

PERCENTAGE RENT PROVISIONS IN SHOPPING CENTER LEASES: A CHANGING WORLD?

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Editors' Synopsis: The author provides an updated analysis of percentage rent provisions in shopping center leases and advises calculation methods for determining percentage rents according to an acceptable definition of gross sales. The author discusses pertinent case law to illustrate drafting and enforcement issues regarding percentage rent provisions, concomitant audit rights of the parties, and the consequences of continuous operation covenants. Finally, this Article provides a discussion of the remedies for default in percentage rent payments and the implications of potential bankruptcy issues.

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I. INTRODUCTION

Because of the generally speculative nature of retail sales, percentage rent provisions are common in shopping center leases. They provide an opportunity for the landlord to share in the future economic success of the tenant's business, often in exchange for a lower base fixed minimum rent. Landlords insert percentage rent provisions in shopping center leases to obtain attractive tenants, secure long-term leases, and provide a hedge against inflation. The use of these provisions also encourages a "team" approach between the landlord and tenant to maximize the profits not only from the tenant's business, but also the shopping center as a whole.² A percentage rent lease provides the landlord with greater rental income when the tenant's business prospers, and it minimizes the risk of the tenant's going out of business and leaving the center when sales are down. The concept of percentage rent is also attractive to a retail tenant, because it enables the tenant to establish an overall cost and budget for operating its business at the premises (based on an acceptable "breakpoint"); enables the tenant to align the payment of rent with actual

² This type of arrangement should not cause a court of law to recharacterize the parties as partners or joint venturers. At least one state provides statutory protection for leases with percentage rent provisions. *See generally* N.C. GEN. STAT. § 42-1 (1999) (providing that "[n]o lessor of property, merely by reason that he is to receive as rent or compensation for its use a share of the proceeds or net profits of the business in which it is employed, or any other uncertain consideration, shall be held a partner of the lessee"). The intention of the parties may be important in this regard. Shopping center leases frequently contain a statement that no partnership or joint venture, or any other relationship other than landlord and tenant, is intended to be created as the result of the provision for the payment of percentage rent or any other provision in the lease.

cash flow; and allows for a “cushion” that limits the tenant’s exposure in the event of a future decline in sales.³

II. DETERMINATION OF PERCENTAGE RENT

A. Breakpoint Calculation

Percentage rent provisions in retail commercial leases usually provide that the percentage rent is in addition to the fixed base minimum rent and is based on a percentage of sales in excess of a fixed dollar amount. The fixed dollar amount in this equation is often referred to as the “breakpoint,” *i.e.*, the minimum amount of sales that must be generated from the leased premises before percentage rent commences. The “natural breakpoint” refers to the amount of gross sales necessary to achieve payment of the minimum rent set forth in the lease and is determined by dividing the fixed annual rent by the agreed-upon percentage rate. Percentage rents also can be calculated based on a percentage of the amount by which gross income exceeds a specified level of sales, regardless of minimum rent. A retail lease may even contain a “pure” percentage rent provision, *i.e.*, the clause would provide for the payment of percentage rent based on gross sales from the first day of the lease with no breakpoint or credit for base rent. Such leases are rare and usually are utilized when the landlord and tenant are directly or indirectly related and the landlord is willing to share more of the tenant’s business risk. Landlords usually will attempt to avoid calculating percentage rents based on net profits, although some large national retailers with bargaining clout have been able to negotiate this method of determining percentage rents. Determination of net profits may be uncertain because of additional factors that enter into the calculation, the

³ See *Coll. Block v. Atl. Richfield Co.*, 254 Cal. Rptr. 179, 182 (Ct. App. 1988) (citations omitted) (“A percentage lease provides a lessor with a hedge against inflation and automatically adjusts the rents if the location becomes more valuable. It is advantageous to the lessee if the ‘location proves undesirable or his enterprise proves unsuccessful.’ Thus, both parties share in the inherent business risk.”); Jennifer E. Doty, *The Effects of Electronic Commerce on the Traditional Shopping Center Lease*, 6 TEX. WESLEYAN L. REV. 85, 87 (1999) (quoting Mitchell Y. Herman, *Modifying Percentage Rent Clauses—And Its Consequences*, 11 NO. 1 COM. LEASING L. & STRATEGY 3 (1998)) (“The purpose of percentage rent is to ‘enable a tenant to remain fiscally viable in lean times while allowing the landlord to share the tenant’s success in prosperous times.’”). RICHARD R. GOLDBERG, *COMMERCIAL REAL ESTATE TRANSACTIONS HANDBOOK* § 13.02[A] (3d ed. 2000) (“Percentage rent affords the landlord protection against inflation. It is most meaningful in leases other than those of the big box variety.”).

application of different accounting methods and standards, and the delay in reporting due to the additional complexity involved in computing net profits.⁴

⁴ “Net profits” are “[p]rofits after deduction of all expenses; [they] may be classified as net before or after taxes. Deducting the cost of goods sold from sales gives the *gross profit*. Deducting the operating expenses (overhead) from gross profit gives the *operating profit*. Deducting income taxes from operating profits gives the *net profit*.” BLACK’S LAW DICTIONARY 1041 (6th ed. 1990). See also Annotation, *Construction and Application of Provision in Lease Under Which Landlord is to Receive Percentage of Lessee’s Profits or Receipts*, 38 A.L.R. 2d 1113 (1954) (discussing the construction and application of leases in which rent terms are based on a percentage of the lessee’s profits); Douglas Hale Gross, Annotation, *Calculation of Rental Under Commercial Percentage Lease*, 58 A.L.R. 3d 384, 437-45 (1974) (discussing the deduction or exclusion of receipts from lessee’s business activity that is ancillary to lessee’s primary business activity); John M. Tyson, *Drafting, Interpreting, and Enforcing Commercial and Shopping Center Leases*, 14 CAMPBELL L. REV. 275, 283-85 (1992) (analyzing percentage rental provisions). Many shopping centers are owned by Real Estate Investment Trusts (“REITs”). A REIT is a business trust or corporation that obtains capital from a large number of investors to purchase or finance real estate. In order for a REIT to avoid taxation at the corporate level on income that it distributes to its shareholders and to avoid a tax penalty or even a possible disqualification, 75% of its income must be derived from investments related to real estate, including “rents from real property.” I.R.C. § 856(c)(3). “Rents from real property” includes rents from interests in real property, charges for services customarily furnished or rendered in connection with the rental of real property, and rent attributable to personal property if such rental does not exceed 15% of the total rent for both the real and personal property. See I.R.C. § 856(d)(1). Additionally, at least 95% of a REIT’s income must be derived from items of gross income that satisfy the 75% test, together with dividends, interest, gain from the sale of stock, securities, and real property, and abatements and refunds of real property taxes. See I.R.C. § 856(c)(2). Given these statutory constraints, and United States Treasury Regulations promulgated thereunder that may now or in the future affect the taxable status of REITs, REITs would be well-advised to avoid entering into percentage rent leases that calculate the payment of percentage rent based on the net income or net profits of the tenant, as opposed to gross sales. Otherwise, they may be deemed to have received net operating income from the tenant’s business, and not rents from real property, in violation of Internal Revenue Code section 856(c)(2). Commentators have suggested that not only percentage rent leases entered into by REITs, but all shopping center leases, should contain a REIT lease provision due to the possibility that a REIT may become the future owner of the center. Under this provision, all rents, including percentage rents, under the lease qualify as rents from real property under section 856(d) of the Internal Revenue Code. Further, under this provision, any change in this statute, or the Treasury Regulations issued thereunder, that disqualified any of the rent payments as rents from real property would allow the landlord to adjust the rent to achieve compliance (subject to the requirement that the total rent paid by the tenant not change) or, if the rent was incapable of being so adjusted, the landlord would have the option to terminate the lease. See Eli Rubenstein and Richard Talcov, *Ensuring Your Property Qualifies for REIT Ownership*, 7 COM. LEASING L. & STRATEGY 6 (1997). Many hotel, healthcare, and retail REITs lease property to tenants who pay percentage rent. REITs customarily report and recognize income from percentage rent leases evenly throughout the year; *i.e.*,

The natural breakpoint can be modified, based on the negotiating strength of the parties, by changing either the percentage rate used to determine the breakpoint or the percentage rate used to determine the payment of gross sales above the breakpoint. A scenario favoring the landlord would set the breakpoint below the natural breakpoint, which would require the payment of percentage rent sooner and in a greater amount, by raising the percentage rent rate (*e.g.*, from three percent to four percent). A compromise position would involve using two separate percentage rates, *i.e.*, one rate as the natural breakpoint rate (*e.g.*, four percent) and another rate to determine the amount of percentage rent payable in excess of the breakpoint amount (*e.g.*, three percent). A provision favoring the tenant, on the other hand, would provide either a higher breakpoint amount based on a lower percentage rate or a compromise position providing for a lower breakpoint percentage rate but using a higher percentage rate to calculate the payment of percentage rent after reaching the breakpoint.

B. Negotiation and Drafting Issues and Strategies

Because most business failures occur during the first four years of a tenant's operation, the parties' establishing a lower base rental at the inception of the lease in return for a higher percentage rent may be logical. This arrangement would provide sufficient time for the business to grow and for the tenant to increase sales volume (assuming that the logic of this strategy convinces shopping center lenders). On the other hand, some tenants, especially established national retailers, may prefer a higher base rent with minimal (or perhaps no) percentage rent to lock in

the tenant pays the projected total annual rent evenly in monthly or quarterly installments throughout the year, and a reconciliation occurs at the end of the year. On August 19, 1998, the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board ("FASB") issued a ruling, Issue No. 98-9, that required reporting contingent rental income (*e.g.*, a portion of sales based on the anticipated achievement of a projected annual amount) later in the year when the contingency no longer exists and the income is quantifiable. The REIT industry argued that this ruling altered longstanding accepted accounting practices and unfairly distorted a REIT's earnings. On November 19, 1998, the EITF withdrew its consensus on contingent rents in interim periods and rescinded Issue No. 98-9. *See* Financial Accounting Standards Board: Emerging Issues Task Force, *at*

<http://www.rutgers.edu/Accounting/raw/fasb/citf/eitfissu.html> (last visited Dec. 11, 2000).

However, the FASB is still considering the issue of how a landlord should account for contingent rental income that is based on a future sales target for the tenant's operations, and may issue a revised ruling on this matter in the future.

a favorable rental and avoid disclosing gross sales. For underwriting purposes, mortgage lenders loaning money on shopping centers historically have preferred a substantial, fixed, minimal rent payment in lieu of percentage rent (which they view as fluctuating and uncertain) that constitutes a substantial portion of the total rent payment.⁵

A landlord with significant bargaining strength, who is entering into a lease with a tenant the future business prospects and sales projections of which are highly speculative, may negotiate a “recapture” provision in the lease. This would enable the landlord to cancel the lease if a certain level of projected sales (and the obligation to pay percentage rent) is not achieved within a specified period of time. In lieu of the landlord’s right of termination upon failure to reach the stipulated level of sales in a timely manner, the lease may require that the tenant commence paying a higher base rent. The landlord also may condition any lease renewal or extension option on the tenant’s having exceeded the breakeven point for the payment of percentage rent. In some instances, recapture benchmarks and rights may be staged to account for the anticipated gradual growth of the tenant’s business. A landlord-oriented percentage rent provision also may provide for an adjustment of both the minimum rent and the percentage rent breakpoint if the shopping center is expanded and one or more anchor or “major” tenants (as defined in the lease) opens for business. The provision would increase the minimum rent and the breakpoint by a percentage effective upon the commencement date of such additional anchor or major tenant’s lease.

The percentage rate generally varies based on the tenant, the type of business conducted on the premises, and other factors such as location, rent, term, and anticipated level of sales volume. For example, a supermarket or discount store chain, which operates a high-volume, low-margin business, generally will have a lower percentage rent rate (perhaps two percent) than a more upscale business that sells high priced items in smaller quantities, such as a jewelry store, bookstore, or exclusive clothing store. These types of establishments may have a percentage rent rate of as high as six percent. An extremely high volume business, such as a movie theater, may pay a percentage rent rate as high

⁵ A publicly traded REIT customarily will have a lower overall level of debt than a conventional shopping center owner and also may be concerned about demonstrating consistent income growth to its shareholders and the market. Therefore, a REIT may be more interested in the “upside” potential of participating in the tenant’s growth in sales and be more willing to accept a lower base minimum rent in return for a higher percentage rent.

as ten percent. A well-recognized national retailer or “superstore” with a proven earnings record and greater influence and negotiating strength than an individual proprietor may, however, be able to obtain a lower percentage rate.

The landlord may wish to address specifically the possibility that some of the leased space is not used for income-producing activities. The landlord may attempt to lower the breakeven point to a specific sales volume below the natural breakpoint to account for the lack of sales from the percentage of the leased space not used to generate sales, resulting in the commencement of percentage rent upon the achievement of a lower sales figure. However, the landlord should attempt to negotiate this adjustment only when the non-revenue space is substantial and does not contribute to the sales volume generated from the rest of the store.

The landlord also may wish to address the situation in which the tenant’s sales consistently fail to reach the breakpoint level. This is especially important when the tenant pays only percentage rent or a nominal fixed minimum rent. In *Kauder, Klotz & Venitt v. Rose’s Stores, Inc.*,⁶ the federal district court in North Carolina stated that “where the percentage lease provides no minimum guaranteed rental or a purely nominal guarantee, the tenant is under an implied obligation to conduct its business in good faith.”⁷ Occasionally, to accommodate a tenant (especially an otherwise desirable tenant) experiencing difficulties, the landlord may agree to amend the lease to reduce temporarily, or even eliminate, the tenant’s fixed minimum rent in exchange for an increase (usually by one or two points) in the percentage rate the tenant pays on gross sales above the breakpoint level. This concession should continue only for that period of time sufficient to determine if the tenant’s business is capable of recovering. Any violation of the terms of such an amendment to the lease should entitle the landlord to elect either returning to the terms of the original lease or terminating the lease. During this period, the tenant would remain liable for all common area maintenance costs and would be required to provide regular, detailed, weekly (or even daily) sales reports to the landlord. The landlord may need to obtain the consent of its mortgage lender and any lease guarantor to effect such a modification, because any change in the determination and amount of the scheduled lease payments will affect these parties.

⁶ 359 F. Supp. 1280 (E.D.N.C. 1973).

⁷ *Id.* at 1284.

III. DEFINITION OF GROSS SALES

It is very important that the parties to a shopping center lease carefully and comprehensively negotiate and draft the percentage rent provision to reflect their expectations accurately. The percentage rent clause should set forth in detail the nature, extent, and scope of the items to be included within and excluded from gross sales for calculating percentage rent. The clause should, to the extent possible, anticipate future developments that may affect the scope or definition of gross sales.⁸

A. Items Included in Gross Sales

Shopping center landlords will endeavor to make the gross sales provision in their leases as expansive as possible, to capture all the income derived directly or indirectly from the tenant's business at the leased premises. The percentage rent provision in a commercial lease should contain clear and comprehensive definitions of terms such as "gross receipts," "gross sales," "gross income," and "net income" and clearly state the nature, extent, and scope of the sales included in or excluded from these definitions.⁹ In cases involving leases with percentage rent clauses, numerous courts have ruled on what items are included within the definitions of "gross receipts," "gross sales," and "gross rents."¹⁰

⁸ A sample form of a retail lease percentage rent provision is attached as the Appendix.

