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The Effects of Electronic Commerce on the Traditional Shopping Center Lease

Jennifer E. Doty

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THE EFFECTS OF ELECTRONIC COMMERCE ON THE TRADITIONAL SHOPPING CENTER LEASE

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INTRODUCTION

The Internet, in addition to its wealth of information, has introduced America to a new way to purchase goods. Along with this new way to shop comes the potential for conflict between the way the retail industry has done business in the past and this new technology. Traditional shopping center leases contain clauses which base the tenant's rent on a percentage of the sales from that store. To ensure its profits, landlords require tenants not compete within a certain radius of the shopping center. With the birth of electronic commerce, customers are ordering their goods directly from retailers online and not entering malls, which, in turn, causes lower profits for landlords. Shopping center tenants who also sell online have the potential to breach their shopping center leases. Therefore, to protect themselves, tenants should draft lease language to address electronic commerce.

Section I of this article will discuss the specifics of shopping center leases and explain how electronic commerce works. Section II will explain the problem and demonstrate how courts have addressed similar problems in the past. And, finally, Section III will propose two different solutions to the problem—a legal one, through drafting, and a technological one.

I. BACKGROUND

A. *Shopping Center Leases*

To understand a shopping center lease, one must first understand a shopping center.¹ Shopping centers, both large and small, create a relationship between landlord and tenant which differs from other types of real property.² This is because it is a cooperative venture in which both rely on the other.³ The tenant relies on the landlord to provide an attractive center in which the tenant can conduct a successful business. This includes not only cleanliness and safety, but also a collection of other tenants that draw customers into the center. The landlord relies on the tenant to conduct a business that attracts customers to the center as well as to the tenant's store. Shopping centers differ from office or apartment buildings because the success of a tenant in an office building does not depend on the landlord or other tenants. "The success, growth and limits of each store create consumer traffic and prosperity for the whole [shopping] center."⁴ As a result, shopping center leases base the rent paid to landlords on the profits of the tenant.

"[A] shopping center may be as small as two or more stores that share a parking area, or as vast as an enclosed regional mall."⁵ For the purposes of this article, shopping center shall be defined as real property containing a collection of retail tenants. However, most of the clauses discussed hereinafter are predominantly found in leases for large malls or shopping centers owned and operated by professional developers or managers.

1. Percentage Rent Clauses

In shopping center leases, the amount of rent a tenant is to pay is described with specificity and usually divided into two elements: fixed minimum rent, also called base rent, and percentage rent.⁶ Fixed minimum rent, as its name suggests, is a fixed amount calculated by multiplying a fixed dollar amount by the number of square feet of the premises.⁷ Percentage rent is paid in addition to the fixed minimum rent and is calculated by multiplying a negotiated percentage rate by the gross sales of that particular store.⁸ Generally, tenants only pay

1. See *Drafting Shopping Center Leases*, 417 PRACTISING L. INST. 445 (1997).

2. See *id.*

3. See Mitchell Y. Herman, *Ins and Outs of Restrictive Clauses in Shopping Center Leases*, 10 No. 6 COM. LEASING L. & STRATEGY 1 (1997).

4. *Id.*

5. *Id.*

6. See John J. Vondran et al., *Retail Leases*, in COMMERCIAL LANDLORD/TENANT PRACTICE: MAIN HANDBOOK 1-1, § 1.26 (Illinois Institute for Continuing Legal Education ed., 1996).

7. See Joseph E. Browdy, *Rent, Escalations and Other Economic Terms of a Lease*, 411 PRACTISING L. INST. 27, 29 (1995).

8. See Vondran, *supra* note 6, § 1.26.

percentage rent on gross sales over a certain breakpoint, which can be based on the fixed minimum rent or a negotiated amount.⁹ “The percentage rent clause establishes the amount of rent due to the landlord based in whole or in part on the amount of business [a] tenant does.”¹⁰ 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.”¹¹ The standard in the industry is approximately four to eight percent depending on the use, size, and creditworthiness of the tenant.¹²

Problems arise with the definition and calculation of the term gross sales. “The typical definition of ‘gross sales’ is very broad, covering all sales of goods, services, or other matters in, at, or from the premises. Tenants typically seek certain exclusions from gross sales,”¹³ such as sales from vending machines, telephones, discounts to employees or seniors, taxes, and items returned.¹⁴ Landlords, on the other hand, seek to limit these exclusions so that the exempted sales do not exceed a small percentage of the total gross sales.¹⁵ When the definition is too broad, problems can arise as landlords expect everything to be included; and tenants expect only those exclusions expressly stated to be included.¹⁶

An example of a percentage rent clause from a tenant’s perspective is as follows:

In addition to the Fixed Minimum Rent, Tenant shall pay to Landlord three percent (3%) of annual Gross Sales in excess of the Percentage Rent Breakpoint. The term “Gross Sales” shall be defined as all sales credited to the Demised Premises, whether for cash or on credit, made by Tenant from the Demised Premises in any Fiscal Year during this Lease Term. Gross Sales, for the purpose of computing Percentage Rent, shall specifically exclude: (1) all sums collected by Tenant for any sales or gross receipts tax imposed by any duly constituted governmental authority, (2) the amount of any cash or credit refund made upon any sale from the Demised Premises previously included in Gross Sales, (3) the amount of any exchange of merchandise among the stores or warehouses of Tenant, (4) all sums collected for extended warranties, and (5) all amounts re-

9. *See id.*

10. Mitchell Y. Herman, *Modifying Percentage Rent Clauses – And Its Consequences*, 11 No. 1 COM. LEASING L. & STRATEGY 3 (1998).

