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Making online sales count

Revenue from the web can add a complex wrinkle to commercial leases based on business sales.

By Marg. Bruineman

The growth of online sales is having an impact on how commercial landlords and tenants are looking at new leases while it introduces some creative re-examination of existing long-term leases.

Turnover or percentage rent allows the landlord and the tenant to share the risk or the success of the business. Instead of paying a flat rent, a minimum rent could be negotiated in addition to a portion of the gross sales of the business after a pre-determined break-even point. It is an attractive model on many levels, allowing tenants and landlords to ride high and low waves together. For commercial spaces in malls or areas undergoing renovations, percentage rent could help the tenant mitigate any lost traffic caused by the renos. And an uncertain tenant may be attracted if the risk is shared through a percentage-rent relationship.

But as many of these businesses achieve offsite sales through the assistance of the Internet, landlords have been asking for a cut of non-traditional sales. How that is defined, calculated, and achieved is subject to interpretation and negotiation. And some wonder if the model can be sustained as e-commerce continues to build steam.

Christene Hirschfeld, a Halifax business lawyer with Boyneclarke LLP, first experienced this shift about a decade ago while negotiating retail space for a client who also had a warehouse in a different, unrelated location. Customers would go to the retail store, but some orders would be packaged and shipped from the warehouse. The landlord included a clause to capture orders placed at the store that were shipped from the warehouse as part of the gross rent calculations for the retail space.

"With the shift for consumers moving more and more to online shopping and the increased use of mobile technology, I think that this issue is just going to keep increasing in importance. If the landlords don't get it right, they run the risk of decreasing the returns they're getting on the buildings so their rents are decreasing. That means, in turn, that the valuation of their properties are decreasing," observes Hirschfeld.

That co-dependency between the online orders and bricks-and-mortar presence resulting from changes in technology and consumer behaviour is showing up on commercial lease agreements with increased complexity. And it's not expected to ease up, at least in the short term.

According to Statistics Canada, e-commerce sales for 2013, the latest available, totalled $9.8 billion, or 1.8 per cent of retail operating revenue, up from 1.5 per cent the previous year. Forrester Research anticipates e-commerce sales in Canada to reach 8.8 per cent by 2019.

But because of this gradual transition

that began a decade or so ago, the issue of online sales has only recently become more of a concern for both landlords and tenants as they work out how to calculate the cost of renting commercial premises. "It hasn't been one of those top-of-mind issues that people have had to pursue or disagree over. But I would say it is definitely becoming more of an issue," says Dennis Tobin, a commercial leasing lawyer at Blaney McMurtry LLP in Toronto who mostly acts for mid- and large-sized retail tenants. "It's on the new crop of leases that you see a much more sophisticated approach."

While the turnover or percentage-rent model has been around for as long as working lawyers can remember, just how online sales fit in from the practical perspective can be tricky. Montreal lawyer Mason Gordon, an associate in McCarthy Tétrault LLP's business law group, says past drafting of turnover-rent clauses often didn't foresee online sales and that could present a challenge for the landlord to get what's expected. So conversations on rent renewals and new leases now often focus on what the percentage rent includes as well as clearly defining what gross turnover and gross profits are.

But even for leases that do take e-commerce into consideration, there is a question about how that is calculated. "A well-drafted turnover lease arrangement will consider and deal with certain issues that weren't really issues in the past," says Gordon. "You really have to look at the specificity of the client's business. Draft these leases with very careful wording to clearly define gross turnover and gross revenue and foresee these situations that weren't necessarily business practices 15 years ago."

The issues could include situations where a shopper uses the physical store to check out the item but makes the purchase from the store's web site. The calculation isn't so simple if the store is part of a chain with a centralized ordering and warehouse facility. The tenant might want to make accommodations for returns and exchanges, so they're deducted from the revenue tally. But the situation can be further complicated if an order is made from a chain's central hub but the item is returned to the store. Loss leaders — products that are priced to attract customers but don't generate revenue for the retailer — as well as frequent purchaser rewards programs or giveaways that don't contribute to the bottom line are additional factors.

"The wording in the landlord's provisions tends to be so generous and wide that without these types of clarifications there can be an argument made that all these be included in gross revenue, that you would be paying rent on that amount," says Greg Liakopoulos, a commercial real estate law partner with Bennett Jones LLP in Calgary. "The tenant, their job, really, is to take a scalpel to that approach."

Internet sales provisions in percentage-rent leases could vary from capturing too much to capturing too little, Liakopoulos adds. And if some of the store's traditional sales are falling into the online sales category, landlords will be concerned about measuring the total gross revenue adequately. So what's included and what's not included ought to be clearly delineated.

But that's not where the discussions end. Enforcement needs to be included in the terms of the lease as well. Negotiations could include whether landlords can have access to electronic record keeping or whether they can have auditing rights to ensure the proper calculations are made. But, asks Liakopoulos, do landlords really have the resources to go through all the reports that are generated to police the rent contributions?

While turnover rents are common, certain sectors, such as grocery and drug stores, stay away from them, preferring to pay a set rent. Yet, for some stores that pay straight rent, the landlords' requests to audit the sales statements are starting to spill over, says Andrew Fortis, who leads Toronto-area Hummingbird Lawyers LLP's real estate and corporate/commercial practices. "They still ask to see your annual revenues, even though percentage rent is not included." So, when it comes time to renew, the landlord could raise rent if the tenant has done well in the location. Fortis has thus far successfully argued that there's no merit in the landlord having access to the books if the rent isn't reliant upon the sales. But, he says, some may not bend on the issue. Like many aspects of the lease, it often simply comes down to who has the power of negotiation in the relationship.

From a landlord's perspective, the challenge is using a static document today that may have to relate to a changing environment 20 years down the road. "If you think about it from the landlord's point of view, they're trying to read a crystal ball as to where technology is going into the future," says Tobin. "One of the key points is technology is changing while the lease is static. And that is the challenge: You've got to get the deals done and you don't know what the future holds."

While lawyers grapple with old leases in an attempt to accommodate the changing realities, Liakopoulos questions the future of percentage rents. "We spend all this time coming up with the perfect words, we have to ask ourselves: 'Hey, landlord, do we have the infrastructure in order to be able to review and confirm what we say we're going to do?'" he says. "If you are going to use them, I think you need to think hard about how it's going to be included."

Harvey Haber, author of *The Commercial Lease: A Practical Guide*, expects that percentage rents will survive current and future trends, at least to a degree. Already, many larger tenants insist on a straight rent arrangement and, for simplicity, that might carry over to other tenants. But there's still a degree of attraction to sharing the risks and the rewards for other arrangements, he says.

Smaller tenants, who have less negotiating power, may have no choice, if that's the desire of the landlord. But then the issue of risk surfaces once again. "The question for the landlord is if he puts in a break-even point, will the tenant make that break-even point, which starts them paying percentage rent," says Haber, who is now working primarily as a mediator and arbitrator with Coe and ADR Management. **CL**