⁹ "Gross receipts" equal the "total amount of money or the value of other considerations received from selling property or from performing services." BLACK'S LAW DICTIONARY 783 (6th ed. 1990) (citation omitted). "Gross sales" equal the "[t]otal of all sales at invoice prices, not reduced by discounts, allowances, returns, commissions, or other adjustments." *Id.*

¹⁰ See, e.g., *In re KDT Indus., Inc.*, 32 B.R. 852, 856 (Bankr. S.D.N.Y. 1983) (holding that vending machine and telephone receipts fell within the definition of "gross receipts" in the lease because they could be viewed as sales of merchandise or as charges for services performed, but that tenant was not required to report employee and senior citizen discount sales to employees and senior citizens at the regular price); *Schoen-McAllister Co. v. Oak Park Nat'l Bank*, 111 N.E.2d 378 (Ill. App. Ct. 1953) (holding that amounts collected by tenant as retailer's occupation tax were included within "gross sales," defined as the total price or charge paid or agreed to be paid on each sale made or service undertaken at the leased premises); *Rossville Vending Mach. Corp. v. Comptroller*, 629

From the landlord's standpoint, a percentage rent lease should include the following items in the definition of "gross sales" or "gross receipts":

1. the entire amount of the gross sales price for cash, check, and/or credit received from the sale, lease, barter, or otherwise of all goods, wares, merchandise, and services provided or performed at, in, on, or from the leased premises;
2. all sales by any subtenant, assignee, licensee, concessionaire, or other occupant of the premises (including, with respect to a subtenant or licensee operating a service business, the rent payable by the subtenant or licensee, or the difference between the base rent applicable to the subleased space and the base rent payable from the subtenant to the tenant for such space);
3. revenues from Internet sales, to the extent agreed upon by the parties;
4. all telephone, mail-order, door-to-door, facsimile, canvassing, catalog, and e-mail orders originating from or filled at the premises, or filled at other stores or locations;
5. unrefunded and forfeited deposits and other amounts received from customers;
6. related services such as delivery, installation, and servicing paid for by customers who ordered merchandise at or from the premises;

A.2d 1283, 1290 (Md. Ct. Spec. App. 1993), *cert. denied*, 634 A.2d 62 (Md. 1993) (stating that "the natural and ordinary significance of 'gross receipts,' as used in the context of the Maryland admissions and amusement tax statute . . . provides no room for reasonable argument that it contemplates deductions or adjustments for expenses, partner/co-venturer reimbursements, or trade discounts before calculation of the tax due"); *McComb v. McComb*, 155 N.W.2d 860, 861 (Mich. Ct. App. 1967) (finding that the entire amount of travelers' checks receipts, and not just the commission paid to tenant to handle the transactions, should be included as gross sales for purposes of a percentage rent clause); *Levy v. Forma*, 65 N.Y.S.2d 505, 507 (N.Y. Sup. Ct. 1946) (ruling that although the amount of the federal excise tax was required to be deducted by tenant as an item of expense, the tax also must be included in gross sales even if it reduced tenant's profit).

7. the fair market value of trade-ins of used products, which retail businesses such as jewelers, appliance dealers, and music and clothing stores commonly accept;
8. the sale price of gift and merchandise certificates;
9. lottery ticket revenue;
10. discount club membership fees for “frequent buyers” and other favored customers, considering the full sales price of items sold to such preferred individuals or entities and the full sales price of items purchased with manufacturers’ coupons;
11. interest and finance charges in connection with sales;
12. vending machine, video and amusement game, pay telephone, postal service, and newspaper revenue;
13. payments from other parties for shelf or advertising space at the premises;
14. layaway, credit, and installment sales in the month in which the goods or services are delivered or provided (collected or uncollected), or in which any portion of the payment is received, whichever occurs first; and
15. fees paid by the tenant to banks or other entities in connection with the acceptance of customers’ ATM or debit cards.

Many retail shopping center leases contain “radius clauses,” which prohibit the tenant from operating a competing business within a certain radius of the shopping center.¹¹ If the tenant violates the radius restriction, the landlord may be entitled to include, within the definition of gross sales in the percentage rent provision, the gross sales generated from the tenant’s store that violates the radius restriction.¹²

¹¹ See Doty, *supra* note 2, at 89 (“A common radius is three to five miles depending upon the population and location of other malls in the area.”).

¹² See *id.* at 89-90.
The usual remedy for violation of a radius clause is inclusion of gross sales from tenant’s new offending store with the gross sales from existing store to calculate the percentage rent payable to the landlord. Another more severe remedy allows for recapture of the premises by the landlord if the tenant fails to

B. Items Excluded from Gross Sales

Landlords usually will resist any attempt by tenants to offset or deduct from the computation of gross sales all or any part of common area expenses or charges and other pass-through items. However, depending on their bargaining strength and negotiating skill, tenants customarily will seek to have some or all of the following items excluded from the computation of gross sales or receipts generated from the premises:

1. transfers and exchanges of merchandise between the tenant's stores and warehouses that do not involve a sale;
2. reserves for bad debts;
3. cash or credit refunds;
4. sales, excise, use, and retailer's occupation taxes that governmental authorities impose directly on the tenant, provided that no income or franchise tax, capital stock tax, tax based directly upon gross receipts, assets, or net worth, or similar tax may be deducted from gross sales;
5. interest, finance, and carrying charges on a sale;
6. returns of merchandise to manufacturers or shippers;
7. proceeds from the sale of used trade fixtures not generating sales from the premises;
8. fees (as opposed to percentage rent) paid to the tenant by a subtenant, licensee, or concessionaire;
9. employee discounts;
10. vending machine sales to employees;

achieve a specified level of business. Whatever the remedy, the overall clause must be reasonable to be enforceable.

Id.

11. accommodation sales and services, such as repairs and alterations, rendered at cost;
12. unredeemed gift certificates; and
13. insurance proceeds.

If the tenant has sufficient bargaining strength, negotiating the following additional deductions from the computation of gross sales or receipts also may be possible:

1. employee and/or senior discounts, generally not to exceed a certain minimal percentage of gross sales;
2. bad debts, to the extent that they are not later recovered and are limited to a defined percentage of gross sales;
3. bulk sales resulting from damage to or destruction of the leased premises or occurring upon expiration of the lease;
4. delivery, shipment, and other service charges incidental to a sale and not resulting in a profit to the tenant;
5. sales from vending machines and pay telephones that are solely for the benefit of employees and not customers; and
6. "loss leader" sales that generate no profit, subject to a percentage limit of gross sales.

Courts that have excluded items from gross sales or receipts in percentage rent provisions generally have done so based on the specific language, or lack of language, in the lease.¹³

¹³ See, e.g., *Pomona Valley Ctr., Inc. v. Nash's of Pomona*, 12 Cal. Rptr. 83, 85 (Dist. Ct. App. 1961) (holding that activities of subtenant, which consisted of displaying goods on hand to exchange in redemption of green trading stamps, were not sales of merchandise and did not constitute gross sales under the lease definition); *Herbert's Laurel-Ventura, Inc. v. Laurel-Ventura Holding Corp.*, 138 P.2d 43, 48 (Cal. Dist. Ct. App. 1943) (holding that money received from concessionaires did not constitute gross receipts because it did not pass into tenant's hands and remained property of licensees); *Taft Realty Corp. v. Yorkhaven Enters., Inc.*, 150 A.2d 597, 599-600 (Conn. 1959) (holding that the lease clause entitling landlord to a percentage of box office receipts did not include a percentage of revenue received from program advertising, sales of sheet music, checkroom facilities, sales of candy and soft drinks, or value of complimentary tickets); *Washington Nat'l Corp. v. Sears, Roebuck & Co.*, 474 N.E.2d 116, 121-22 (Ind.

Tenants with significant bargaining strength also may seek offset rights against percentage rent if the landlord defaults under the lease. Some landlords actually may prefer this arrangement to offset rights against fixed minimum rent because it is less likely to be offensive to mortgage lenders who are concerned about dilution in fixed income payments due under the lease. However, any right granted to the tenant to offset against percentage rent due under the lease should be limited to a specified portion of the percentage rent otherwise due.

C. Lottery Ticket Proceeds as Part of Gross Sales

In recent years, numerous states have instituted state lotteries within a statutory framework that strictly regulates the sale of lottery tickets and the collection and disposition of the receipts these sales generate. In connection with this development, numerous retail businesses now act as sales and collection agents. Percentage rent provisions in leases executed before lotteries were instituted, and even some provisions in later leases, do not expressly address whether lottery receipts and other related payments, such as bonuses for winning tickets, are included within the definition of gross sales for the purpose of calculating percentage rents.

Following the sale of lottery tickets, tenants normally collect the cash customers paid to purchase the tickets, and the state pays a commission for each ticket sold. In addition, tenants often are entitled to additional compensation if a winning ticket is purchased at the leased premises. However, the percentage rent provision in the lease may not be sufficiently specific or comprehensive to include all such payments within the definition of gross sales for the purpose of computing percentage rent. Tenants may argue successfully that they are obligated

Ct. App. 1985) (ruling that under the definition of gross sales in the lease, income from services or labor, including amounts received by tenant for gift wrapping, alterations, bike set-up, auto labor, service contracts, and appliance repair, were excludable from rent due); *Taylor v. Rosenthal*, 213 S.W.2d 435, 436 (Ky. 1948) (holding that because the description of gross receipts in a theater lease expressly excluded tax on admissions, only admission ticket sales would be included and sales from the lobby concession stand would not be included); *V.R.O.K. Co. v. Turin Theatre Corp.*, 92 N.Y.S.2d 104, 105 (N.Y. Sup. Ct. 1949) (ruling that gross box office receipts did not include sums received for federal admissions tax, which were levied on consumers and “merely collected by the theatre operator for the Government and held as a special fund in trust for the United States”).

to include only the commissions received from the state as part of gross sales. This issue is of special concern with older leases, in which the parties may not have contemplated this specific source of revenue because state lotteries did not exist at the time the parties entered into the lease.

Several court decisions have addressed the specific issue of whether gross sales, as defined in the lease, include only commissions the tenant earned on the sale of lottery tickets, as opposed to the entire gross receipts from such sales. In *Circle K Corp. v. Collins (In re Circle K Corp.)*,¹⁴ the tenant had executed a lease in 1975 that obligated payment of rent based on a percentage of gross sales at the tenant's convenience store premises in Phoenix, Arizona. When the lease was executed, lotteries were illegal in Arizona.¹⁵ The tenant filed a Chapter 11 bankruptcy petition in 1990 and shortly thereafter filed a motion to assume the lease.¹⁶ The landlord objected. The Arizona bankruptcy court then held a hearing to determine the amount owed under the lease. The tenant argued that the computation of the rents should not include the proceeds from the sales of the lottery tickets, but only the tenant's commissions on the sales. The landlord argued that the language of the lease was clear and unambiguous and that the rent should be calculated based on the gross receipts from the sale of the lottery tickets. The bankruptcy court held that the percentage rent calculation should include only the commission amounts, and not the total sales price of the lottery tickets. The majority of the Bankruptcy Appellate Panel disagreed with the bankruptcy trial judge, however, and held that the percentage rent calculation properly includes the total sales price of the lottery tickets. On appeal, a divided Ninth Circuit court reversed (by a 2-1 majority), ruling that the landlord was entitled to a percentage rent based only on the commissions received in exchange for selling the lottery tickets. The three-judge panel acknowledged that "[i]t is a close question whether the . . . lease provides for percentage rent of two percent of [the tenant's] commissions from lottery sales or two percent of total ticket sales price" but found that the percentage rent was due only on the commissions that the landlord received from the lottery ticket sales.¹⁷ The panel majority ruled that state-sponsored lottery ticket sales were in a "class by

14 98 F.3d 484 (9th Cir. 1996).

15 *See id.* at 485.

16 *See id.* at 486.

17 *Id.*

themselves” and were different from the general category of commercial operations that were described in the percentage rent clause in the lease.¹⁸ The panel majority also found that the tenant acted more as a tax collector for the state than as a retailer, and that only the commission is “properly considered a ‘gross receipt[]’ from ‘services’ performed on the premises.”¹⁹ The panel majority further held that lottery sales were not part of the tenant’s regular business and that the parties had not contemplated them at the lease’s execution.

In his dissenting opinion, Judge Fernandez argued that the tenant had drafted the lease and should be bound by the express provision regarding gross sales, which was not ambiguous and referred to “gross receipts of every kind and nature originating from sales and services on the demised premises.”²⁰ Judge Fernandez also stated, “The most important public policy ought to be that companies . . . abide by their lease agreements, not that gambling tickets be sold.”²¹

In *Hartig Drug Co. v. Hartig*,²² the Iowa Supreme Court found the reasoning of the *Circle K Corp.* court persuasive and held that while the definition of retail sales under the lease for a retail pharmacy business covered revenues the tenant actually received in connection with commissions for lottery sales and the compensation from the United States Postal Service for the sale of stamps from the leased premises, the tenant could exclude that portion of the sales and compensation for those services that the tenant did not actually retain. At the inception of the lease, the tenant did not maintain a postal station, and the state of Iowa had no lottery. The lease broadly defined gross sales as “the aggregate of all retail sales of every kind, type, and description, and services performed for patrons made in, upon, or from the demised premises by the tenant or by any sublessee, licensee, concessionaire, [or] other occupant. . .”²³ The court noted that the amount of lottery tickets and stamps sold had little or no relationship to the amount of business

18 *Id.*

19 *Id.*

20 *Id.* at 489.

21 *Id.*

22 602 N.W.2d 794 (Iowa 1999).

23 *Id.* at 796.

revenue the leased premises generated.²⁴ The court found that the sales proceeds from lottery tickets and postage stamps were similar to taxes, because the tenant collected and remitted the amounts owed to the governmental entity, merely acting as a collector or conduit for the transmittal of such amounts.²⁵ However, the court ruled that the tenant should have included in gross sales the lottery commissions received and the compensation paid for operating the postal substation at the leased premises, because these amounts constituted compensation for “services performed for patrons.”²⁶

IV. REVENUE FROM INTERNET SALES

A. Drafting and Enforcement Issues

The emergence in recent years of the Internet as a significant and steadily growing retail sales medium has raised new issues with respect to negotiating, drafting, and enforcing leases containing percentage rent provisions. A typical gross sales definition in a commercial retail lease may not cover sales completed via the tenant’s Internet website, which by definition do not occur at the leased premises. Furthermore, the tenant may attempt to deduct the amount of a subsequent refund in connection with an item of merchandise returned at the store, even though the tenant never reported the original Internet sale as part of gross

²⁴ *See id.*

²⁵ *See id.* at 798.