11. *Id.*

12. *See* Gail M. Stern, *Percentage Rent in Commercial Leases* ALI-ABA VIDEO LAW REVIEW 25, 29 (Oct. 26, 1989).

13. *See* Vondran, *supra* note 6, § 1.30.

14. *See id.* § 1.31.

15. *See id.*

16. *See* Taft Realty Corp. v. Yorkhaven Enters., 150 A.2d 597, 599-600 (Conn. 1959).

ceived for repairs to merchandise, provided such repairs are performed off the Demised Premises.¹⁷

An example of a percentage rent clause from a landlord's perspective is as follows:

The term "gross sales" or "gross receipts" as used in this lease shall include all sales made and all cash and credit revenue of Tenant and any persons, firms or corporations claiming through or under Tenant as subtenant, concessionaire, licensee or otherwise, at, in, upon or from the demised premises and the store in business conducted therein by Tenant, its subtenants, concessionaires and licensees, and all other things of value received or receivable by Tenant, its subtenants, concessionaires and licensees arising from any transaction whatsoever, including orders for sales received in the demised premises and delivered from any other store or place and those involving sales, exchanges of goods, wares and merchandise or other property, whether solely for case or on a charge basis, collected or uncollected, and including the gross compensation or consideration received or receivable for services rendered to customers in the conduct of business upon the demised premises less the following.¹⁸

2. Radius Clauses

To ensure the maximization of percentage rent, a landlord will request that the tenant agree to a radius clause.¹⁹ A radius clause in a shopping center lease prohibits the tenant from doing business within a specified area, which is measured by a radius from the shopping center.²⁰ Landlords use radius clauses to restrict tenants from opening a competing store, which could cannibalize sales from the existing store and result in lower percentage rents paid to the landlord.²¹

"The two primary factors to be considered in establishing the area in which the tenant is to be restricted are the location of the shopping center and the type of business engaged in by the tenant."²² Before drafting radius clause language, the parties involved should be aware of the tenant's other existing stores, tenant's use,²³ other existing businesses in the shopping center with similar uses, and the demographics of the community surrounding the shopping center.²⁴ Since a supermarket draws its customers from a relatively short distance, "[a] supermarket chain will agree to a much smaller radius restriction than a high-fashion ladies ready-to-wear store or department store,"²⁵ which

17. Tandy Corp., Radio Shack Lease (Mar. 9, 1993).

18. Herman, *supra* note 10.

19. See *Drafting Shopping Center Leases*, *supra* note 1, at 460.

20. See Herman, *supra* note 3.

21. See Vondran, *supra* note 6, § 1.11.

22. *Drafting Shopping Center Leases*, *supra* note 1, at 460.

23. Tenant's use refers to the type of goods or services provided by the tenant.

24. See *Drafting Shopping Center Leases*, *supra* note 1, at 460.

25. *Id.*

draws its customers from a greater distance. A common radius is three to five miles depending upon the population and location of other malls in the area.²⁶

"A radius clause should include: (a) the persons restricted, (b) the type of business restricted, (c) the area restricted, (d) the period of time during which the restriction is to be effective, (e) a prohibition against direct or indirect competition or financial investment, and (f) any exceptions thereto."²⁷ The language should also be clear as to how the distance of the radius is to be measured, whether by straight lines or by existing roads.²⁸

An example of a radius clause is as follows:

If during the term of the lease, or any renewal or extension thereof, either Tenant or any person, firm or corporation, directly or indirectly controlling, controlled by or under common control with Tenant shall directly or indirectly operate, manage, conduct or have any interest in any commercial establishment within three (3) linear miles of the shopping center, then, in any such event, for the purpose of computing percentage rent, Landlord may require that all sales made from any such other commercial establishment, which would have been Gross Sales if made in or from the Demised Premises be included in the computation of percentage rental as though said sales had actually been made in or from the Demised Premises, and Tenant agrees to pay such percentage rent to Landlord computed on the basis of such combined sales.²⁹

Tenants generally try to avoid radius clauses, but most will agree to a reasonable restriction that they do not intend to violate.³⁰ As a compromise, tenants will attempt to limit radius clauses to only the affiliate on the lease, not the parent company, other affiliates, franchises, subsidiaries, partners, or shareholders.³¹ As an incentive to make tenants more amiable to a radius clause, exceptions can be made. Some common exceptions from a radius clause include any existing stores already operating within the radius, any planned expansion, or any stores that may be purchased by the tenant as part of a chain of two or more stores.³² While tenants will attempt to gain many exclusions and keep the language very specific, landlords will try to keep the language broad so that the clause includes all affiliates of tenant's parent company and covers a broad geographic area.

