UNCHARTED TERRITORY FOR RETAIL TENANTS AND LANDLORDS: FACTORING ONLINE RETURNS INTO GROSS SALES CALCULATIONS

by Joseph Goddard
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With the rise of e-commerce, declining foot traffic in malls and shuttering department stores, retail landlords and brick-and-mortar tenants have faced a wave of challenges in recent years. As a result, both landlords and tenants are constantly searching for new and unique ways to improve their bottom line. One recent area where this has become an issue concerns in-person returns from online sales, and how they affect a retail tenant's percentage rent calculation.

Many retail leases contain a percentage rent provision in which a tenant pays a portion of its gross sales above a certain threshold to the landlord in addition to the tenant's other rental obligations. These provisions often include numerous exclusions that can be deducted from a tenant's gross sales calculation, including employee discounts, gift certificates prior to redemption and fees paid to credit card companies. Many leases also contain language allowing retailers to deduct the sales price of items that have been returned by customers.

As a result of the rising popularity of online shopping, disputes have arisen between retail landlords and tenants as to whether tenants can deduct the sales price of items bought online and subsequently returned in store from the gross sales calculation in their lease agreement.

CONSIDERATIONS FOR LANDLORDS AND TENANTS

If you're a retail landlord or tenant reviewing your lease agreement and are concerned that it is ambiguous as to whether or not online returns are excluded from the calculation of gross sales, you can take solace in the fact that you're not alone. Last year, David Simon, CEO of Simon Property Group (the largest owner of shopping centers in the United States) lamented to industry analysts that the issue of online return exclusions needed to be addressed in future leases. Simon and many other retail landlords have seen their revenues from percentage rent provisions adversely affected as tenants increasingly seek to exclude such online returns from the determination of their percentage rent obligations, and there currently is no consistent industry standard that governs the issue, causing it to be negotiated on a case-by-case, deal-specific basis.

Landlords will argue that deducting such online sales from a tenant's percentage rent obligation is unfair, because such items were not previously included in gross sales. The meteoric rise in popularity of online shopping has already caused enough headaches for retail landlords; the last thing many want to see is their shopping center morphed into a de facto distribution center for online sales and returns. In the long term, lower gross sales figures can adversely affect real estate valuations, hindering the landlord's ability to refinance or sell a property.

Tenants counter that while such returned items were not previously included in their gross sales calculation, the in-store return process generates increased foot traffic in shopping centers which presumably leads to an increase in sales and benefits the center as a whole.

When addressing this issue, landlords and tenants should take into consideration their respective bargaining power, the nature of the tenant's business and the likelihood that foot traffic from such returns will benefit the shopping center as a whole. Tenants that are located on exterior pad sites or near the entrance to a shopping center would likely be a convenient return option for consumers, and therefore bring less foot traffic than a tenant centrally located within the development. Furthermore, if the tenant is in the business of selling items that are particularly expensive, the resulting foot traffic from the customer returning an expensive purchase and subsequently buying coffee and a bagel in the food court isn't helping the landlord's balance sheet if such return is fully deducted from a gross sales calculation.

NEGOTIATION STRATEGIES

From a landlord's perspective, the most favorable language in a lease addressing the online sales return issue is to state that only returns of items that were previously included in a tenant's gross sales calculation can subsequently be deducted from such calculation. Landlords should also insist that the lease provides them adequate audit rights pertaining to tenant's gross sales reports to ensure that returns are not being improperly deducted. For tenants, a blanket exclusion for retuned items from gross sales would be the best case scenario; however, few (if any) landlords are likely to agree to such a provision. In today's omnichannel retail experience environment, tenants may attempt to carve out an exclusion for returns of any items ordered at or delivered to their store, regardless of whether such original purchase was included in gross sales, using the aforementioned argument that returns of such items generate increased foot traffic in the shopping center. If the parties are willing to compromise on the online sales returns issue, often the easiest solution is to allow such exclusion for items returned in store, but only up to a certain (and small) percentage of a tenant's total gross sales calculation, typically ranging from two to five percent.

BOTTOM LINE

Gross sales provisions in retail leases are often complicated and cumbersome for both landlords and tenants to interpret, and the emergence of e-commerce has exacerbated this problem. Older leases often do not adequately address the issue, and with no clear industry standard in place, new leases should clearly and definitively state the nature of returned items that can be excluded from a tenant's gross sales calculation. Whether a landlord or tenant is attempting to interpret existing gross sales calculation language or negotiate a new lease, they should retain an experienced real estate attorney to advise them throughout the process.

ABOUT THE AUTHOR

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Joseph Goddard concentrates his practice in the acquisition, disposition, financing, and development of various types of real estate projects. He also represents both landlords and tenants in commercial lease negotiations and advises clients in the resolution of commercial landlord-tenant disputes. Additionally, Joseph has experience handling general commercial transactions and corporate governance matters.

Before entering private practice, he served as in-house counsel for a publicly-traded REIT that owns, operates, and develops a nationwide portfolio of malls and shopping centers. This experience gave Joseph a unique perspective which enables him to analyze issues and anticipate potential pitfalls in a transaction from a client's point of view.