²⁶ *Id.* at 799. *See also* *Anest v. Bellino*, 503 N.E.2d 576, 579-80 (Ill. App. Ct. 1987), *appeal denied*, 508 N.E.2d 725 (Ill. 1987) (ruling that a percentage rental clause applying to all gross sales did not include gross lottery sales when the state of Illinois had not enacted lottery legislation at the time of execution of the lease. The court found that: (1) the phrase “gross sales” was imprecise, (2) the money received from lottery ticket sales, minus the amounts retained by the lottery agent as commissions, only temporarily came into possession of the lottery agent, and (3) “amounts which are not income to a lessee are not received by him within the meaning of gross sales.”); *Cloverland Farms Dairy, Inc. v. Fry*, 587 A.2d 527, 528 (Md. 1991) (holding that a broad lease clause providing for a percentage rent on “gross sales made in the store” did not include gross lottery sales when the lease preceded the state of Maryland’s authorizing lotteries, and finding that the parties could not have contemplated the sale of lottery tickets and that tenant actually was selling services to the state in return for sales commissions. The court noted that Maryland had enacted legislation in 1988 providing that percentage rent lease clauses did not include gross lottery sales unless expressly provided otherwise by the parties.); *Leases: Percentage Rent on Lottery Ticket Sales*, REAL. EST. L. REP., June 1997, at 1 (explaining the *Circle K Corp.* case). The Ninth Circuit panel majority in *Circle K Corp.* relied upon and cited *Cloverland Farms Dairy, Inc.* and *Anest* in its holding. *See Circle K Corp.*, 98 F.3d at 486-488.

sales from the premises. This occurs because most percentage rent provisions allow refunds to be excluded from gross sales. To protect against this result, the percentage rent provision should state that the tenant may exclude refunds from the computation of gross sales only if the original sale was made at the leased premises and that the gross sales reported to the landlord include the amount of the sale. However, the tenant may then avoid including the amount of an Internet purchase as a sale from the leased premises by requiring that refunds be made only if such goods or merchandise are returned by mail.²⁷

An even more significant issue is whether, and to what extent, Internet sales should be included within gross sales for purposes of computing percentage rent at a conventional “bricks and mortar” store. As one commentator has noted, “Many Web sites accept credit card applications and offer special promotions, delivery options and account information.”²⁸

Some landlords have attempted (with little success) to prohibit retail tenants from promoting their individual websites within the leased premises. As the uses and adaptations of Internet sales continue to evolve, eventually customers of retail tenants likely will place orders for goods and merchandise directly from in-store computer terminals and kiosks that provide direct access to the retailer’s website. These orders could be filled at or delivered from the leased premises, other stores operated by the tenant, or central distribution centers.

B. Determination of Parties’ Intent

Many existing retail leases were entered into before the advent of the Internet, so the parties could not have contemplated or addressed this means of generating sales. As in the case of lottery sales proceeds, courts may be reluctant to include Internet sales proceeds within the definition of gross sales under such circumstances, especially if Internet

²⁷ See Kevin Kenyon, *In-Store Returns from E-Commerce Could Hurt Malls*, 20 SHOPPING CENTERS TODAY 3, at 1 (1999), available at <http://www.icsc.org/srch/sct/current/sct9903/02.htm> (discussing the problem of retail tenants claiming deductions for refunds when items purchased via the Internet are returned to tenants’ “bricks and mortar” store).

²⁸ Stephen W. Snively, *KillPercentageRent.com: Internet Sales and Shopping Center Leases*, PROB. & PROP., July-Aug. 2000, at 39.

sales are not generated at or from the leased premises.²⁹ However, the tenant fully retains the proceeds from Internet sales, unlike lottery sales, and the proceeds are part of the tenant's regular business and may have at least an indirect relationship with the amount of sales the leased premises generates. Landlords naturally will argue that all or some portion of the tenant's Internet sales should be included within the definition of gross sales, while tenants will argue that Internet sales should be excluded. The lease should clearly address Internet sales.

A court may be required to ascertain the intent of the parties based on all the facts and circumstances. The use of the Internet is still too new to have generated case law precedent in this area, and percentage rent clauses in retail leases have been modified only recently to incorporate the concept of Internet sales. One commentator has suggested that gross sales for percentage rent purposes should include at least a portion of the sales occurring in the market area of the leased premises, even if not made at or from the store, except when the lease does not prohibit the tenant from opening a competing store in the same area and the tenant opens such a store.³⁰ This would require the court, or the landlord and

²⁹ See *supra* note 25.

³⁰ See Snively, *supra* note 27, at 41 (providing sample lease provisions for the determination and calculation of percentage rents in connection with Internet sales). The author suggests, as an aid in calculating the amount of gross revenue applicable to Internet sales, the identification of an "Internet Sales Area," determined by reference to United States Postal Service zip codes. See *id.* at 42. See generally Doty, *supra* note 2, at 98-100 (suggesting the following methods of addressing the issue of whether to include Internet sales in the computation of percentage rent: (1) offering landlord a higher percentage rent rate of sales, or a guarantee of a certain level of sales for a fixed period of time, in exchange for lower gross sales based on the exclusion of Internet sales; (2) requiring tenant to report and pay percentage rent on all sales made or shipped within the restricted area of any radius clause in the lease; (3) landlord's establishing a website with links to each tenant in the shopping center; (4) determining percentage rent based on tenant's sales generated from landlord's site; and (5) eliminating the percentage rent provision altogether); Steven J. Roberts & John H. Lewis, *Internet Sales and Percentage Rent: A Practical (and Pre-Existing) Solution*, COM. LEASING L. & STRATEGY, Feb. 2001, at 1 (arguing that Internet sales, for purposes of determining percentage rent, should be treated the same as catalog sales); Mark Borsuk, *Nowhere yet Everywhere: Investigating Online Buying's Impact on Retail Property Values*, THE SPACE PLACE 25 (June 1999) (discussing the impact of Internet sales on retail tenant's deductions for online returns, the percentage to be applied if its primary merchandise mix changes, and the related issues of exclusive use and radius clauses and noting that "[c]yberspace may significantly diminish the value of co-tenancy. What happens when the co-tenant in the mall significantly reduces store size, changes use or alters merchandise mix?"), available at

tenant when drafting a percentage rent provision, to ascertain the appropriate market area and the portion of the tenant's Internet sales applicable to that area, which may depend on the relative negotiating strength of the parties.³¹ A retail tenant generally may open a competing store unless prohibited from doing so by a specific provision in the lease. However, courts sometimes are willing to impose an implied duty on the tenant not to divert sales deliberately to another competing location to avoid paying percentage rent.³²

<http://www.thespaceplace.net/columns/nowhere.htm> (last visited Dec. 11, 2000); Mark Borsuk, *Millennium Madness: Online Buying Takes the Shop out of Shopping*, THE SPACE PLACE 24 (Feb. 1999), at

http://www.thespaceplace.net/columns/millennium_madness.htm (arguing that "it only takes a small change in store sales to have a dramatic impact on individual store profitability. . . [O]nline shopping is analogous to building a sister store nearby. It transfers a portion of in-store sales from the old store to cyberspace as if it were a new store."), available at <http://www.thespaceplace.net/columns/nowhere.htm> (last visited Dec. 11, 2000); Pam Stubing & Mark Swirsky, *Impact of Internet Shopping on Retail Trends*, Fitch IBCA (July 9, 1998), at <http://www.fitchibca.com>; Richard M. Steuer, *Retailing on the Internet*, ANTITRUST, Summer 1998, at 50 (discussing the legal relationship between manufacturers, retailers, and selling products over the Internet); Moody's Investors Service, "CMBS: The Impact of the Internet on Retail Real Estate Version 2.0," *Structured Finance* (Special Report) (Apr. 21, 2000) (providing an in-depth analysis of the Internet's impact on retail real estate and commercial mortgage-backed securities financing).

³¹ See *id.*

³² See, e.g., *Kauder*, 359 F. Supp. at 1282-83 (holding that tenant's opening of a new store two miles away was not done with willful intent to diminish gross sales or divert business and therefore did not breach the lease provision requiring tenant to operate the business diligently and continuously and to use all proper and reasonable efforts to maximize gross sales); *Masciotra v. Harlow*, 233 P.2d 586, 589-90 (Cal. Ct. App. 1951) (finding no express lease covenant that tenant would not carry on a restaurant business at another location and no implied covenant that tenant would conduct business in a way that was mutually profitable for the parties); *Downtown Assocs., Ltd. v. Burrows Bros. Co.*, 518 N.E.2d 564, 567-68 (Ohio Ct. App. 1986) (finding that when the plain language of the lease provided that percentage rent payments would be based solely on premises specified in the lease and tenant did not unreasonably or in bad faith divert business to another location, the lease contained no implied covenant requiring that gross sales from tenant's operations in other locations be included); *Michigan Ave. Nat'l Bank v. Evans, Inc.*, 531 N.E.2d 872, 875-77 (Ill. App. Ct. 1988), *appeal denied*, 537 N.E.2d 811 (Ill. 1989) (finding, based on language in the lease and conduct of the parties, that gross sales included sales of merchandise delivered elsewhere). Cf. *Krieger v. Elkins*, 620 P.2d 370, 373 (Nev. 1980) (holding that, based on lease language stating that gross sales included sales made "in connection with business transacted upon or from the demised premises," gross sales included "outside" sales when orders were placed by telephone to the store and services were performed at, or merchandise was delivered to, customers' residences); *Elfstrom v. Brown*, 366 P.2d 728, 731-32 (Or. 1961), *reh'g denied*, 368 P.2d 333 (Or. 1962) (ruling that the definition of gross sales included tenant's business operations

If a sale is generated via the Internet but the customer receives the goods or merchandise at the leased premises, the tenant may argue that gross sales should not include the sale because it did not originate at the store. The landlord, on the other hand, will analogize such a transaction to a catalog sale that is filled at the leased premises and will insist that the sale be included within the gross sales definition for calculating percentage rent.³³ If the tenant initiates a sale from the leased premises via the Internet, but the order is filled at another location, the landlord likely will argue for its inclusion in gross sales, while the tenant will vigorously contest this assertion. The ultimate resolution of these issues will depend primarily on the relative bargaining strength of the parties. These are serious issues that will become even more important as use of the Internet expands and Internet revenues constitute a significantly greater proportion of the tenant's total sales. The traditional concept of percentage rents, and certainly the customary method of determining and allocating gross sales, may need to be examined, modified, and updated to meet this challenge. In any event, agreements should require tenants to keep detailed computer records of all Internet sales for purposes of computation and allocation. The parties may agree to determine a separate breakpoint for calculating Internet sales, as opposed to in-store sales.

C. Emerging Trends

Interestingly, at least one company, General Growth Properties, Inc., has created a website designed specifically to allow retail tenants to sell goods online.³⁴ By logging on to this site, consumers are now able to select and purchase items from different stores within a single shopping center and make one payment for all of the goods ordered. The goods can be shipped to the buyer, or they can be picked up at a distribution center owned and operated by the company that designed the website or

conducted outside of the leased premises when the terms of the lease defined gross sales as income).

³³ See Sandi Owen, *State Sales & Use Tax on Internet Transactions*, 51 FED. COM. L.J. 245, 257 (1998) ("In sales transactions involving physical goods, the purchase of a product over the internet is essentially no different from a purchase by mail order or telephone order.").

³⁴ See <http://mallibu.com>; INVESTMENT PROPERTY & REAL ESTATE CAPITAL MARKETS REPORT, Jul. 2000, at 11.

from the individual stores at the mall. If this concept is successful and spreads nationally, landlords will encounter additional challenges.

Another current development is the “hiring” of the landlord to handle the tenant’s Internet sales. Under this scenario, the landlord offers certain “back office” services to the tenant, such as servers, software, and round-the-clock customer service and delivery of goods and packages. In return, the tenants (often high-end fashion and clothing retailers) pay a percentage of sales from the sites. Each brand sells from its own website and is responsible for its design and content. The tenant allegedly benefits by not having to incur significant marketing or human resource expenditures, or taking the time to build brand recognition. These initiatives constitute a concerted effort by landlords to reduce the threat of Internet sales to their ability to collect percentage rents as measured by traditional standards. Although the probability of the success of such ventures may be low, some landlords also are contemplating offering “virtual mall” shopping experiences on the Internet. Other shopping center landlords are installing high-speed broadband wiring at their shopping centers in exchange for a portion of the revenues derived from such services, in order to provide to tenants various e-business and Internet applications, including individual webpages, designated host services, and value-added software, in exchange for a portion of the revenues derived from such services.

V. AUDIT RIGHTS

A. Audit Records and Reporting

Percentage rents may be payable annually (based on either a calendar or fiscal year), quarterly, monthly, or upon attainment of a specified level of sales. If percentage rents are payable less frequently than annually, the parties must conduct a recalculation and reconciliation at the end of the year. The landlord would be required to refund any overpayment to the tenant, or, conversely, the tenant would be obligated to remit any underpayment to the landlord. When percentage rent is payable annually and partial periods (such as the period from the lease commencement date to the end of the first lease year) occur, the landlord should adjust the breakpoint for payment of percentage rent accordingly. An equitable adjustment may be made for fractional years at the beginning or end of the lease term, based on an estimate of the volume of sales that would normally occur during the partial lease year. The tenant may (justifiably)

require that no percentage rent be payable until such time as sales reach the breakeven point.

Accurate, timely, and complete reporting of gross sales is extremely important to the landlord in computing the percentage rent owed by the tenant. It helps the landlord gauge the success of the tenant's business, establishes the amount of additional income owed, and enables the landlord to measure the desirability of renewing the tenant's lease. The lease provision that covers the landlord's audit rights should clearly distinguish between percentage rent, additional rent, and other forms of compensation or reimbursement paid to the landlord. According to the percentage rent provision in the lease in *Felco, Inc. v. Doug's North Hill Bottle Shop*,³⁵ "[p]ayment of percentage rent shall be accompanied by complete financial statements, North Dakota Sales Tax return and a statement of base sales and of the computation of such [percentage] rent."³⁶ The provision also granted the landlord the right to examine the tenant's sales records for a period of 45 days after submission of each quarterly statement. The clause further provided that the landlord waived any claim for additional rent if the claim were not made within 90 days after submission of the tenant's statement. From 1988 to 1992, the leased premises generated sufficient sales to trigger the payment of percentage rent under the lease formula. However, the landlord did not demand payment of these amounts until 1995, when the tenant requested a new lease. The tenant refused to pay, and the landlord sued to recover more than \$51,000 in past due percentage rent. Based on its interpretation of the applicable lease provisions, the court ruled that the landlord was entitled to the past-due percentage rent. The court agreed with the landlord that the terms "additional rent" and "percentage rent" were not synonymous. The court held that the landlord had not waived the payment of percentage rent, because the landlord was making a claim only for the percentage rent that the tenant actually owed, not additional rent owed as a result of any disagreement by the landlord as to the amount calculated by the tenant.³⁷

³⁵ 579 N.W.2d 576 (N.D. 1998).

³⁶ *Id.* at 578.

³⁷ The court remanded the case to the trial court to determine if there had been an oral modification of the lease to waive the past due percentage rent. The court also ruled that if no oral agreement were found, the landlord would be entitled to interest on each year's payment of percentage rent from the date it was due. *See id.* at 583.

The meaning ascribed to the terms in a percentage rent provision can have significant consequences in other contexts. In *Trustees of First Union Real Estate v. Mandell*,³⁸ the building owner leased the entire facility to a national retail tenant. The building owner was involved in a “sandwich lease”; *i.e.*, the building owner leased the ground under the building from the fee owner and owned the building that it leased to the national retail tenant. The ground lease required the building owner, the “prime tenant,” to pay an annual fixed minimum rent of \$36,000. In addition, the prime tenant was obligated to pay 50% of all percentage rent received from the retail tenant “under their lease . . . during the initial term and any period thereof.”³⁹ A dispute arose between the fee owner and the prime tenant as to whether the words “and any period thereof” referred to the “initial term” (in which event, as argued by the prime tenant, percentage rent would cease upon the expiration of the initial lease term) or referred to “their lease” (in which event, as asserted by the fee owner, the payment of contingent rent by the prime tenant would continue during any extension of the ground lease). Both the ground lease and the (sub)lease between the prime tenant and the national retailer contained ten successive five-year options to extend. The court ruled that the disputed language created a patent ambiguity, *i.e.*, one that appeared on the face of the contract, and that the parties’ intent would be determined solely by reference to the language in the ground lease and not by relying on parol evidence. Based on its analysis of the contract as a whole, including other terms and provisions in the lease that the court found would make the prime tenant’s contention nonsensical and illogical, the court held that the prime tenant would remain contractually obligated to pay the fee owner percentage rent should both the prime tenant and the subtenant exercise their option rights to extend their respective lease terms.⁴⁰

In *CMI Food Service, Inc. v. Hatridge Leasing*,⁴¹ the lease for a fast food restaurant required the tenant to pay “either the minimum rent or percentage rent, whichever is greater.”⁴² The landlord claimed that this

38 987 F.2d 1286 (7th Cir. 1993).