"If the clause is to be effective, there should be injunctive relief and an action for damages."³³ The usual remedy for violation of a radius

26. *See id.*

27. *Id.*

28. *See Herman, supra* note 3.

29. Example of a Westerham Company lease for Gateway Shopping Center.

30. *See Vondran, supra* note 6, § 1.11.

31. *See Herman, supra* note 3.

32. *See Drafting Shopping Center Leases, supra* note 1, at 461.

33. *Id.*

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.³⁴ Another more severe remedy allows for recapture of the premises by the landlord if the tenant fails to achieve a specified level of business.³⁵ Whatever the remedy, the overall clause must be reasonable to be enforceable.³⁶

The issue discussed in this paper is whether the term "commercial establishment," as shown above in the example of a radius clause, includes selling goods and services over the Internet. If this new form of retailing is considered competition, there could be a breach of an existing mall lease.

B. *The Internet and Electronic Commerce*

Electronic commerce, Internet retailing, virtual shopping, or whatever you choose to call it, is the newest way to shop for goods and services. Until recently, shopping meant going to the mall or possibly ordering from a catalog or television. "Today, with personal computers and modems, consumers have instantaneous, twenty-four-hour access to a full range of goods and services from all over the world without having to leave their home or office."³⁷

"The hectic pace and pressure of a career, plus home and family responsibilities are making Americans busier than ever."³⁸ This hectic pace is causing people to look for timesaving and efficient ways to buy retail goods and services. Approximately 20 million Americans now shop online³⁹ and it was estimated that they would spend \$22 billion dollars in 1997.⁴⁰ Estimates for the year 2002 project \$350 billion in electronic commerce sales.⁴¹ Of the \$22 billion in sales, approximately eighty percent (80%) occurred between businesses, and the remaining twenty percent represent sales directly to the consumer.⁴² With this kind of growth, it is obvious that people are spending more time shopping in front of their computers and less time in malls. Although opinions differ as to the extent of the demise of the shopping center,⁴³ it is inevitable that Internet shopping will erode certain segments of the shopping center business.

34. See Browdy, *supra* note 7, at 31.

35. See *id.*

36. See Vondran, *supra* note 6, § 1.11.

37. Sandi Owen, *State Sales & Use Tax on Internet Transactions*, 51 FED. COMM. L.J. 245, 249 (1998).

38. Lee Carpenter, *Swimming Away from Retail's Sea of Sameness*, SPORTING GOODS BUS., Aug. 10, 1998, at 18, 18.

39. See Dana Canedy, *Virtual Stores Give the Big Retailers a Foothold Against On-Line Upstarts*, N.Y. TIMES, July 27, 1998, at D2.

40. See Owen, *supra* note 37, at 248.

41. See *id.*

42. See *id.*

43. See generally Kevin Kenyon, *Specialty Leasing Pros Debate Issues*, SHOPPING CTRS. TODAY, May 1998, at 110, 112.

“Electronic commerce is defined as ‘the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques.’”⁴⁴ What this means is that a person can sit down in front of their computer, dial into the Internet, pull up the virtual storefront⁴⁵ of their favorite retail store, and browse through the merchandise. If a shopper chooses to purchase an item, most Internet retailers allow them to do so by entering a credit card number and the item will be shipped directly to them. Like catalog shopping, this saves time and the hassle of crowded malls, parking lots, and unpleasant store personnel.

Methods for conducting business online differ from retailer to retailer. First, web sites differ. Some web sites are merely informational. They are like a catalog, such that they provide customers with product information and a phone number, which the customer has to call to place an order.⁴⁶ Other web sites are just advertisements for a retail store.⁴⁷ However, the virtual storefronts, which present the problem addressed in this paper, actually sell merchandise online.

Second, methods of distribution also differ. Some retailers have electronic methods of ordering the goods directly from the manufacturer, while others use stock from their regional distribution centers or retail stores to fill the electronic orders.⁴⁸ Other retailers, such as Office Depot and Pizza Hut, allow customers to e-mail an order before coming into a local store to pay for and pick up the item.

An example of a typical electronic commerce transaction of a customer purchasing a book is as follows: (1) a customer uses a personal computer and a modem to access a virtual website⁴⁹—this can be done by directly inputting the address of the virtual storefront like <http://www.amazon.com>,⁵⁰ or by using a search engine to find the site, if the address is unknown;⁵¹ (2) the customer browses through the virtual store and selects the desired items to purchase⁵²—many websites call this selection process “putting items into a shopping basket”;⁵³ (3) once all the desired items have been selected, the customer can

44. Owen *supra* note 37, at 248 (quoting Walter Hellerstein, *Telecommunications and Electronic Commerce: Overview and Appraisal*, 12 STATE TAX NOTES 519, 520 (1997)).

45. See NED SNELL, SAMS’ TEACH YOURSELF THE INTERNET IN 24 HOURS 312 (2d ed. 1998). Snell defines virtual storefront as “just a fancy buzzword for a webpage from which you can buy stuff.” *Id.*

46. *See id.* at 321-22.

