."

BOSS helps supplement the BOPIS fulfillment option, especially for stores running low on inventory. It enhances distribution efficiency by having warehouses or distribution centers fulfill customers' orders instead of putting the onus on store associates. BOSS also allows brands to keep smaller physical locations, as they'll be able to tap into enterprise-wide inventory to complete orders. And, it helps drive more potential sales by increasing in-store foot traffic, since customers will need to visit a store to pick up their purchases.

Finally, shipping orders to stores for pickup eliminates the need to team up with third-party or last-mile delivery platforms – a big cost savings.

In addition to the retailer never having to signal they are out of stock of something, BOSS ensures that customers will receive free shipping on their orders with no minimum purchase amount. Similar to BOPIS, it also gives consumers a more personalized in-store experience, during which they can ask store associates for help if they have questions or request product recommendations.

ROPIS

ROPIS, which stands for "reserve online pickup in-store," is not exactly a "B" retail acronym, but it falls within the family and is growing in popularity as a fulfillment option. While its concept is similar to BOPIS or click-and-collect, the main difference is that customers don't pay for their items until they arrive at the store.

With ROPIS, shoppers can reserve items on the retailer's website or mobile app and visit their nearest store to complete the purchase and retrieve their items. If customers have selected ROPIS because they want to try on or test merchandise before they buy, their first stop in the store is usually the pickup counter or cash wrap. They also may head straight to the dressing room at a specialty retail shop. If they decide the item is the perfect fit or works as expected, they can then proceed with a typical in-store checkout flow to complete the purchase.

ROPIS promotes higher foot traffic in stores, which can result in more impromptu purchases, as customers may spot items they would like to add to their final orders. It also enables store associates to upsell or cross-sell products before customers check out.

As mentioned, ROPIS is especially useful for customers who want to try on or look at products prior to making a purchase. This gives customers more flexibility, as they can choose to swap their reserved items for an alternative if they see something better suited to their needs in the store. ROPIS may attract the types of shoppers who prefer to research products before buying them – especially if the products are higher end.