39 *Id.* at 1288.

40 *See id.* at 1292-92. *See also* Alvin L. Arnold and Marshall E. Tracht, *Landlord-Tenant: Construing a Percentage Rent Clause*, REAL EST. L. REP., Sept. 1993, at 6 (discussing the holding in the *Trustees of First Union* case).

41 890 S.W.2d 420 (Mo. Ct. App. 1995).

42 *Id.* at 421.

language was a mistake, and that the parties actually had agreed before executing the lease that rent would consist of minimum rent plus a percentage of sales. The landlord asked the court to reform the lease to conform with the alleged intention of the parties. The tenant contended always to have understood the lease to require paying either the minimum rent or percentage rent, whichever was greater. The tenant had not calculated the rent correctly, and, contrary to the lease rental provision, had consistently paid minimum rent plus a percentage of sales using a formula different from that set forth in the lease. The appellate court found that “[t]he trial court could have concluded from the evidence that [the tenant] did not know how to calculate the rent according to the lease terms . . . and erroneously calculated the percentage rent and erroneously paid the minimum rent” and held that “the [landlord] did not establish by clear and convincing evidence that the alleged mistake was mutual and that the [tenant] intended for the lease to provide for a minimum plus a percentage of sales.”⁴³

A percentage rent provision should require that a duly authorized representative of the tenant sign all monthly or quarterly statements of gross sales submitted by the tenant. An independent certified public accountant or the tenant’s chief financial officer should certify the annual aggregate amount of gross sales, determined at the end of each year during the lease term to be true, complete, and correct. The percentage rent provision should also specify that the landlord has the right to audit the tenant’s books and records, including the records of subtenants, licensees, and concessionaires, and the tenant’s income and excise tax returns at least once during each lease or calendar year, upon prior notice, to determine gross sales for calculating the percentage rent owed by the tenant. The lease should further grant the landlord sufficient time to complete the audit and make a final determination whether the submitted sales figures are accurate. The landlord must have the ability to determine if certain items have been wrongfully or erroneously excluded from gross revenues, resulting in an understatement of percentage rent due. The tenant should agree to cooperate fully with the landlord regarding access, availability of records, and furnishing requested information.

If the lease audit discloses that gross sales exceed the amount the tenant reported by a certain percentage (*e.g.*, two percent) or if the tenant fails or refuses to maintain or deliver the required records or statements

⁴³ *Id.* at 424.

of gross sales, the tenant should be obligated to reimburse the landlord for the cost of the audit and the amount of the deficiency, with interest at the lease default rate.⁴⁴ If the audit discloses an understatement of gross sales by more than a certain percentage, the landlord also may seek to exercise the right to terminate the lease upon written notice to the tenant within a specified period of time.

B. Independent Lease Audits

Recently, some companies have begun to offer a specialized service, sometimes referred to as a “Phase One Lease Audit,” for shopping center landlords. The goal of such an audit is to examine and audit a tenant’s expenses, including items excluded from gross sales, and make certain that the tenant’s reported sales are accurate and complete. These companies will check for mathematical and clerical errors in the tenant’s calculation of gross sales, which may result if the tenant failed to charge the correct amount or omitted a charge that should have been added to gross sales in accordance with the percentage rent provision in the lease. These companies will further determine if the tenant has appropriate management controls and procedures to ensure the proper receipt, handling, and processing of cash and other receipts and the proper accounting and reporting of revenues. This service may be especially valuable when the amount of percentage rent is significant and the calculation is complex, or when the computation of gross sales is not standardized or is performed at a low level in the tenant’s hierarchy.

The lease should clearly set forth the tenant’s obligation to maintain accurate and complete books, records, and statements for the calculation of gross sales or receipts. The lease should require the tenant to utilize an accounting system in accordance with generally accepted accounting principles, and to retain all books, records, and statements pertaining to the leased premises for a minimum period of two—preferably three—

⁴⁴ See *Michigan Ave. Nat’l Bank*, 531 N.E.2d at 880 (holding that when the lease gave landlord the right to inspect and audit tenant’s sales records once a year within a three-year period and required tenant to maintain sales records for at least three years, a statutory 10-year limitation period in which to recover amounts due for percentage rents was not eliminated by implication); *Keystone Square Shopping Ctr. Co. v. Marsh Supermarkets, Inc.*, 459 N.E.2d 420, 424-25 (Ind. Ct. App. 1984) (ruling that when the lease provided landlord with the right to challenge tenant’s sales reports within 120 days after submission and landlord did not complain about under reported annual sales for a particular year for almost two years, the sales report was “conclusive” under the lease and landlord waived any underpayment of percentage rent).

years after the expiration of each lease year, or until the resolution of any existing dispute. The definition of “books and records” should include the following items:

1. general ledger or summary records of all receipts and disbursements from operations at, in, or on the leased premises;
2. daily sales and/or point-of-sale reports;
3. sales journals;
4. profit and loss statements;
5. tax reports;
6. regular and prenumbered sales slips;
7. cash register tapes;
8. computer records and receipts;
9. e-mail records;
10. sales checks;
11. bank statements and deposit records;
12. settlement statements regarding revenue received from or by subtenants, licensees, and concessionaires; and
13. all other records and receipts required under generally accepted accounting principles. The tenant should maintain a separate non-commingled bank account for all revenue received from the operation of the tenant’s business at the leased premises.

C. Tenant Audit Rights

A tenant with significant negotiating leverage may be able to obtain the reciprocal right to audit the landlord’s books and records for the amount of percentage rent the tenant owes and the right to audit the landlord’s calculation of the tenant’s share of real estate taxes and other

common area expenses. When the lease is silent regarding the tenant's right to audit the landlord's books and records, the landlord may be deemed a fiduciary of the tenant, responsible for providing the tenant with sufficiently detailed and complete information about the landlord's calculation of percentage rents and common area expenses.

In *P.V. Properties, Inc. v. Rock Creek Village Associates Ltd.*,⁴⁵ the Maryland Court of Special Appeals considered the issue of whether a shopping center tenant was entitled to an itemized statement of common area expenses when the lease was silent in this respect and the landlord refused to supply the tenant with such a statement. Under the terms of the lease, the tenant was obligated to reimburse the landlord for its pro rata share of common area maintenance expenses. The lease further provided that the landlord would furnish annually to the tenant a "written statement setting forth the total actual costs" that it incurred for operating and maintenance costs for the shopping center.⁴⁶ The court held that the obligation of good faith and fair dealing implied in every contract required the landlord to provide the tenant with an annual statement outlining in detail the type and amount of each of the expenses incurred. The imposition of this duty, the court stated, would afford the tenant a means of verifying the charges assessed against the tenant. The court further held that a limited fiduciary relationship existed between the landlord and tenant with respect to the landlord's obligation to render an accounting in the form of an itemization of the actual common area maintenance costs. According to the court,

[T]here is a limited fiduciary relationship between [the landlord] and [the tenant]. [The landlord] maintains and exclusively controls the records which document its expenses. [The tenant] is forced to rely on the good faith and fair dealing of the landlord in assessing the charges. Therefore, under these circumstances, a confidential and fiduciary relationship exists between the parties.⁴⁷

⁴⁵ 549 A.2d 403 (Md. Ct. Spec. App. 1988).

⁴⁶ *Id.* at 405.

⁴⁷ *Id.* at 410. See *Allied Inv. Corp. v. Jasen*, 716 A.2d 1085, 1095 (Md. App. 1998). The *Allied* court stated:

An accounting is an appropriate remedy where one party is under an obligation to pay money to another based upon facts and records which are known and kept exclusively by the party to whom the obligation is owed, or where there is

Some large, national retailers are uncomfortable with supplying the landlord with detailed information regarding their gross sales at the premises. These tenants may ask the landlord (and any outside auditor) to agree in writing not to disclose or disseminate this information, without the tenant's prior consent, to any parties other than on a need-to-know basis, in response to a legal summons, or in connection with court or administrative proceedings, without the tenant's prior consent. Some especially sensitive retail chain stores may even agree to accept a higher minimum rent in lieu of any percentage rent to avoid disclosure of their sales volume and items of gross revenue.

VI. CONTINUOUS OPERATION COVENANTS

A. Scope of Covenant

If a shopping center tenant (especially an anchor tenant) discontinues its business, the landlord may experience a decrease in customer traffic and the loss of a unique business that the landlord and other tenants in the center had depended upon to help generate revenue (including percentage rent) for their own stores and the shopping center as a whole. The failure of an anchor tenant to continue to operate may even trigger the right held by other tenants to terminate their leases, or entitle them to a rent reduction or other concessions.⁴⁸ The landlord may find it difficult to attract new tenants to a shopping center with a vacant store, resulting in a decreased value of the entire center and problems in attracting or maintaining reasonably priced financing.

The percentage rent provision in the lease should attempt to deal with the issue of continuous operation of the leased premises based on the tenant's size, marketing strength (usually as an anchor tenant or a national, multi-state retailer), and the nature of the business. To address this possibility, many shopping center leases contain a "continuous operation" covenant, requiring the tenant to operate and maintain its

a confidential or fiduciary relation between the parties, and a duty rests upon the defendant to render an account.

Id. at 1095 (quoting *P.V. Props.*, 549 A.2d at 409). See also Gary Goldman, *Tenant Triage: Operating on a Landlord's Operating Expense Clause*, 16 No. 2 PRAC. REAL EST. L. 19, 24, 25-26 (2000) (finding the landlord to be a fiduciary of the tenant under the general purpose clause).

⁴⁸ Clauses that permit other tenants in a shopping center to terminate their leases if an anchor tenant goes dark are referred to as "co-tenancy" clauses.

existing business diligently and actively at all times during the term of the lease to maximize percentage rent. The lease also may require the tenant to staff the store adequately, maintain an adequate inventory of goods, and (in conjunction with the use clause in the lease) not change the nature or scope of the business. The language must be carefully drafted to protect both the landlord's and the tenant's interests and intentions. The covenant should expressly state that it is a bargained-for inducement to maintain the proper tenant mix and balance in the shopping center and maximize sales volume at the store. The covenant should stress the interdependent nature of the tenant's business and the other stores at the center.

A comprehensively drafted operating covenant should state the minimum amount of leased space that the tenant and permitted subtenants, licensees, and concessionaires should use in their business operations, the permitted use or uses of such space, and the required days and hours of operation. The covenant also should state the circumstances under which the landlord will be able to enforce rights and remedies for violation of the covenant, including how quickly it may do so after the tenant vacates the premises. In *Hamilton West Development, Ltd. v. Hills Stores Co.*,⁴⁹ the federal district court for the Northern District of Ohio held that the use provision in the lease was ambiguous and would not be construed to imply a duty of continuous operation by the tenant. The court suggested the following as an example of an explicit provision requiring the tenant to remain open continuously for business: "Tenant covenants that the premises shall be opened for business, kept open for business and used by Tenant and any assignee, subtenant or occupant, continuously during the term of this Lease . . ." ⁵⁰

B. Enforceability of Covenant

Courts are generally reluctant to imply a covenant of continuous operation absent express language in the lease, but they may do so if all or most of the factors mentioned above are present. For example, in *Scot Properties, Ltd. v. Wal-Mart Stores, Inc.*,⁵¹ the Fifth Circuit refused to imply a continuous operation covenant from a sublease requiring the

⁴⁹ 959 F. Supp. 434 (N.D. Ohio 1997).

⁵⁰ *Id.* at 440 n.11.

⁵¹ 138 F.3d 571 (5th Cir. Tex. 1998).

payment of both minimum and percentage rent. The court held that the parties had negotiated a minimum base rent amount that was presumptively substantial in the absence of any continuous operation clause. The court therefore refused to imply any covenant to pay an adequate amount of percentage rent.⁵² The sublease provided that the tenant would not desert the premises, but the court held that this language was insufficient as a matter of law to require the tenant to operate its business continuously at the premises. The lease also contained a provision under which the tenant would pay percentage rent on “Gross Sales . . . whether such sales be obtained at the Demised Premises or elsewhere.”⁵³ Although seemingly inconsistent with its holding that the parties would be bound by the percentage rent clause as drafted, the court stated that it would not construe this language as requiring the tenant, a large national retailer, to pay percentage rent based on global operations at other locations. The court found that such an expansive interpretation would be unreasonable and unacceptable.⁵⁴

⁵² *See id.* at 576.

⁵³ *Id.* at 572.

⁵⁴ *See id.* *See also* *W. & S. Life Ins. Co. v. Crown Am. Corp.*, 877 F. Supp. 1041, 1044-45 (E.D. Ky. 1993) (refusing to enforce the operating covenant in a shopping center operating agreement against tenant because of impracticality and harm to tenant); *8600 Assoc., Ltd. v. Wearguard Corp.*, 737 F. Supp. 44, 46 (E.D. Mich. 1990) (holding that it is “within the court’s discretion to refuse an injunction to enforce a continuous operations clause in a lease agreement when it would unreasonably tax the time, attention and resources of the court”); *CBL & Assoc., Inc. v. McCrory Corp.*, 761 F. Supp. 807, 809-10 (M.D. Ga. 1991) (denying injunctive relief on the basis that monetary damages were sufficient and the court would be faced with the undue, long-term burden of continuous supervision of an ongoing business); *Brentwood Investors v. Wal-Mart Stores, Inc.*, No. C-95-0856 (EHC), 1998 WL 337968, at *13-14 (N.D. Cal. June 19, 1998) (refusing to imply a covenant of continuous operation because the lease contained no operating covenant, the use clause was not restrictive, the tenant could assign or sublet without the landlord’s approval, and the fixed minimum rent was substantial); *New Park Forest Assoc. II v. Rogers Enters., Inc.*, 552 N.E.2d 1215, 1219-20 (Ill. App. Ct. 1990), *appeal denied*, 561 N.E.2d 694 (Ill. 1990) (declining to issue a temporary injunction because of the difficulty of court supervision and the enforcement of detailed lease provisions); *Casa D’Angelo, Inc. v. A & R Realty Co.*, 553 N.E.2d 515, 521-22 (Ind. Ct. App. 1990) (holding that, even though tenant had made substantial payments of percentage rent, the parties’ intention at the execution of the lease was that percentage rent was speculative and not a substantial consideration; therefore, no covenant to generate percentage rent would be implied); *Keystone*, 459 N.E.2d at 423-24 (holding that when parties occupied equal bargaining positions and the lease permitted tenant to assign without landlord’s consent, the court would not imply a covenant that tenant would continuously operate the business for the duration of the lease); *Madison Plaza, Inc. v. Shapira Corp.*, 387 N.E.2d 483, 487 (Ind. Ct. App. 1979) (refusing to issue an injunction for tenant’s breach of a continuous operation clause because of the nature and size of tenant’s business operation