47. *See id.*

48. See Craig W. Harding, *Selected Issues in Electronic Commerce: New Technologies and Legal Paradigms*, 491 PRACTISING L. INST. 7, 11 (1997).

49. *See id.*

50. See SNELL, *supra* note 45, at 78-80.

51. *See id.* at 136-43.

52. *See id.* at 314.

53. *See id.*

purchase the items by entering a credit card number;⁵⁴ (4) the retailer receives the order, verifies the credit card, and then forwards the order to the place of distribution⁵⁵—usually at this stage, retailers will e-mail confirmation of the order back to the customer as well;⁵⁶ (5) the distributor ships the item ordered to the customer by mail or courier service.⁵⁷

Every day new retailers go online. To date, the most successful online retailers have been sellers of goods and services such as books, music, computers, software, travel, and investments. It is estimated that of the online sales made to consumers, 40% are attributed to computer-related merchandise, 20% to books, 16% to travel, 10% to clothing, 6% to music, 5% to gifts, and 3% to investments.⁵⁸ The apparel retailers have been less successful so far; however, more and more are entering the virtual marketplace every day. In 1998 the Gap, Macy's, Eddie Bauer, J. Crew, Victoria's Secret, and Levi-Strauss all introduced new virtual storefronts. Along with the entry of more traditional mall tenants into online retailing comes the potential problem of tenants doing business within a radius of a store.

II. THE PROBLEM

A problem can arise when tenants who have shopping center leases with percentage rent and radius clauses start selling goods and services online as well as from the mall. The sales made over the Internet could be sales that would otherwise be made from the mall. Shopping centers, like taxing authorities, base their ability to collect money on amounts generated from a specific real location. However, the Internet, with its lack of a permanent establishment, does not fit within these traditional confines.⁵⁹ The issue is whether electronic commerce, with its lack of a permanent establishment, violates the conventional radius restrictions of a shopping center lease. The following is a hypothetical situation to better illustrate the situation.

In 1990, Tony's Music Store signed a lease with Lawrence Properties for a 3,000 square foot store in Sandy Cliffs Shopping Center. The term of the lease is five years with two options to renew for five years each. Tony's is to pay fixed minimum rent in the amount of \$10.00 per square foot per year, or \$30,000 annually. In addition to fixed minimum rent, Tony's is to pay 5% of its gross sales over a breakpoint of \$600,000. The lease defines gross sales as it is defined above in the

54. See *id.* at 313-14.

55. See Harding, *supra* note 48, at 11.

56. See SNELL, *supra* note 45, at 316.

57. See Harding, *supra* note 48, at 11.

58. See Kenyon, *supra* note 43, at 112.

59. See Kyrie E. Thorpe, Comment, *International Taxation of Electronic Commerce: Is the Internet Rendering the Concept of Permanent Establishment Obsolete?*, 11 EMORY INT'L L. REV. 633, 651 (1997).

example from a tenant's perspective. The lease also contains a radius clause that reads: "[t]enant shall not directly or indirectly operate, manage, conduct or have any interest in any commercial establishment within three miles of Sandy Cliffs Shopping Center during the term of the lease and any extensions thereof." In the event tenant violates this clause, landlord may require that all sales made from the offending commercial establishment be included in the computation of percentage rent for the Sandy Cliffs Store. By amendment in 1995, Tony's exercised one of the options to renew the lease for another five years. The amendment only revised the term and states that all other terms and conditions of the lease shall remain the same. In 1997, Tony's decided to tap into the Internet market. As a result, Tony's corporate office hired two Internet experts to design a website from which Tony's can sell cassette tapes and compact discs. The system works such that the corporate office receives the electronic orders, then passes them along to the appropriate regional distribution center where they are filled. The orders are shipped to the customer directly. Annual sales for Tony's Sandy Cliffs store were \$900,000 in 1995, \$920,000 in 1996, \$800,000 in 1997, and \$780,000 in 1998. Noticing Tony's decreasing percentage rent payments, Lawrence Properties begins to investigate the cause of the loss. A preliminary investigation showed that the shopping center was the same, most of the tenants' rents were up, there were no vacancies, and the tenant mix⁶⁰ remained the same. Further investigation into Tony's annual report for 1998 showed that its sales for the year were up, partly due to its sales over the Internet.⁶¹

A. Possible Causes

There are several scenarios that could give rise to the situation where a landlord and a tenant are at odds about how to deal with traditional retail leases and Internet sales. Old long-term leases could be one of the reasons. Many shopping center leases have a term of five to ten years, and the parties usually extend these leases by merely amending of the term without substantially changing the rest of the document. Many drafters of lease language only react to problems they have already faced. Since the business being conducted in the store has not changed, there appears to be little reason to change the language defining gross sales. Also, since there has not been any litigation in this area to date, it is reasonable to assume that most leases have not been altered to consider online sales. With the Internet being in its infancy, many drafters of lease language are inexperienced at addressing this problem.