If a percentage rent lease requires the tenant to exercise “best efforts” to maximize gross sales, the court may imply a continuous operation requirement. In *United Dominion Realty Trust, Inc. v. Wal-Mart Stores,*

and the requirement of lengthy court supervision); *M. Leo Storch Ltd. P’ship. et al. v. Erol’s, Inc.*, 620 A.2d 408, 412-14 (Md. Ct. Spec. App. 1993) (refusing to permit landlord to enforce a continuous operation clause because the burden and length of supervision would outweigh any advantages but stating, “We do not hold that injunctive relief may never be ordered to enforce a continuous operation clause under compelling circumstances”); *Ciolfi v. Boston Chicken, Inc.*, No. CIV. A. 97-4821, 1997 WL 625450, at *3-4 (Mass. Super. Ct. Oct. 6, 1997) (refusing to specifically enforce a continuous operation covenant when business traffic and volume at a shopping center were insufficient to cover tenant’s expenses, tenant was not an anchor tenant, there was no evidence that tenant had generated sales sufficient to generate percentage rent, economic viability of the center was not threatened, and the court would be required to supervise an ongoing business for as long as 30 months); *Kroger Co. v. Chem. Sec. Co.*, 526 S.W.2d 468, 472 (Tenn. 1975) (holding that because base rental was a substantial sum and tenant’s grocery store business had never generated sufficient gross sales to generate percentage rent, the percentage rent clause was not determinative); *Frederick Bus. Props. Co. v. Peoples Drug Stores*, 445 S.E.2d 176, 181 (W. Va. 1994) (finding that “although there is no specific provision in the lease agreement which addresses the issue of continuous operation, there are provisions in the lease which are inconsistent with implying a covenant of continuous operation”); *Thompson Dev. v. Kroger Co.*, 413 S.E.2d 137, 141-42 (W. Va. 1991) (denying an injunction because base rent was significant and lease language contradicted landlord’s claim of an implied covenant of continuous operation); 49 AM. JUR. 2D *Landlord and Tenant* § 69, *Commercial Leases; Implied Covenant of Continuous Operation* (1995) (stating that courts usually will not imply a continuous operation agreement in a lease that requires lessee to pay substantial fixed base rent, that allows lessee to assign a lease without lessor’s permission, or that the parties actively negotiated); Rawson Foreman & Jennifer Block, *When Are Continuous Use and Occupancy Clauses Enforceable?*, COM. LEASING L. & STRATEGY, May 1995, at 1 (stating that “while not likely to be specifically enforceable, a clause attempting to require continuous occupancy and operation will be upheld by a court upon a showing that the parties bargained for the provision”); Francis N. Mastroianni, *Caveat Lessor: Courts’ Unwillingness to Find Implied Covenants of Continuous Use in Commercial Real Estate Leases*, 24 REAL EST. L.J. 236, 243 (1996) (arguing that “courts avoid the . . . remedy of specific performance for fear of becoming long-term supervisors of shopping center’s daily business”). *But see* *Mass. Mut. Life Ins. Co. v. Assoc. Dry Goods Corp.*, 786 F. Supp. 1403, 1414, 1419-20 (N.D. Ind. 1992) (holding that landlord had successfully demonstrated likelihood of significant and irreparable harm for which monetary damages would be insufficient and requiring tenant to continue to operate the department store for the remaining lease term); *Lippman v. Sears Roebuck & Co.*, 280 P.2d 775, 780 (Cal. 1955) (holding that a covenant of continuous operation could be implied in a percentage rent lease when base rent was not substantial or adequate payment in lieu of percentage rent); *Dover Shopping Ctr., Inc. v. Cushman’s Sons, Inc.*, 164 A.2d 785, 790-91 (N.J. Super. Ct. App. Div. 1960) (ordering continuous operation of a bakery when difficulty of enforcement was minimal and the lease contained an affirmative operating covenant, percentage rent clause, and clause specifically granting landlord the right to seek an injunction for breach of covenant).

Inc.,⁵⁵ the South Carolina Court of Appeals ruled that an implied obligation of continuous use existed when the percentage lease contained a specific use provision and required the tenant to exercise best efforts to produce gross sales from the premises. The court imposed a “substantial consideration” test to determine whether the minimum rent amount constitutes substantial consideration for the leased premises. If not, then the courts apparently are willing to presume that the percentage rent clause signifies the parties’ intent that the lessee generate that rent through continuous operation.”⁵⁶

C. Unfair Competition from Tenant’s Competing Store

Occasionally, a shopping center tenant with a percentage rent lease (which may or may not contain a continuous operation provision) may abandon the premises and open a new or competing business nearby but attempt to keep the existing lease in place, paying only the base rent, to prevent a competitor from opening a business in the original space. Does the tenant owe an implied duty of good faith and fair dealing to the landlord not to discontinue the business at the leased premises and re-open the business at a new (and often free-standing) store or shopping center nearby, while continuing to pay the basic minimum rental at the old space to prevent termination of the lease and to prevent competitors from renting the original space? This tactic seems especially unfair if the following factors are present:

1. The lease contains a specific and limited use provision.
2. The tenant is paying a below-market fixed rental at the original space, and the percentage rent comprises a substantial portion of the total rent.

⁵⁵ 413 S.E.2d 866 (S.C. Ct. App. 1992).

⁵⁶ *Id.* at 869. See also *BVT Lebanon Shopping Ctr., Ltd. v. Wal-Mart Stores, Inc.*, No. 01-A-01-9710-CV00607, 1999 WL 236273, at *9-10 (Tenn. Ct. App. April 23, 1999), *aff’d* _____ S.W.3d _____, 2001 WL 201518 at 82 (Tenn. Mar. 1, 2001) (finding an implied covenant of continuous occupancy based, in part, on evidence that minimum rent was well below fair market value rental and stating that “[t]he ‘substantial-insubstantial’ question is tied closely to market value in the law governing implied covenants of continued occupancy”). Cf. *Forrest Drive Assocs. v. Wal-Mart Stores, Inc.*, 72 F. Supp. 2d 576, 584 n.3 (M.D.N.C. 1999) (noting that the substantial consideration test would not be applied in North Carolina); *Leases: No Implied Duty to Continuously Operate Premises*, REAL EST. L. REP., June 2000, at 1 (discussing the court’s opinion in *Forrest Drive Assocs.*).

3. The tenant has been granted an exclusive use of the space.
4. The term of the lease is lengthy.
5. The landlord has reversion rights in the tenant's fixtures.
6. The lease contains strong restrictions on the assignment or sublease of the space.⁵⁷

In *Rothe v. Revco D.S., Inc.*,⁵⁸ the tenant relocated the retail business to another location less than a year after exercising a renewal option. The lease provided for the payment of both fixed and percentage rent, and the tenant continued to pay only the base rent after it relocated its business to the new space. The court held that the tenant was not obligated to operate continuously from the premises or continue to pay percentage rent, even though the use clause in the lease provided that the tenant could use the space only for the operation of a drugstore and the assignment clause required the prior consent of the landlord. The court stated that “[t]he evidence falls short of establishing the existence of an express or implied covenant of continued operations or good faith.”⁵⁹

⁵⁷ See generally *Lagrew v. Hooks-SupeRx, Inc.*, 905 F. Supp. 401, 405 (E.D. Ky. 1995) (finding that, based on the existence of five of six factors considered determinative by the court, a covenant of continuous operation by tenant would be implied); *Pequot Spring Water Co. v. Brunelle*, 698 A.2d 920, 924-26 (Conn. App. Ct. 1997), cert. granted, 701 A.2d 658 (Conn. 1997) (finding that based on the analysis of factors in *Lagrew*, an implied covenant of continuous operation exists when tenant paid a percentage of its gross sales as sole rental under the lease, the lease was for 25 years, the lease contained strong restrictions on assignment, and tenant's right to fixtures was as owner under stock purchase agreement); *supra* note 31 and accompanying text.

⁵⁸ 976 F. Supp. 784 (S.D. Ind. 1997).

⁵⁹ *Id.* at 795. See also *Forrest Drive*, 72 F. Supp. at 582-84 (refusing to impose a duty on tenant to operate continuously or continue to pay percentage rent when the use clause in the lease referred to the “intended use” of the department store but stated that tenant could use the space for any lawful purpose); *Oklahoma Plaza Investors v. Wal-Mart Stores, Inc.*, 155 F.3d 1179, 1180-81 (10th Cir. 1998) (refusing to imply a covenant of continuous operation even though the default clause in the lease would be triggered if tenant “deserted or vacated” the space when the leased space could be used for any lawful purpose except as a supermarket, tenant could assign or sublet without landlord's consent, and tenant could remove goods and fixtures at any time); *Westside Ctr. Assocs. v. Safeway Stores 23, Inc.*, 49 Cal. Rptr. 2d 793 (Ct. App. 1996) (ruling that when the lease and the reciprocal operating agreement intentionally omitted a continuous operating covenant and use restrictions, tenant could discontinue business at the leased premises and exercise the option to extend the lease term); *Fourth & Main Co. v. Joslin Dry Goods*

However, in *Leeds v. Alpha Beta Co.*,⁶⁰ the California appellate court held that a supermarket percentage rent lease would imply a covenant of continuous operation when the minimum rent was insubstantial and the tenant abandoned the premises and reopened for business two miles away. The court quoted its prior holding in *College Block v. Atlantic Richfield Co.*,⁶¹ stating that “[t]o make a commercial lease mutually profitable when the rent is a minimum plus a percentage, or is based totally on a percentage, a covenant to operate in good faith will be implied into the contract if the minimum rent is not substantial.”⁶²

A shopping center may contain a radius clause that prohibits the tenant from opening a competing store within a certain proximity to the center. Some percentage rent leases permit the tenant to go dark without creating a lease default. However, the landlord may then exercise a recapture right to terminate the lease and relet the space.

D. Damages for Breach of Covenant

When the tenant has breached an express or implied covenant to operate continuously in the leased space, courts must fix the method for determining damages. Some courts measure damages for the breach of

Co., 648 P.2d 178, 180 (Colo. Ct. App. 1982) (finding that tenant did not breach the lease by discontinuing the business and moving to a new space, even though the lease required tenant to “keep the premises open and ready for business during the usual hours on all regular business days,” when the percentage rent provision was subject to a maximum sales volume and tenant paid an amount equal to the maximum rentals that the tenant could possibly have earned under the lease if it had remained in possession of the premises); John A. Glenn, Annotation, *Lease of Store as Requiring Active Operation of Store*, 40 A.L.R.3d 971 (1971).

⁶⁰ 75 Cal. Rptr. 2d 162 (Ct. App. 1998).

⁶¹ 254 Cal. Rptr. 179 (Ct. App. 1988).

⁶² *Id.* at 182. See also *Stein v. Spainhour*, 521 N.E.2d 641, 643-44 (Ill. App. Ct. 1988) (holding that tenant breached the lease by closing a fast food business at the leased premises and paying only minimum rent instead of a percentage of sales when tenant opened a new fast food business one block away); *Olympus Hills Ctr., Ltd. v. Smith’s Food & Drug Ctrs.*, 889 P.2d 445, 451-56 (Utah Ct. App. 1994), *cert. denied*, 899 P.2d 1231 (Utah 1995) (holding that when tenant with a percentage rent lease ceased operation, moved to a new location less than two miles away, and downgraded the use of the original premises to a discount store, tenant had breached the implied covenant of good faith and fair dealing, entitling landlord to the benefit of the bargain, even when the lease contained no continuous operating covenant or use or radius restriction).

an operating covenant by the decline in value of the shopping center.⁶³ When the tenant is not the anchor or largest tenant, or has relocated the business to another location, courts may apply a different measure of damages. These courts require the tenant to continue to pay all or some portion of the percentage rent that would have become due had the tenant not vacated the premises.⁶⁴ Courts likely will not agree to measure damages based on the loss of rents paid by other tenants at the center, because such damages are extremely difficult, if not impossible, to calculate. In addition to other damages, the landlord may wish to address the issue of a right to recover those unreimbursed tenant improvement costs paid for by the landlord, plus any rent or other concessions.

Some percentage rent leases provide that the tenant pay a stipulated termination payment if the tenant ceases operation at the premises. Such payments, while often significant, are usually for much less than the amount of base rental that would be due for the remainder of the lease term. However, they do defray the landlord's cost of new tenant improvements and leasing commissions. As in other contracts containing such clauses, a liquidated damages provision in a percentage lease may be enforced if the party seeking to enforce the provision can demonstrate that sophisticated business people negotiated the provision,

⁶³ See, e.g., *Scott-Reitz Ltd. v. Rein Warsaw Assocs.*, 658 N.E.2d 98, 105 (Ind. Ct. App. 1995) (upholding a damage award based on the diminished value of the shopping center without tenant's lease); *Hornwood v. Smith's Food King No. I*, 807 P.2d 208, 212 (Nev. 1991) (fixing damages "as the present worth of the property with the anchor tenant less the present worth of the property [excluding value derived from current or future subtenants] without the anchor tenant"); *Pleasant Valley Promenade v. Lechmere, Inc.*, 464 S.E.2d 47, 62 (N.C. Ct. App. 1995) (stating that "diminution in market value may be applied to redress breach of contract occurring between an anchor store and the shopping center in which it resides"); *BVT Lebanon Shopping Ctr.*, 1999 WL 236273, at *20 (stating that "this court finds diminution in market value of the shopping center to be the proper measure of damages for breach of the implied covenant of continuous occupancy").

⁶⁴ See, e.g., *Lippman*, 280 P.2d at 781 (finding that "[f]or breach of an implied covenant to remain in business, the measure of damages ordinarily is the amount which the [landlord] would have received from his share of the proceeds of the business had the [tenant] operated it in its usual and customary manner"); *Stein*, 521 N.E.2d at 644 (measuring damages by applying "the percentage formula to the reasonably expected net sales of the [tenant] for the period remaining in the lease"); *Simhawk Corp. v. Egler*, 202 N.E.2d 49, 50-51 (Ill. Ct. App. 1964) (holding that tenant who discontinued the business at the leased premises was still obligated to pay a percentage of profits in addition to minimum rent); *Pequot*, 698 A.2d at 926 (fixing the measure of damages for breach of the implied covenant of continuous operation as the "fair rental value of the premises during the time of the breach" and stating that "[t]he dollar value of that amount is a question of fact").

the anticipated damages are speculative and not easily calculable at the inception of the lease, and the calculation of damages is reasonable and not in the nature of a penalty.⁶⁵ The lease may set forth a formula for calculating damages for the failure to pay percentage rent, such as an estimated monthly average of percentage rent based on the total sales generated for a designated period of time before the default. If the tenant has paid no percentage rent, the lease may require payment of a stipulated amount per diem as damages, in addition to the minimum rent.

In *WR Joint Venture v. Record Town*,⁶⁶ the Wisconsin Court of Appeals examined whether, upon the tenant's default under a commercial lease, damages would be determined under a general default paragraph or under a separate liquidated damages paragraph that established a formula for computing percentage rent due if the tenant closed the store. The court noted that no gross sales existed from which to compute the amount due as a result of the closing. The formula provided that, in such an event, the tenant would pay as damages, in addition to the minimum rent due,

an amount per year equal to one-third (1/3) of the total percentage rent paid by Tenant for the last three (3) lease years immediately preceding such termination, and if less than three (3) lease years shall have elapsed, an amount per year equal to four (4) times the average quarterly percentage rental theretofore paid. In the event no percentage rental has been paid by Tenant, Tenant shall pay to Landlord the sum of Twenty Dollars (\$20.00) per day in addition to the said minimum rent.⁶⁷

The trial court had denied the landlord's motions for a temporary injunction and a permanent injunction directing that the tenant reopen for business, and the appellate court did not disturb this ruling. However, the appellate court reversed the trial court's holding relating to the calculation of damages. The appellate court found that the percentage rent damages provision was not a stipulated damages clause or the exclusive remedy for all damages that tenant could recover. Rather, the provision applied only to the computation of damages that the landlord

⁶⁵ See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 356 cmts. (1979) (discussing liquidated damages).

⁶⁶ No. 97-0136, 1997 WL 757562 (Wis. Ct. App. Oct. 30, 1997) (unpublished disposition).