60. Tenant mix means the combination of tenants with certain uses.

61. This is a hypothetical scenario created by the author.

Another situation where the problem could arise is when the real estate and legal departments of a retailer are not aware of what the computer or technology departments are doing. Since many retailers have separate or outside counsel for real estate matters, it is easy to see how a real estate attorney may not be aware of or recognize the ramifications of online retailing. Attorneys who negotiate and draft retail leases now need to inquire into the other business opportunities that their clients are exploring.

B. *How Courts Have Addressed Similar Problems Before the Internet*

Because the Internet is new and the problems and solutions have yet to fully develop, both landlords and tenants have not had to take into consideration online sales when negotiating gross sales language in shopping center leases. From a landlord's perspective, Internet sales should be included in the calculation of gross sales. "[W]ithout carefully crafted percentage rent clauses, gross sales from this newest form of consumerism will be lost."⁶² Whereas, from a tenant's point of view, Internet sales should be excluded from the definition of gross sales.

Landlords are going to be very aware when their bottom line is affected. If, along with the growth of electronic commerce, comes a decrease in a store's gross sales because customers are buying online instead of in the mall, landlords are going to look to wherever they can to recoup their losses. With very little case law to date addressing this problem, a landlord may need to look to how courts have addressed these issues before the Internet.

1. Breach of Contract

When a tenant does not pay rent or violates other material terms of the lease, the landlord is entitled to a remedy for breach of contract.⁶³ Depending on how a lease was originally drafted, a 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.⁶⁴ Other leases have language that allows landlords to collect percentage rent on the sales generated in violation of a radius clause. Courts have said that the measure of damages in the breach of a lease is "the amount it takes to place the landlord in the position he would have occupied had the breach not occurred"⁶⁵

62. Debby Zurzolo, *Rents In the Internet Age*, SHOPPING CENTER WORLD, Jan. 30, 1998, at 1.

63. See JOSEPH WILLIAM SINGER, PROPERTY LAW 827 (2d ed. 1997).

64. See generally Browdy, *supra* note 7.

65. *Schneiker v. Gordon*, 732 P.2d 603, 612 (Colo. 1987).

2. Radius Clauses

“The common law looks unfavorably at radius clauses, and the courts interpret them narrowly.”⁶⁶ Courts have been reluctant to enforce unreasonable geographical restrictions because the effect is a restraint on trade.⁶⁷ When determining the enforceability of restrictive covenants such as radius clauses, courts have traditionally used a “reasonableness” test.⁶⁸ “A ‘reasonableness’ test allows a court to consider the enforceability of a covenant in view of the realities of today’s commercial world and not in the light of out-moded theories developed in a vastly different commercial environment.”⁶⁹ The following eight-part reasonableness test, as laid out in *Davidson Bros., Inc. v. D. Katz & Sons, Inc.*, incorporates most of the elements that other courts have considered over the years when assessing the reasonableness of a radius clause.⁷⁰ The factors include:

(1) The intention of the parties when the covenant was executed, and whether the parties had a viable purpose which did not . . . interfere with . . . antitrust laws, or public policy. (2) Whether the covenant had an impact on the considerations exchanged when the covenant was originally executed. . . . (3) Whether the covenant clearly and expressly sets forth the restrictions. (4) Whether the covenant was in writing, . . . (5) Whether the covenant is reasonable concerning area, time or duration. . . . (6) Whether the covenant imposes an unreasonable restraint on trade or secures a monopoly for the covenantor. . . . (7) Whether the covenant interferes with the public interest. (8) Whether, even if the covenant was reasonable at the time it was executed, “changed circumstances” now make the covenant unreasonable.⁷¹

Prior to the reasonableness test, courts used a “touch and concern” analysis. Since the touch and concern analysis did not address whether a covenant had become obsolete over time, it has been replaced with the reasonableness test,⁷² and will not be addressed herein.

In applying the reasonableness test to the Tony’s Music Store example above, the first step is to look at the intention of the parties when the original lease was executed. At the time Tony’s and Lawrence Properties entered into the lease agreement, both parties had an interest in seeing the Tony’s store succeed in Sandy Cliffs Shopping Center. Tony’s had no intent of opening another store within the restricted area; which, at the time, was the only way Tony’s perceived could con-

66. Mitchell Y. Herman, *The Practical Problems of Enforcing Restrictive Clauses*, 11 No. 6 COM. LEASING L. & STRATEGY 1 (1998).

67. *See id.*

68. *See Davidson Bros. v. D. Katz & Sons*, 579 A.2d 288, 295 (N.J. 1990).

69. *Id.*

70. *See Herman, supra* note 66 at 1.

71. *Davidson Bros.*, 579 A.2d at 295.