⁶⁷ *Id.* at *1 n.2.

could recover if the tenant's business failed to remain open in the leased space.⁶⁸

VII. REMEDIES FOR DEFAULT IN PAYMENT OF PERCENTAGE RENT

A. Proper Notice

When declaring defaults under percentage rent leases, landlords should be careful to ensure that the default notice clearly sets forth the amount of percentage rent (as well as minimum fixed rent) due as the result of the tenant's breach of the lease. In the case of *In re KDT Industries, Inc.*,⁶⁹ the bankruptcy court for the Southern District of New York held that a default notice to the tenant, stating that the tenant had failed to include items in gross receipts sufficient to calculate percentage rent and had failed to keep separate and accurate records of gross receipts, was insufficient to constitute a proper notice of default under the lease. The court found that the notice did not specify a dollar amount that the tenant must tender to cure the default. The court noted that equity does not favor a forfeiture and that the landlord had failed to utilize the procedures set forth in the lease for a full audit of the tenant's books and records to determine the actual amount due.⁷⁰

⁶⁸ See *id.* at *1, *3. See also *Landover Mall P'ship. v. Kinney Shoe Corp.*, 944 F. Supp. 443, 447 (D. Md. 1996) (holding that the liquidated damages provision, requiring payment of double the amount of minimum rent in the event of default in observing the continuous operation clause, was reasonable and enforceable); *Mayor's Jewelers v. Pub. Employees Ret. Sys.*, 685 So. 2d 904, 906-07 (Fla. Dist. Ct. App. 1996) (Farmer, J., concurring), *review denied*, 691 So. 2d 1081 (Fla. 1997) (refusing to enjoin tenant from closing the store when the lease contained a liquidated damages provision and economic damages provided tenant with an adequate remedy at law).

⁶⁹ 32 B.R. 852 (Bankr. S.D.N.Y. 1983).

⁷⁰ See *id.* at 858. A retail lease usually sets forth the method of computing damages and the landlord's remedies for the tenant's failure to pay percentage rent. See Doty, *supra* note 2, at 94.

Depending on how a lease was originally drafted, the landlord's remedy may be recovery of damages for tenant's failure to pay percentage rent on sales generated from the store and not reported. Many retail leases have default language that allows the landlord to terminate the lease and replace the tenant with another. Other leases have language that allows landlords to collect percentage rent on the sales generated in violation of a radius clause.

Id.

The Kansas bankruptcy court in the case of *In re Valley View Shopping Center, L.P.*⁷¹ issued a similar ruling. The court held that the landlord's prepetition default notice to the debtor, which leased a shopping center from the landlord, did not give the debtor a meaningful opportunity to cure the default as required by the lease, and therefore did not operate to terminate the lease. The parties had disputed the amount of percentage rent due under the lease. The default notice gave the debtor 10 days to cure the delinquency and stated the amount of the fixed rent that was due. However, the court ruled that the notice did not set forth a specific amount due for the percentage rental. According to the court, "The case . . . is even more compelling because it involves disputed percentage rental."⁷²

B. Avoidance of Ambiguity

A landlord, with the mortgage lender's concurrence, should attempt to negotiate and draft a percentage rent provision in a commercial lease to clarify intent and avoid ambiguity sufficient to enable a court sympathetic to the tenant to exclude certain receipts or sales from the computation.⁷³ As previously noted, the definition of gross receipts or gross sales in the percentage rent provision should include all receipts and sales, including lease payments and revenues, generated by or from the operation, use, and occupancy of the leased premises, whether or not currently contemplated by the parties, as a result of the operations and activities of the tenant and by or on behalf of any other party entitled to the possession, use, occupancy, economic benefit, or enjoyment of all or any portion of the leased premises, such as subtenants, assignees, licensees, concessionaires, or other occupants.⁷⁴ If the tenant sublets

⁷¹ 233 B.R. 120 (Bankr. D. Kan. 1999).

⁷² *Id.* at 124. A shopping center tenant's willful failure to pay percentage rent generally constitutes a material breach of the lease. See, e.g., *S.E. Nichols, Inc. v. Am. Shopping Ctrs., Inc.*, 515 N.Y.S.2d 638, 639 (App. Div. 1987), *appeal dismissed*, 518 N.E.2d 8 (N.Y. 1987), *reargument denied*, 519 N.E.2d 346 (Table, No. 1354) (holding that tenant was not entitled to withhold percentage rent payment and place it in an escrow account as a result of landlord's alleged failure to replace the roof, because the percentage rent provision was an integral part of the lease and tenant's willful breach of that provision was material and independent from landlord's covenant to make repairs).

⁷³ See *supra* Part III.C. (discussing lottery sales cases).

⁷⁴ See *supra* Part III.A. (discussing the definition of gross receipts or gross sales in percentage rent provisions).

space to a retail operation (such as a jewelry store) that generates a lower volume of sales but at a higher profit margin (or vice versa) than the present use of the premises, the landlord should adjust the percentage rent provision to account for this situation; *i.e.*, the landlord may need to revise the minimum rent upward (or downward), or the subtenant should agree to pay not less (or not more) than the average amount of percentage rent allocable to such space before the subletting occurred. The lease should also provide, if such is the intention of the parties, that gross receipts or sales are not limited to or by any commissions or fees paid to or retained by the tenant as a result of such receipts or sales. Furthermore, the provision should state that gross receipts or sales will not be diminished or reduced if, or to the extent that, all or a portion of the gross receipts or sales are paid or transferred, either voluntarily or involuntarily, to a third party or if, or to the extent that, the tenant fails to receive any monetary benefit or profit therefrom.

VIII. BANKRUPTCY ISSUES

A. Assignment and Subletting

Shopping center landlords are the beneficiaries of special protections under section 365 of the Bankruptcy Code (“Code”).⁷⁵ These special protections recognize the need of shopping center landlords to maintain the proper tenant mix to generate customer traffic, the interdependence of the tenants in providing different types of goods and services, and the importance of quickly determining whether the lease will be affirmed, rejected, or assigned by the tenant-debtor.

⁷⁵ See 11 U.S.C. § 365(b)(3) (1994). See also *In re Goldblatt Bros. Inc.*, 766 F.2d 1136, 1140 (7th Cir. 1985), *reh’g, en banc, denied* Jan. 28, 1991 (stating that special protections are available to shopping center landlords); 3 COLLIER ON BANKRUPTCY ¶ 365.01 (Lawrence P. King ed., 15th ed.1999) (referring to the “extraordinary protection” afforded shopping center landlords under the Code).

The term “shopping center” is not defined in the Code.⁷⁶ The legislative history of the Bankruptcy Reform Act of 1978 discusses the definition of a shopping center:

A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement.⁷⁷

Bankruptcy courts generally have given an expansive meaning to the term shopping center, and have considered the presence of the following factors as indicating that a property is a shopping center:

1. a combination of leases;
2. a common landlord;
3. all the tenants in the center engaging in retail sales and distribution of goods;
4. a common parking area;
5. a master lease;
6. adjoining or contiguous stores;
7. fixed hours during which the stores are all open;
8. joint advertising;

⁷⁶ See *In re Joshua Slocum, Ltd.*, 922 F.2d 1081, 1086 (3d Cir. 1990) (holding that because the Code does not define shopping center, the proper definition depends on case-by-case interpretation) (citing *In re Goldblatt Bros.*, 766 F.2d at 1140); Doty, *supra* note 2, at 86 (distinguishing shopping centers from office or apartment buildings “because the success of a tenant in an office building does not depend on the landlord or other tenants”).

⁷⁷ H.R. REP. NO. 95-595, at 348 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6305.

9. payment of percentage rents by the tenants;
10. development, designation and promotion of the project as a shopping center or mall;
11. restrictive use provisions in the leases;
12. right of tenants to terminate their leases if an anchor tenant terminates the lease or ceases doing business;
13. joint participation by tenants in common area maintenance; and
14. existence of a tenant mix.⁷⁸

Section 365(b)(3)(C) of the Code provides that the debtor's right to assume or assign defaulted shopping center leases is conditioned upon a heightened standard for "adequate assurance of future performance," as opposed to the standard for non-shopping center leases, which are covered by section 365(b)(1) of the Code.⁷⁹ The higher standard for shopping center leases provides, in part, that "any percentage rent due . . . will not decline substantially."⁸⁰ This requires proof of the tenant's (or proposed assignee's) future income. Section 365(b)(3)(C) also provides that the debtor's assumption or assignment of the lease is subject to all the provisions of the relevant leases, including radius, location, use, or exclusivity, and section 365(b)(3)(D) requires adequate assurance that any assignment or assumption "will not disrupt any tenant mix or

⁷⁸ See *In re Joshua Slocum*, 922 F.2d at 1087-88. Based on its analysis of the factors described in the cases of *In re Goldblatt* and *In re 905 Int'l Stores, Inc.*, 57 B.R. 786, 788-89 (E.D. Mo. 1985), the court held that the property constituted a shopping center, even though no master lease existed and the stores were free-standing (although contiguous) and not attached. See *id.* See also *In re Sun TV and Appliances, Inc.*, 234 B.R. 356, 360-64 (Bankr. D. Del. 1999) (ruling that even though no master lease existed and tenant-debtor's lease did not provide for percentage rent or require that the store remain open during the same hours as the mall, tenant-debtor's ground lease for an out-parcel separated from the shopping mall by a "ring road" was a shopping center lease); Edward K. Esping, *What is "Shopping Center" Within Meaning of Bankruptcy Code Provision Governing Assumption and Assignment of Debtor's Leases by Bankruptcy Trustee (11 USCS § 365(3))?*, 117 A.L.R. FED. 321, §§ 3-4 (1994) (discussing under what circumstances a commercial development constitutes a shopping center).

⁷⁹ See *In re Joshua Slocum*, 922 F.2d at 1086. "Congress recognized that unlike the usual situation where a lease assignment affects only the lessor, an assignment of a shopping center lease to an outside party can have a significant detrimental impact on others, in particular, the center's other tenants." *Id.* at 1086.

⁸⁰ 11 U.S.C. § 365(b)(3)(B) (1994).

balance.”⁸¹ This language prohibits the debtor from conducting a new or different business or assigning the lease to a tenant that would conduct business in a manner inconsistent with the existing permitted use(s) of the space, the existing tenant mix, or the theme of the shopping center.

Bankruptcy courts determine whether the proposed assignment violates the Code by analyzing the facts of each case and considering such factors as the specific lease provisions, the existing tenant mix in the center, the tenant-debtor’s present business, and the business and financial strength of the proposed assignee. In the case of *In re Sun TV and Appliances, Inc.*,⁸² the Delaware bankruptcy court refused to strike the use provision from the lease, stating that “section 365(b)(3)(C) expressly includes adherence to use provisions and preservation of tenant mix as necessary elements of ‘adequate assurance of future performance of a lease of real property in a shopping center.’”⁸³ Section 365(b)(3)(C) also requires that any assignment or assumption of the lease will not cause a breach of the provision of any other lease, financing agreement, or master agreement relating to the shopping center.⁸⁴

In *Lamonts Apparel, Inc. v. SI-Lloyd Associates*,⁸⁵ the tenant argued that the landlord had unreasonably withheld consent to the tenant’s attempted assignment of the clothing store lease. The tenant proposed to allow a consumer electronics business and a bedding store to each occupy one of the floors of the tenant’s existing business. The court upheld the landlord’s refusal to agree to this arrangement, finding that the proposed subleases actually amounted to the execution of new leases and the substitution of new tenants for the existing one under substantially different terms, including the use of the property and the percentage rent that the proposed assignees would pay. The court noted that the tenant had filed a Chapter 11 bankruptcy proceeding at approximately the same time that it closed the store in 1995. The court stated, “According to the parties, the outcome of this case will control the claim that [the landlord] filed in the bankruptcy court for damages for termination of the lease.”⁸⁶

81 *Id.* § 365(b)(3)(C)-(D).

82 234 B.R. at 356.

83 *Id.* at 370.

84 *See* 11 U.S.C. § 365(b)(3)(C).

85 967 P.2d 905 (Or. Ct. App. 1998).

86 *Id.* at 907 n.2.

Section 365(a) of the Code authorizes the debtor or trustee to assume or reject, subject to the court's approval, any executory contract or unexpired lease of the debtor. Section 365(b)(2) of the Code explicitly prevents enforcement of ipso facto clauses in leases, which trigger automatic default upon a bankruptcy filing or upon "events or conditions that are likely to occur or exist around the time that a case is commenced."⁸⁷ Such events or conditions may include the insolvency of the debtor, the commencement of a Chapter 7 or Chapter 11 case, or the appointment of or taking possession by a trustee or a custodian.⁸⁸

Shopping center landlords are particularly concerned with the prospect that the tenant's bankruptcy trustee (or debtor in possession) will attempt to assign the shopping center lease to another tenant who will conduct a business that the landlord does not believe will comport with the existing tenant mix at the center, that the assignee's use of the premises will violate the permitted use provision of the existing lease, or that the assignee's use will conflict with exclusive uses granted to other tenants. Section 365(f) of the Code generally favors the free assignability of leases and allows the debtor or trustee to assign the tenant's lease, notwithstanding the existence of provisions in the lease or applicable state law prohibiting, conditioning, or restricting assignment.⁸⁹ The debtor or trustee may assign an unexpired lease of the debtor only if assumption is in accordance with section 365(a) and provides adequate assurance of future performance by the assignee, whether or not there has been a default under the lease.⁹⁰ Under section 365(b)(3)(A) of the Code, the shopping center tenant-debtor or trustee must provide adequate assurance of future rent payments and other lease obligations upon an assignment of the lease and must prove that the financial strength of the assignee and any guarantors is at least equal to that of the debtor at the time they entered into the lease.

If bankruptcy courts find that section 365(b)(3)(C) should be read in conjunction with section 365(f)(1), they will hold unenforceable both shopping center lease clauses that directly prohibit assignability and provisions that are so restrictive in their scope and application that they

⁸⁷ COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 365.05[4].

⁸⁸ *See id.*

⁸⁹ *See* 11 U.S.C. § 365 (f)(1) (1994).

⁹⁰ *See id.* § 365(f)(2).

constitute de facto prohibitions on assignment. The Delaware bankruptcy court reached this conclusion in the case of *In re Rickel Home Centers, Inc.*⁹¹ The court addressed a number of issues related to the proposed assignment of the Chapter 11 debtor's shopping mall leases, which were in separate locations. The landlords argued that the proposed assignments would violate the use restrictions in the leases, which required operating the leased premises only as home improvement centers. However, the debtor's president offered testimony, which was not challenged or contradicted by the landlords, that the home improvement center concept was obsolete or, at the least, that such stores were struggling to remain in existence. The landlords relied on section 363(b)(3)(C) of the Code, which provides that acceptance or rejection of leases is subject to all the provisions of the leases. However, the court stated that "Section 365(b)(3)(C) is not meant to be read in isolation."⁹² According to the court, it must be read in conjunction with section 365(f)(1), which provides that anti-assignment provisions are unenforceable in bankruptcy. Based on the uncontested testimony of the debtor's president, the court found that the use clauses of the leases were de facto anti-assignment clauses. According to the court, the clauses were so restrictive that they would make it impossible for the debtor to assign the leases to any entity. The court therefore struck the restrictive use provisions from the leases.⁹³

One of the landlords also argued, regarding the percentage rent provisions in its shopping mall lease with the debtor, that the proposed assignment would result in a substantial decline in payment of the percentage rent. The court rejected this argument, noting that the debtor had not been paying any percentage rent because it had liquidated its business at the premises. Therefore, the court held, no decline in percentage rent existed because none had been paid under the lease.⁹⁴ The landlord also asserted that the percentage rents owed by other tenants in the shopping center would drop because the proposed new tenant's business at the store "would not generate a strong customer base."⁹⁵ The court also held in favor of the tenant on this issue, pointing

⁹¹ 240 B.R. 826 (Bankr. D. Del. 1999), *appeal dismissed*, 209 F.3d 291 (3rd Cir. 2000), *cert. denied*, 2000 WL 949134 (U.S. Oct. 2, 2000).