72. *See id.* at 296.

stitute a "commercial establishment." As to the issue of whether consideration was exchanged, it is difficult to say that there was not. Both parties were professionals dealing at arms length, and generally such contracts are found to be valid without evidence of fraud.⁷³ Tony's may have an argument that the covenant did not clearly and expressly set forth the restrictions. The language is general and does not directly address Internet retailing. The restriction was obviously in writing, because it was in the lease that both Tony's and Lawrence signed. An issue for debate is whether the covenant is reasonable concerning area, time, and duration. Lawrence would argue that three miles during the term of the lease is reasonable. Tony's would agree that the distance and the duration are reasonable; but would argue that including other business ventures such as electronic commerce, is not reasonable.

The issue of whether the covenant imposes an unreasonable restraint on trade is where Tony's is most likely to be successful. Courts apply a balancing test to weigh the burdens against the benefits. For Lawrence to prohibit Tony's from selling online to customers residing within the restricted area around Sandy Cliffs would be too great of a burden in this growing technological age. With more and more retailers going online, it is unreasonable to expect tenants not to participate in this new form of commercial enterprise. Courts do not want to interfere with the public's interest in shopping for goods from their home. To let one landlord prohibit online sales to many people across the nation would constitute a much greater burden on the public interest than it would benefit to the landlord. To determine what role the changed circumstances play in this reasonableness analysis—

The trial court must first determine whether the covenant was reasonable at the time it was enacted. If it was reasonable then, but now adversely affects commercial development and the public welfare . . . , the trial court may consider whether allowing damages for the breach of the covenant is an appropriate remedy.⁷⁴

If Tony's is not able to establish the unreasonableness of Lawrence's claim of violation of the restrictive covenant, Tony's may have to pay damages. If Tony's is able to show the unreasonableness of the restrictive covenant because Internet retailing was not contemplated at the time of lease execution and/or because there has been a change in circumstances since the execution of the lease, then damages would not be due.

73. See *Black Indus., Inc. v. Bush*, 110 F. Supp 801, 805 (D.N.J. 1953).

74. *Acme Mkts., Inc. v. Wharton Hardware & Supply Corp.*, 890 F. Supp. 1230, 1245 (D.N.J. 1995).

3. Percentage Rent Clauses

“The percentage [rent] payment requirement is an integral part of the lease agreement and plaintiffs’ willful breach of that provision cannot be considered immaterial.”⁷⁵ Percentage rent is an essential element of a lease which, when defaulted on, can result in the termination of a lease and/or damages ordered against a tenant. To default on a percentage rent clause, a tenant must violate a term of the clause. Most commonly, this is when a tenant does not include sales from certain items into the calculation of gross sales from which percentage rent is paid.

The term gross sales has no definitive judicial meaning, is imprecise, and depends principally upon the wording established by the parties in a particular contract.⁷⁶ When analyzing these clauses, courts give the most weight to the plain meaning of what is to be included in the calculation of gross sales, a percentage of which is for payment to the Landlord as percentage rent.⁷⁷ In *Taft Realty Corp. v. Yorkhaven Enters., Inc.*,⁷⁸ the court explained that the term “box office receipts” was clear and did not include the sale of concessions or other items, only tickets for admissions.⁷⁹ In the Tony’s Music example given above, Lawrence should argue that Internet sales were not expressly excluded from the clause defining what was and what was not to be included in the calculation. Tony’s would argue that the sales were not made from the premises.

Since percentage rent leases are meant to grant landlords rent based on sales from the premises, it is presumed that all sales reasonably related to the location are to be included in the calculation.⁸⁰ Here is where the problem lies. The old leases do not fit with Internet sales because, it is questionable whether they fall under the definition of “reasonably related”? Is it when the goods are shipped out of the store? Or, is it when a person purchases the goods and has them shipped to his or her home instead of going to the store? Should the landlord or the tenant be penalized for advances in technology? Until such time as the judicial system rules on these matters, the matter is unresolved.

III. PROPOSED SOLUTIONS

There are two primary reasons why solutions must be found to the issues presented herein. The first is the interest of allowing new technology to grow. “In order for e-commerce to flourish, many believe

75. *S.E. Nichols, Inc. v. American Shopping Ctrs.*, 515 N.Y.S.2d 638, 639 (1987).

76. See Douglas Hale Gross, Annotation, *Calculation of Rental Under Commercial Percentage Rent Lease*, 58 A.L.R. FED. 3D 384, 400 (1975).

77. See *id.*

78. 150 A.2d 597 (Conn. 1959).

79. See *id.* at 599.

80. See Gross, *supra* note 76, at 397.

that a global legal framework must be developed that provides companies and consumers with legal certainty and the protections enjoyed in more traditional commercial settings.”⁸¹ The second reason is to prevent the new Internet retail industry from being so burdened by costly litigation that it is unable to flourish. “The increased costs of dealing with these new legal uncertainties may offset any reduction in costs achieved through the use of new technologies and, as a result may slow needlessly the rate at which businesses are willing to implement new technologies.”⁸² Since the courts have not yet ruled in this situation, the following suggestions are intended to give landlords and tenants ideas about how to protect themselves while benefiting from this new consumer source.

A. *The Legal Approach—Drafting*

The best way to prevent a misunderstanding is to clearly draft the parties’ intent so that later interpretation is not necessary or cumbersome. To clarify, drafting is a solution, but negotiation is the key to getting two adverse parties to reach an agreement. The best solution would be to eliminate percentage rent altogether; however, this may not be agreeable to landlords. A more flexible suggestion may be a carefully drafted clause, which meets the needs of both the landlord and the tenant. In the negotiation of a gross sales clause, a tenant will want all sales from the Internet to be expressly excluded from the calculation of gross sales for a store; a landlord will want all sales, including Internet sales to be included, especially if the Internet sales take significant sales away from the store.

An example of a proposed negotiated percentage rent clause:

The term “gross sales” shall be defined as all sales credited to or made from the premises by tenant, its sub-tenants, concessionaires, or licensees in any fiscal year during the lease term. Gross sales, for the purpose of calculating percentage rent shall expressly exclude: (1) all sums collected by tenant for any sales or gross receipts tax imposed by any duly constituted governmental authority, (2) the amount of any cash or credit refund or exchange made upon any sale from the premises, previously included in gross sales, (3) all sums collected for extended warranties, and (4) the amount from any Internet sales by tenant which do not originate from or are not supplied from the premises.

When drafting a radius clause, a distinction should be made between opening another store and doing business within the restricted area. When a tenant intends to do business over the Internet, the radius clause should have the tenant agree not to open another store

81. Michael Geist, *Web Watch: Electronic Commerce: The Global Policy Perspective*, 2 No. 6 WALLSTREETLAWYER.COM: SEE ELEC. AGES 25, Nov. 1998.

82. Amelia H. Boss & Jane Kaufman Winn, *The Emerging Law of Electronic Commerce*, 52 BUS. LAW. 1469, 1470 (1997).

within the restricted area. Even though language that does not allow a tenant to do business within a certain area will probably not pass the reasonableness test, and might be considered a restraint on trade, it would be much less expensive to avoid the problem than to have to litigate it in order to determine the outcome.

An example of a proposed negotiated radius clause:

In consideration hereof, tenant or any person, firm or corporation directly or indirectly controlled by or under common control with tenant shall not open, operate, or manage another retail store within three (3) miles of the shopping center at any time during the term of the lease or any renewal or extension thereof.

To prevent a conflict, tenants should amend their leases before conducting business online. If a tenant asks for consent to lower the rent it pays to the landlord while a lease is still in effect, the tenant should be prepared to offer some sort of concession as consideration to hedge against a loss to the landlord. The options for incentives are as vast as the creativity of the negotiators. One option might be to offer a higher percentage rent rate or guarantee a certain sales level for a fixed period of time. A landlord may be more willing to allow the Internet sales exclusions from the calculation of gross sales if the fixed minimum rent or the percentage rent rate was higher. A one-half of one percent or one percent increase in the percentage rent rate, depending on sales projections, may be a viable solution. In the Tony's Music Store example, Tony's could offer to pay six percent (up from the five percent negotiated in the original lease) of his gross sales to the landlord. Had Tony's proposed to amend its lease before going online, it could have avoided the potential for litigation, and Lawrence would have collected \$12,000 in percentage rent instead of \$10,000 on the lower sales in addition to the base rent.⁸³

Another solution may be to have the tenant guarantee its gross sales will not fall below the average gross sales from that store of the past two years. This would hedge against the landlord's potential loss of percentage rent dollars and allow the tenant to pursue new technology. In the Tony's example, Tony's paid \$15,000 in 1995, and \$16,000 in 1996, as percentage rent in addition to the \$30,000 annual fixed minimum rent. If Tony's had proposed to amend its lease prior to selling from its virtual storefront, again it would avoid the potential for litigation, and Lawrence Properties would have received \$15,500 in percentage rent for both 1997 and 1998, instead of the \$10,000 it received in 1997, and the \$9,000 received in 1998.⁸⁴

Although this may seem unreasonable for the tenant to have to pay more, consideration should be given to the fact that sales over the Internet are not charged percentage rent, or even sales tax. The store

83. See Chart A-1.

84. See Chart A-1.

sales may not be substantially affected by Internet sales, but if the tenant did end up paying more rent, the added cost would most likely be factored into the price of the goods and be passed along to the consumer. Since the Internet is such a growing source of retail sales, it is foreseeable that most, if not all, traditional mall tenants will soon be selling online in addition to having actual stores.

B. *The Technical Approach*

Drafting beforehand is the best prevention to later conflict, however, there may be another way for landlords to collect percentage rent on Internet sales. If a landlord is not willing to accept the potential for loss of profits, there are technological ways of dealing with the lack of a permanent establishment from which Internet sales are made. Probably one of the easiest solutions, although not a popular one with tenants, would be to require tenants who have leases with a radius clause to report and pay percentage rent on all sales made to or shipped within the restricted area. Since records for ordering and shipping are computerized, a zip code could identify where an item was being shipped. If the destination is within the restricted area the sale could be added to the sales generated by the store. This solution may be perceived as overreaching by landlords and is unlikely to be considered viable unless another compromise could not be reached.