⁹² *Id.* at 831.

⁹³ *See id.* at 831-32.

⁹⁴ *See id.* at 835.

⁹⁵ *Id.*

to the express language of section 365(b)(3)(B) of the Code, which provides that the adequate assurance of future performance under a shopping center lease requires that “any percentage rent due under such lease will not decline substantially.”⁹⁶ The court ruled that this language clearly applies only to percentage rent due under the specific lease to be assigned and not to rents owed by other tenants in the shopping center.⁹⁷

Whether the court’s decision in the case of *In re Rickel* signals an erosion of the special protections granted to shopping center landlords under section 365(b)(3) of the Code is unclear. This case certainly raises some interesting issues regarding attempts by bankrupt tenants to assign leases with percentage rent provisions. The proposed assignee in the case of *In re Rickel* acknowledged that the assignments would lead to the stores’ being closed for a period of six months prior to reopening. However, the court noted that none of the leases to be assigned contained a prohibition against going dark.⁹⁸ The court also found that the six-month delay in reopening was reasonable under the circumstances and would not adversely affect the tenant mix in the shopping centers because the new tenant, Staples, Inc. (“Staples”), had a substantial net worth and had demonstrated that it was operating a nationally profitable business.⁹⁹ Because no demonstrable decline was found in the existing level of percentage rent being paid and no apparent disruption was found in the type of business to be conducted at the premises that would adversely affect the other mall tenants, the court’s decision seems reasonable and justified.

Staples did not intend to occupy the entire space in each of the leased stores but planned to sublease portions to other parties. Additionally, Staples’ president testified that in the office supply industry, a 24,000-square-foot store was the most desirable size to conduct this business.¹⁰⁰ To address the landlords’ concerns with this stated intention of Staples, the court declined to remove the assignment provisions entirely from the leases and held that “once the leases have been assigned to Staples . . . Staples will be subjected to all the provisions of the leases for purposes

⁹⁶ *Id.* (quoting 11 U.S.C. § 365(b)(3)(B)).

⁹⁷ *See id.*

⁹⁸ *See id.* at 834.

⁹⁹ *See id.* at 835.

¹⁰⁰ *See id.* at 833-34.

of their subletting efforts.”¹⁰¹ Also, Staples represented to the court that “it intends to seek tenants that will complement the existing tenant mix, and that it seeks the landlord’s acceptance of any proposed sublet tenant.”¹⁰²

Presumably, given the court’s ruling on the applicability of all of the assignment and subletting restrictions regarding Staples’ subsequent subleases, the gross sales of such subtenants would be included for calculating the percentage rent due under the leases between the landlords and Staples. However, whether the percentage rent provisions in the Staples leases with the landlords would directly bind such subtenants is unclear. A landlord may attempt to remove this ambiguity by adding language to the percentage rent provision in the retail lease that attempts to capture all or some portion of the profit (*i.e.*, the amount, if any, that the assignee or subtenant pays in excess of the fixed rent and additional rent payable by the tenant for the corresponding period of such assignment or sublease) that the tenant realizes from an assignment or sublease of the leased premises.

Many bankruptcy courts have not been receptive to lease assignment provisions that they consider overly restrictive and have consistently invalidated them as “anti-assignment.” These courts usually base their reasoning on the stated Congressional policy goal of rehabilitating the debtor and assisting in reorganization or liquidation efforts. These courts aim to achieve this goal by favoring the assumption and assignment of unexpired leases to realize the full economic value of the property of the bankruptcy estate. Therefore, these courts have interpreted section 365(f)(1) of the Code to invalidate provisions unduly restricting, conditioning, or prohibiting the debtor’s right to assign the subject lease.¹⁰³

101 *Id.* at 837.

102 *Id.* at 834 n.5.

103 *See, e.g., In re Standor Jewelers W., Inc.*, 129 B.R. 200, 202 (B.A.P. 9th Cir. 1991) (invalidating a restriction in the lease requiring tenant to pay landlord 75% of the appreciation in value of the lease in the event of assignment, even though the restriction was valid under California law); *In re Jamesway Corp.*, 201 B.R. 73, 78 (Bankr. S.D.N.Y. 1996) (invalidating a profit sharing provision in the event of assignment or sublease); *Robb v. Schindler*, 142 B.R. 589, 590-91 (D. Mass. 1992) (invalidating a lease clause conditioning assignment upon tenant’s payment of 80% of net proceeds to landlord); *In re Howe*, 78 B.R. 226, 228-30 (Bankr. D.S.D. 1987) (invalidating a provision of an executory sale contract conditioning vendor’s consent to assignment on payment of 4% “assumption fee”); *In re Nat’l Sugar Ref. Co.*, 21 B.R. 196, 198-99

However, other bankruptcy courts are more reluctant to ignore or modify lease provisions that otherwise limit the tenant's right to assign or sublet. In the case of *In re Joshua Slocum Ltd.*, the Third Circuit held that a provision in the debtor's shopping center lease authorizing either party to terminate the lease if the debtor's gross sales for the first six years did not average a stipulated amount per year could not be excised.¹⁰⁴ The court reasoned that the lease provided that rent was calculated as a percentage of sales and that such a clause was necessary to enable the landlord to accurately calculate the amount of minimum total rent expected. However, the court stated that "[e]ven under the tightly drawn definition of 'adequate assurance' in the shopping center context, Congress did not envision literal compliance with all lease provisions."¹⁰⁵ The *In re Rickel* court distinguished this holding by stating that the disputed provision in the *In re Joshua Slocum* case was "clearly more material and substantial to a lease than the alterations clauses at issue in this case."¹⁰⁶

B. Proration of Percentage Rents

Section 365(d)(3) of the Code provides, in relevant part, that "the trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title."¹⁰⁷

This section entitles the landlord to collect the full lease rental for the period between commencement of the bankruptcy petition and the

(Bankr. S.D.N.Y. 1982) (finding landlord's right to request profits realized by tenant upon assignment applied only to consensual assignment and was unenforceable in bankruptcy); *Robb v. Schindler*, 142 B.R. 589, 591 (Bankr. D. Mass. 1992) (Listing clauses in leases or executory contracts that were invalidated because they restricted assignment and prevented maximum realization of assets by the debtor); *In re Boo.com North America, Inc.*, 2001 WL 1923949 (Bankr. S.D.N.Y. Dec. 15, 2000) (holding that assignment/sublease profit-sharing provision in debtor's lease was invalid and that all sublease profits belonged to bankruptcy estate).

104 922 F.2d at 1090.

105 *Id.*

106 *In re Rickel*, 240 B.R. at 834.

107 11 U.S.C. § 365(d)(3) (1993).

subsequent assumption or rejection of the lease by the debtor in possession or the trustee. Because this obligation of the debtor to pay rent arises only after the bankruptcy court has entered an order for relief, determining exactly when the obligation to pay such rent arises becomes especially important in a percentage rent lease. When percentage rent, real estate taxes, or common area maintenance expenses become due after commencement of the bankruptcy proceeding, courts disagree on whether to apportion percentage rent between prepetition and postpetition periods or whether to require payment in full, regardless of when rent accrued.¹⁰⁸ Most courts have characterized payments due under section 365(d)(3) as “administrative expenses.”¹⁰⁹

Although section 365(d)(3) requires the debtor in possession or the trustee to perform the debtor’s obligations under any unexpired commercial lease in a timely manner and gives the landlord the right to compel timely payment of postpetition, prerejection rent, it does not give the landlord a “superpriority” administrative expense claim to the prejudice of other administrative or priority claims, nor does it entitle the landlord to immediate payment of rent if the debtor is administratively insolvent.¹¹⁰ Once the lease is rejected, the landlord’s rights under

¹⁰⁸ See *In re All for a Dollar, Inc.*, 174 B.R. 358, 361 (Bankr. D. Mass. 1994) (“Congress did not explicitly address whether obligations owed under a lease, albeit at the contract rate, should be allocated.”).

¹⁰⁹ See *In re Barrister of Delaware, Ltd.*, 49 B.R. 446, 447 (Bankr. D. Del. 1985) (holding that trustee must immediately pay landlord’s postpetition, prerejection claim for rent as an administrative expense without complying with notice and hearing requirement); *In re Washington Mfg. Co.*, Nos. 388-01467, 388-01468, 388-01469, 1993 WL 156083, at *9 (Bankr. M.D. Tenn. May 11, 1993) (holding that timely satisfaction of postpetition leasing obligations is required in spite of any opposing conditions of section 503(b)(1) and landlord is entitled to an administrative claim for such amounts); *In re Telesphere Communications, Inc.*, 148 B.R. 525, 530-32 (Bankr. N.D. Ill. 1992) (awarding landlord’s rental claim under section 365(d)(3) “superpriority” status ahead of other administrative claims). Cf. *In re Mr. Gatti’s, Inc.*, 164 B.R. 929, 945 (Bankr. W.D. Tex. 1994) (ruling that under section 365(d)(3), landlord is not automatically entitled to an administrative expense claim or superpriority claim for postpetition, prerejection debtor obligations).

¹¹⁰ See *In re Microvideo Learning Sys., Inc.*, 232 B.R. 602, 609 (Bankr. S.D.N.Y. 1999), *aff’d* No. 99 Civ. 3808 (HB), 1999 WL 1084252 (S.D.N.Y. Dec. 1, 1999) (holding that, while section 365(d)(3) requires timely performance of debtor’s obligations, it does not give landlord a superpriority administrative expense claim or a right to immediate payment where debtor is administratively insolvent); *In re Almac’s, Inc.*, 167 B.R. 4, 9 (Bankr. D.R.I. 1994) (stating that “leases already rejected . . . are not entitled to immediate administrative claim treatment under § 365(d)(3) for the post-petition, prerejection period”); *In re Appletree Mkts., Inc.*, 139 B.R. 417, 419 (Bankr. S.D. Tex.

section 365(d)(3) are terminated and replaced by section 503(b)(1) of the Code, which enables the landlord to seek an administrative expense claim for services provided during the postpetition, prerejection period. Section 502(g) of the Code controls the postrejection rights of the landlord and treats such breach of contract claims as arising prepetition.

Courts that adhere to the minority view hold that section 365(d)(3) requires debtors to pay rental payments, including percentage rents, in full if they become due during the postpetition period without proration for amounts due but unpaid before the bankruptcy filing.¹¹¹ However, such a bright line test is unappealing to other bankruptcy courts. These courts, which are in the majority, reject the billing date approach as contrary to the statute's purpose of rehabilitating the debtor and enabling the debtor's business to continue, and hold that the rent should be equitably prorated. These courts maintain that the billing date approach produces results that are inconsistent with the priority and distribution schemes under the Code. They also find that strict application of the billing date approach could result in an inequitable windfall to the landlord if the debtor pays rent or other obligations in advance during the postpetition, prerejection period; *i.e.*, the debtor in such circumstances

1992) (finding that "[o]ften in Chapter 11 cases, administrative expenses are not paid until confirmation").

¹¹¹ See, *e.g.*, *Koenig Sporting Goods, Inc. v. Morse Rd. Co.* (*In re Koenig Sporting Goods, Inc.*), 229 B.R. 388, 394 (B.A.P. 6th Cir. 1999), *aff'd* 203 F.3d 986 (6th Cir. 2000) (holding that, because a full month's rent became due on the first day of the month, which was two days before debtor rejected the lease and vacated the premises, debtor was required to pay a full month's rent); *In re DeCicco of Montvale, Inc.*, 239 B.R. 475, 483 (Bankr. D. N.J. 1999) (holding that "a debtor-in-possession leasing nonresidential real property must pay in full all obligations which come due during the post-petition, pre-rejection period, regardless of whether some of those charges accrued pre-petition"); *In re F & M Distribs., Inc.*, 197 B.R. 829, 832 (Bankr. E.D. Mich. 1995) (holding that "because § 365(d)(3) is unambiguous, this Court must follow its plain language without regard to any equitable or policy considerations." The court found that the terms "obligation" and "claim" do not have the same meaning in the Code and that the obligation to pay taxes arose postpetition.); *In re Krystal Co.*, 194 B.R. 161, 163 (Bankr. E.D. Tenn. 1996) (holding that the plain reading of section 365(d)(3) precludes an accrual and proration analysis); *Inland's Monthly Income Fund, L.P. v. Duckwall-ALCO Stores, Inc.* (*In re Duckwall-ALCO Stores*), 150 B.R. 965, 975 (D. Kan. 1993) (holding that section 365(d)(3) is clear and unambiguous in requiring that debtor comply with all obligations arising under the lease after a petition is filed); *In re Appletree Mkts.*, 139 B.R. at 420 (holding that "the plain meaning of Section 365(d)(3) provides for payment of obligations *arising after* the petition is filed, not before"); *Bullock's, Inc. v. Lakewood Mall Shopping Ctr.* (*In re R.H. Macy & Co.*), No. 93 Cir. 4414 (SS), 1994 WL 482948, at *13 (S.D.N.Y. Feb. 23, 1994) (holding that reassessed taxes were an obligation that arose postpetition and had to be timely performed pursuant to section 365(d)(3)).

would be paying for services for a period of time during which the landlord would not be obligated to provide such services. Several courts warn that the reverse situation also could occur under the billing date approach; *i.e.*, the tenant could manipulate the bankruptcy proceeding to its advantage. For example, the tenant could file for bankruptcy relief one day after the date that payment was due under the lease for the next year. If the tenant did not in fact pay the rent on the due date, the landlord would not be entitled to any of the annual rent as a postpetition, prerejection performance obligation under section 365(d)(3).¹¹²

¹¹² See, *e.g.*, *Nat'l Terminals Corp. v. Handy Andy Home Improvement Ctrs.*, 222 B.R. 149, 153 (Bankr. N.D. Ill. 1997), *aff'd* 144 F.3d 1125, 1128 (7th Cir. 1998) (rejecting landlord's argument that the rental obligation arises when it becomes payable and requiring equitable proration of percentage rent over the entire lease year); *In re R.B. Furniture, Inc.*, 141 B.R. 706, 712 (Bankr. C.D. Cal. 1992) (holding that "[d]ebtor was not free to pay the pre-petition part of the tax without violating the statutory distribution scheme in the Code"); *In re Almac's, Inc.*, 167 B.R. at 8 (holding that rents under Chapter 11 debtor's leases had to be prorated to cover only the postpetition, prerejection lease period, regardless of the actual billing date and that accrual should be on a monthly basis (as with base rent) under an accrual fiscal-year formula); *In re S & F Concession, Inc.*, 55 B.R. 689, 691 (Bankr. E.D. Pa. 1985) (prorating rents for prepetition and postpetition periods); *Santa Ana Best Plaza v. Best Prods. Co. (In re Best Prods. Co.)*, 206 B.R. 404, 406-07 (Bankr. E.D. Va. 1997) (following majority accrual theory and requiring tenant-debtor to pay only a share of real property taxes accrued postpetition); *In re Warehouse Club*, 184 B.R. 316, 317 (Bankr. N.D. Ill. 1995) (finding that "the [property tax] obligation arose when it accrued, not when the bill became due"); *In re Victory Mkts., Inc.*, 196 B.R. 6, 10 (Bankr. N.D.N.Y. 1996) (adopting an accrual approach and holding that section 365(d)(3) is ambiguous in the context of a lease obligation to reimburse landlord for real estate taxes); *In re Revco D.S., Inc.*, 111 B.R. 626, 629 (Bankr. N.D. Ohio 1989) (holding that "[a]ll percentage rent earned from the beginning of the bankruptcy administration to the end of the Lease year should be paid as it is a postpetition expense of the Debtor's estate"); *Schneider & Reiff v. William Schneider, Inc. (In re William Schneider, Inc.)*, 175 B.R. 769, 772-73 (Bankr. S.D. Fla. 1994) (ruling that debtor's obligation to pay real property taxes arose when taxes accrued, not on the payment date); *Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934, 940 (Bankr. S.D.N.Y. 1997) (finding that "debtor-tenant's obligation under the lease to pay real estate taxes accrues on a daily basis and that, under § 365(d)(3), postpetition bills must be prorated so that debtor pays only those charges accruing during the postpetition, prerejection period"); *In re Ames Dep't. Stores, Inc.*, 150 B.R. 107, 108 (Bankr. S.D.N.Y. 1993) (rejecting the argument that time for payment governs when a lease obligation arises); *Child World v. Campbell/Massachusetts Trust (In re Child World)*, 161 B.R. 571, 576 (Bankr. S.D.N.Y. 1993) (holding that section 365(d)(3) requires timely payment only of lease obligations billed during the postpetition, prerejection period that actually cover the postpetition, prerejection period); *In re Swanton Corp.*, 58 B.R. 474, 475 (Bank. S.D.N.Y. 1986) (finding that "[e]quity requires proration"); *In re Ernst Home Ctr.*, 209 B.R. 955, 964 (Bankr. W.D. Wash. 1997) (finding that "the intent behind Section 365(d)(3) is to provide landlords current payment for current services, not to accord landlords a windfall by paying a prepetition portion of their claim ahead of other unsecured prepetition creditors").

The calendar method of proration, which is based on the number of days prepetition and postpetition in the calendar year during which percentage rent is payable, is the one most used by bankruptcy courts, but it may not be the fairest method. As commentators have noted:

[T]hat method of proration fails to take into account the realities of the timing of sales, the positions taken by many tenants with regard to payment of gross sales and the time that the obligation to pay gross sales actually arises under the lease. While many leases still require tenants to pay percentage rent based upon monthly gross sales, it is much more common, particularly with chain and anchor stores, to find that the tenant pays percentage rent either (1) at the end of some calendar or fiscal year or (2) only at such time that the tenant reaches its annual gross sales breakpoint.¹¹³

Other courts reject both the majority calendar method and the minority billing date approaches. In *Equitable Life Assurance Society v. Petrie Retail, Inc. (In re Petrie Retail, Inc.)*,¹¹⁴ the Federal District Court for the Southern District of New York held that the tenant's percentage rent obligation under section 365(d)(3) should be based on the "sales breakpoint approach."¹¹⁵ The sales breakpoint approach requires determining the date that gross sales from the premises exceeded the annual breakpoint, as described in the lease, for triggering the tenant's duty to pay percentage rent.¹¹⁶ According to the court, "[a]t that point, the tenant is clearly obligated to pay percentage rent on all sales made in the remainder of the lease year."¹¹⁷ The court rejected the sales volume approach that the bankruptcy court had adopted, under which the court prorated percentage rent by multiplying the total amount of percentage rent due for the lease year by a ratio in which the numerator was equal to the total amount of postpetition sales, the denominator equal to the aggregate annual sales, and the product equal to the amount owed as

113 Arthur S. Waldenstein et al., *Drafting Around Bankruptcy Problems: Whose Property is it Anyway?*, 1 INT'L COUNCIL OF SHOPPING CENTERS U.S. SHOPPING CENTER LAW CONFERENCE, § 5, at 4-8 (Oct. 28-31, 1998).

114 233 B.R. 256 (S.D.N.Y. 1999).

115 *See id.* at 260.

116 *See id.*

117 *Id.*

postpetition rent. The court also rejected the landlord's argument that the billing date approach should be utilized, *i.e.*, that the entire annual percentage rental should be deemed a postpetition obligation of the tenant because it became payable after the petition date.¹¹⁸ The court further rejected the debtor's argument that the calendar method should be adopted, *i.e.*, that the percentage rent should be prorated by multiplying the total percentage rent payable by a ratio in which the numerator was equal to the total number of days after the petition date during the lease year and the denominator equal to the total number of days in the lease year.¹¹⁹

The court then determined that if the breakpoint was exceeded after the bankruptcy filing, the percentage rent would be calculated as a percentage only of sales made postpetition and the entire amount of the percentage rent would be characterized as a postpetition obligation of the tenant. The court also stated that if the sales breakpoint had been exceeded prepetition, only the share of percentage rent arising from postpetition sales would be a postpetition obligation of the tenant. The court ruled that all percentage rent owing under that lease was recoverable by the landlord under section 365(d)(3) because one of the debtor's stores reached the breakpoint after commencement of its voluntary petition for reorganization under Chapter 11 of the Code. The court determined that one of the other leases, which was for another store the tenant operated, had exceeded the lease breakpoint prepetition and held that only the percentage rent owed from postpetition sales could be recovered. The district court remanded the case to the bankruptcy court for specific findings on the volume of sales from the store both before and after the bankruptcy filing date and for calculation of the amount of percentage rent owed, because the record was unclear as to when the tenant operated a third store that exceeded the breakpoint under the lease.¹²⁰

As evidenced by the divergent views of bankruptcy courts, the amount the tenant will owe the landlord under a percentage rent lease provision in a tenant bankruptcy proceeding remains unclear. If the tenant did not achieve the breakpoint for the payment of percentage rent until after the petition was filed, the landlord plausibly could argue that,

118 *See id.*

119 *See id.* at 261.

120 *See id.* at 261.

until that date, the tenant had no obligation to pay percentage rent and the entire amount owed was a postpetition, prerejection obligation for which the landlord was entitled to timely payment.

If the tenant reports, or is capable of reporting, gross sales on a monthly basis, the most equitable method of prorating gross sales may be to apportion them based on historical sales. The landlord may be advantaged by having the lease provide that percentage rent will be payable in monthly installments (perhaps based on one-twelfth of the annual gross sales breakpoint, or an estimate based on the prior year's aggregate gross sales, with or without an adjustment). Leases that require the tenant to pay monthly installments of percentage rent also may prevent the tenant from arguing that percentage rent, or some portion thereof, is not "rent reserved" under the lease. Thus, the landlord would be entitled to a claim for lease termination damages under section 502(b)(6) of the Code.

Section 502(b)(6) limits the landlord's claim to the extent it exceeds the rent reserved under the lease for one year or fifteen percent, whichever is greater, but not to exceed three years of the remaining term of the lease. Absent a requirement for monthly payment of percentage rent, the tenant may argue that the landlord should not be entitled to termination damages for the payment of a speculative amount of percentage rent. For example, the argument may work when the percentage rent is payable annually, or calculated monthly but payable at the end of the calendar year, and the tenant does not pay any percentage rent postpetition until the time that the tenant rejects the lease and would have been required to pay percentage rent at the end of the lease year. However, the landlord also could argue that section 502(b)(6) refers only to "rent reserved" under the lease, not rent paid, and that equitably the landlord should be entitled to a reasonable estimation of the prorated percentage rent as part of its claim.¹²¹

IX. CONCLUSION

¹²¹ See *In re Vause*, 886 F.2d 794, 798, 803 (6th Cir. 1989) (holding that section 502(b)(6)(B) of the Code, which limits a landlord's recovery under a rejected lease to "any unpaid rent due under such lease," requires proration when rent is payable in a single annual payment at the end of the year and rejection occurred four days before due date); *Nat'l Terminals Corp.*, 196 B.R. at 93 (noting that to avoid extending credit to tenant, landlord presumably could have provided in the lease that tenant pay one-twelfth of anticipated real property taxes due at the beginning of each rental month).

As the result of recent marketplace developments and current trends in federal and state case law, shopping center landlords may wish to revise and update the percentage rent provisions in their leases. The traditional lease definition of gross sales and the customary method of calculation of percentage rent may no longer be sufficient. Although the usual concerns of retail landlords and tenants regarding percentage rent leases, such as the enforceability of continuous operation clauses, audit rights, and rights and remedies in bankruptcy, remain important, the advent of e-commerce and the rapid and continually evolving changes in the nature and operation of retail businesses fueled by the Internet pose unique and difficult challenges. The world has changed, and the Internet is here to stay. Shopping center landlords are becoming more interested in capturing e-business from their everyday mall traffic and working with mall tenants on new marketing and sales initiatives. They realize the financial and goodwill benefits of providing tenants with such amenities as delivery services, software, telecommunications access and services, concierge services, and processing work orders over the Web. Tenants are becoming more interested in expanding their business through Internet sales, whether or not such sales are generated from or filled at their leased space in the shopping center. Retail landlords and tenants and their respective counsel should develop new and creative strategies and solutions to ensure that percentage rent provisions keep pace with these changes.

APPENDIX

The following provides an example of a percentage rent provision in a shopping center lease. It does not, however, include all of the many suggestions proposed in the preceding Article for practitioners' consideration.

Article ____

Minimum Rent and Percentage Rent

A. Minimum Rent. Tenant shall pay Landlord the monthly Minimum Rent set forth in Article 1 in advance, on or before the first day of each calendar month during the Term, except that Minimum Rent for the first full and any initial partial calendar month shall be paid when Tenant executes this Lease.

B. Percentage Rent. Tenant shall pay Landlord Percentage Rent each Lease Year equal to the applicable percentage of the amount by which Gross Sales exceed the applicable Breakpoint for such Lease Year set forth in Article 1. Percentage Rent for each Lease Year shall be paid on a monthly basis commencing with the first month in each Lease Year in which Tenant's Gross Sales for such Lease Year exceed the applicable Breakpoint. Such payments shall be made on or before the fifteenth (15th) day of each calendar month with respect to Gross Sales made during each preceding month. The term "Lease Year" has the meaning specified in Article ____.

C. Breakpoint Prorations. The Breakpoint for any Partial Lease Year shall be prorated on a per diem basis. If Minimum Rent is abated or reduced for any reason during any Lease Year, the Breakpoint for such period shall be reduced proportionately. If two Breakpoint amounts are in effect during different portions of a given Lease Year under Article 1, the Breakpoint for such Lease Year shall be the weighted average of both Breakpoint amounts, determined as follows: (a) each Breakpoint amount shall be multiplied by the number of days during which it is in effect, and then divided by 365, and (b) the amounts so computed shall be added to obtain the weighted average Breakpoint for such Lease Year.

D. Adjustments. If the Center is expanded during the Term by the addition of one or more Majors, the Minimum Rent and the Breakpoint, including each subsequent level thereof if either is scheduled to increase

during the Term under Article 1, shall be increased by ten percent (10%) as of the date each such additional Major opens for business. Commencing with the fourth full Lease Year, and each Lease Year thereafter, Landlord reserves the right to increase the monthly Minimum Rent to an amount equal to eighty-five percent (85%) of the average total monthly Minimum Rent and Percentage Rent payable by Tenant during the three Lease Years prior thereto, with a proportionate adjustment of the Breakpoint; provided, in no event shall the Minimum Rent ever be reduced below the rate of Minimum Rent then in effect or otherwise payable under this lease.

E. Gross Sales Records. Tenant shall ensure that the business of Tenant and of any subtenant, licensee or concessionaire in, at or from the Premises is operated such that the following books and records (collectively, "Tenant's Records") are prepared, preserved and maintained in accordance with generally accepted accounting principles: (i) daily dated, sealed, continuous, cash register tapes, (ii) serially numbered sales slips, (iii) settlement report sheets of transactions with subtenants, concessionaires and licensees, (iv) bank statements, (v) general ledger or summary record of all receipts and disbursements from operations in, at or from the Premises, (vi) state and local sales and use tax returns, and (vii) such other records that would normally be kept pursuant to generally accepted accounting principles, or as Landlord may reasonably require in order to determine Gross Sales hereunder. A separate bank account shall be maintained for all revenue from the Premises and no funds from any other source shall be deposited in such account. Tenant shall retain Tenant's Records at the Premises or at the home or regional office of Tenant for at least three (3) years from the end of the Lease Year to which they are applicable or, if any audit is required or a controversy should arise between the parties regarding Percentage Rent, until such audit or controversy is terminated, even though such retention period may be after the expiration of the Term or earlier termination of this Lease.

F. Gross Sales Statements. Tenant shall provide Landlord with a monthly statement of Gross Sales within fifteen (15) days after the end of each calendar month, signed by an authorized representative, which shall show Gross Sales and an itemization of any exclusions or deductions therefrom for such month, as well as year-to-date amounts for the current Lease Year. If any Percentage Rent is due for such month, the payment shall accompany such statement. In addition to such regular monthly statements, Tenant shall provide an annual statement within sixty (60)

days after the end of each Lease Year, which shall show the total amount of Gross Sales for such Lease Year and shall be certified to be true, complete and correct by an independent certified public accountant reasonably satisfactory to Landlord, or at Tenant's option by Tenant's chief financial officer. If such annual statement shows that Tenant underpaid Percentage Rent for such Lease Year, Tenant shall include the additional amount with such statement, and if such statement shows that Tenant overpaid Percentage Rent, Landlord shall provide a credit or refund. Tenant shall require that any subtenant, licensee or concessionaire furnish similar statements.

G. Audits. Landlord may from time to time (but not more frequently than once each calendar year), upon at least ten (10) days' notice to Tenant, cause a complete audit or examination to be made of Tenant's Records and such books and records of any subtenant, licensee or concessionaire for all or any part of the three Lease Years immediately preceding such notice. During such audit, Landlord or its authorized representatives shall have full and free access to Tenant's Records and the right to require that Tenant, its agents and employees furnish such information or explanation with respect to such items as may be necessary for a proper examination and audit thereof. If such audit or examination discloses that any of Tenant's statements of Gross Sales understates Gross Sales made during any Lease Year by one percent (1%) or more, or if Tenant shall have failed to furnish Landlord any monthly Gross Sales statements during any Lease Year or shall have failed to prepare and maintain Tenant's Records as required herein, Tenant shall pay Landlord the cost of such audit or examination, including travel and related expenses, and any deficiency in Percentage Rent, with interest at the Default Rate. If such audit or examination shall disclose an understatement of more than five percent (5%), Landlord shall also have the right to cancel this Lease upon written notice given to Tenant within six (6) months after such audit. Landlord's acceptance of Percentage Rent shall be without prejudice to Landlord's examination, audit and other rights hereunder.

H. Gross Sales Defined. "Gross Sales" shall mean the entire amount of the actual sale price, whether for cash, credit or otherwise, of all sales of goods and services and all other income and receipts whatsoever of all business conducted at, on or from the Premises, including, without limitation: (i) mail, catalogue, telephone, facsimile, internet, electronic, video and computer orders, orders by means of other technology-based systems whether now existing or hereafter developed, and other orders, received, placed or filled at 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 (not to be construed to

authorize vending or game machines unless specifically set forth in Article 1), (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, and (viii) all other gross Sales by any sublessee, concessionaire or licensee. However, Gross Sales shall not include (but Tenant shall keep separate records as part of Tenant's Records): (a) returns to shippers or manufacturers, (b) proceeds from the sale of used trade fixtures, (c) any cash or credit refunds upon any sale made in or from the Premises when the merchandise is returned by the purchaser, (d) 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), and (e) the exchange of merchandise between the stores and warehouses of Tenant, if any, when 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. No deduction shall be allowed for any uncollected or uncollectible amounts or reserves, nor for cost of products or services sold or other costs, charges or expenses of purchasing, financing, selling, transportation, overhead or taxes except as expressly provided herein. Trade-ins shall not reduce the sale price of the item sold for purposes hereof. Layaway, credit and installment sales shall be included in the month in which the goods or services are delivered or provided, or in which any portion of the payment is received, whichever first occurs, regardless of when or whether full payment is received.