Another solution may be to combat technology with technology. A landlord may want to set up its own mall website so that users could access the tenant's website through a link⁸⁵ created from the mall website.⁸⁶ In the Tony's Music scenario, Lawrence Properties could set up a mall website called "SandyCliffs.com" and create links to all its tenants who have web pages. A user could access this virtual mall by typing in SandyCliffs.com, then clicking on any tenant from which they wanted to shop. Tony's would benefit from the online sales and Lawrence would be able to track how much Internet business Tony's is doing through the mall website. Landlords could in turn charge percentage rent on those sales generated from the mall website. This solution could be initially costly for a landlord to set up; however, it could pay off in the long run. The down side is that landlords will have a hard time getting tenants to agree to pay percentage rent on items they do not pay rent on now, unless it becomes the universal norm or the tenants receive some sort of benefit from it. Tenants may like the additional exposure for their virtual storefronts, but probably not at a cost of five percent.

This solution will not be as successful with existing tenants who are amending their leases for renewal as it will be when incorporated into

85. See SNELL, *supra* note 45, at 75 (defining "A link is an object in a web page that you can click to jump to another page, or another part of the page you're on.>").

86. See Lucy Amaral, *Developers Learn to Love the Internet*, SHOPPING CENTERS TODAY, May 1998, at 216.

a whole deal for a store. For a tenant to make sound business decisions about expansion, analysis of the entire deal, including base rents, percentage rents, and extra costs, is required. When the requirement to participate in a mall website is presented as part of a whole deal, a potential tenant will be able to weigh it against projected sales for that store and Internet sales in that area. Until such time as tenants have a good understanding of how much business is being done in malls and how much is being done on the Internet, it will be difficult for them to make business decisions.

Even technological solutions have flaws. Since a user can access a website without going through the link of a mall website, this may not be economic or efficient for a landlord. Depending on how a user shops, a user may access a virtual storefront by a search engine⁸⁷ such as Yahoo, Lycos, or Excite. In this case the search engine only pulls up key words that match the tenant's virtual storefront, not the landlord's cybermall. When a user directly accesses the tenant's website, the landlord cannot track or account for sales not generated through the mall website.

An upside to the mall website is the exposure the tenant gets from having a logo or link on the mall webpage. With millions of people online, the Internet offers greater exposure than could be generated by any other single medium. With global access to the Internet, this exposure is especially beneficial for nationwide and international companies.

CONCLUSION

Electronic commerce has created a form of retailing that does not fit within the traditional framework of the shopping center or the shopping center lease. People are now able to shop from their computers at home; cutting out what is essentially a middleman—the mall. With this loss of foot traffic comes a loss of sales generated from the mall, which in turn lowers rent paid to landlords. Although only time will tell the extent to which consumers will choose to shop from home and not at the mall, the potential for conflict between landlords and tenants regarding their leases is significant.

Even though there has not been any litigation yet regarding this conflict, landlords and tenants first must be aware of the possibility for problems and then take the appropriate steps to prevent them. To protect themselves from defaulting on a lease, tenants who are planning to, or are actually doing business on the Internet, should closely review their leases for a radius clause that prohibits the conduct of business in a restricted area and for percentage rent clause that may require the reporting of any Internet sales to the landlord. If prohibi-

87. See SNELL, *supra* note 45, at 136. A search engine is a program used to search for web sites by category or key word. See *id.*

tive clauses are found, tenants should negotiate whatever is necessary to amend the leases, to ensure that their new online businesses do not breach any existing contracts. Agreeing to a higher percentage rent rate could be the incentive necessary to get a landlord to agree to the exclusion of Internet sales from the calculation of gross sales.

To prevent a loss of profits, landlords need to be aware of what their tenants are doing over the Internet. Landlords should attempt to require tenants to include the online sales in the calculation gross sales. This can be accomplished by requiring that retailers either participate in a cybermall or report all online sales shipped within the radius of a store for calculation of percentage rent. This will be easier for landlords who are negotiating deals with new tenants rather than with renewing tenants because increased rents can be factored throughout the whole deal.

“The law has some catching up to do, but the legal issues surrounding cyber-retailing echo those of traditional retailing, and the rules should be much the same.”⁸⁸ With awareness of technology and mutual accommodation, both tenants and landlords will be able to profit from this new form of retailing in the twenty-first century.

Jennifer E. Doty

88. Richard M. Steuer, *Retailing on the Internet*, 12 ANTITRUST 50, 52 (1998).

CHART A-1

Tony's Music Store

Premises:	3,000 square feet		
Fixed Minimum Rent:	\$10.00 per square foot		
Annual Base Rent:	\$30,000		
Percentage Rent Breakpoint:	\$600,000		
	Gross Sales	5%*	6%**
1995	\$900,000	\$15,000	
1996	\$920,000	\$16,000	
1997	\$800,000	\$10,000	\$12,000
1998	\$780,000	\$ 9,000	\$10,800

*5% of gross sales over 600,000 breakpoint (900,000 - 600,000 = 300,000 x 5% = 15,000)

**6% of gross sales is shown for demonstration purposes if landlord and tenant negotiated a higher percentage rent rate in exchange for amending a lease.