BRICKS MEET CLICKS: HOW OMNICHANNEL RETAIL IS IMPACTING LEASING FUNDAMENTALS

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By

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I. HISTORICAL CONTEXT OF RETAIL LEASING

Retail is as ancient as humanity and civilization, but was historically limited to a set physical location. Out-of-store retail was inaugurated with catalog sales in the late 1800s when Sears and Roebuck issued their first catalog. And for the next hundred years, retail was transacted either at a specific store or through a catalog sale, with an order placed by mailing it or on the phone. In the early 1990s, with the advent of safe encryption of credit cards, early experimental online sales began to take root. The founding of Amazon in 1994 completed the stage for the dramatic revolution that has drastically changed ---and continues to change ---the way we shop today.

The retail real estate legal community was initially concerned with how this would play out. With rent valuations traditionally based on sales origination, and calculation of gross sales and ensuing percentage rental stream to landlords, how would online sales change this structure? Yet early confusion quieted down: the volume of online transactions was not transformative. Ecommerce was somewhat limited to books and music, tangible goods easily acquired at a desktop computer. The traditional shopping patterns stuck, with online just another venue to purchase certain categories of goods.

However, the confluence of three elements in 2007 and 2008 created the perfect storm for enormous change: sophisticated digital technology, a drastic recession, and the computer-era purchasing demographic combined to significantly modify shopping behavior.

First, the creation of the iPhone in 2007 was the catalyst for rapidly advancing mobile technology, and opened channels for smarter, faster, targeted, and interactive e-tail.

At around the same time, another transformative—or rather cataclysmic --event occurred that also rocked the retail world: the global economic meltdown that heralded seismic shifts in our retail real estate landscape. Within a few years, thousands of stores shuttered, entire silos of concepts died, and the reshaped environment became populated by stronger retailers who used this recession to curate their brands.

And thirdly, the emergence of the millennial class (roughly defined as 18 to 35-year-olds) translated to a preference for digital shopping for the instant gratification generation. Constituting approximately one quarter of the US population, this powerful segment has demonstrated that we can shop with our fingers rather than our feet.

Today, peering through the rearview mirror affixed to the forward-looking retailer, the Great Recession was good for the state of retail. It weeded out the weak performers and forced brands to focus on their core merchandise and to listen to the customer. The retailers that learned this lesson quickly, who nimbly shed underperforming locations, shelved obsolete concepts, and shrank real estate footprints, are still alive and more likely to be expanding again. Chasing square footage to keep Wall Street happy proved cannibalistic and fatal. The revitalized retailer is dealing with an altered reality.

Clearly we prefer fewer and better choices and focused merchandising. The increasingly urbanized American customer wants to explore and to shop. But we have voted that we are reluctant to part with our money for something unless it delivers, at a bare minimum, either true value or a transcending experience. And the smart retailer completely understands that.

Same store sales, especially with hard goods and specialty apparel, continue to experience muted growth across all channels. Even luxury players, who were responsible for much of the success of urban retail during the period from 2010 through 2015, have been experiencing setbacks these last few years---as a result of international exchange rates favoring the US dollar, stratospheric real estate valuations in New York City and other high-street gateway marketplaces, and more cautious spending behavior. Fortunately for the retail real estate industry, there are current indications that some of the malaise that struck the luxury sector has begun to ease.

Online shopping concomitantly continues to grow exponentially, fueled by mobile apps and morphing technology, and the looming threat to render certain physical establishments irrelevant is not being diminished. Both the size and the sheer number of retail real estate brick and mortar establishments will continue downsizing for the foreseeable future.

What survives and thrives is the retailer that embraces our new Omnichannel universe and incorporates the reality of today in its strategic business planning.

Often, the best use of brick and mortar space is as a showroom: a space to see it, touch it, try it. Or the store may in fact be the space to return goods ordered on an IPad on the couch and delivered by FedEx that the consumer can't bear to rebox, giving the retailer the old-fashioned chance to capture the customer's fancy and transact a serendipitous sale. Savvy retailers know that no merchandise, no matter how spectacularly displayed, can be truly amazon-proofed. Yet, certain classifications require a store setting---a computer can never hand you a glass of wine, and our technology does not yet allow a prospective purchaser to feel the soft fibers of cashmere through a screen. What has emerged is the world of Omnichannel where the silos of bricks and clicks sit not side by side, but integrated as an organic whole.

The interplay between internet and storefront sales, when properly crafted, creates a synergy that results in a sum greater than its separate parts. A synthesized understanding of the offline and online customer delivers a seamless Omnichannel experience that reinforces loyalty and motivates the consumer to shop. Great brands figure this out. No one wants to enter retail space and be accosted by register sheriffs, as the roaring success of Apple demonstrates that an interactive open environment without the irritants results in increased sales. Instant gratification and paperless tracking are now expected.

In fact, we now know that successful Omnichannel has become the new driver of bricks and mortar, not its death knell. Warby Parker, Bonobos and Birch Box are illustrative examples of innovative on-line concepts that have morphed into successful Omnichannel retailers. They began as a fresh way for consumers to order product on line to satisfy a market that previously did not exist, but they have partially transformed into brick and mortar establishments by understanding the customers' need for real space to try on and experiment.

These traditional on-line only retailers did not merely open stores to afford their shopper a chance to shop, but rather, seized on specific consumer demand for showroom space to test and try on merchandise in a physical setting. The key to their critical success is seamlessly blending the on-line and in-store experience to provide optimal ease and accessibility of product. We are living in a universe that is the convergence of internet media and actual physical space.

Retail CFOs and General Counsels must now confront and grapple with such issues as when is the sale recognized, where the revenue is recorded, what are the best return policies and procedures and of course who gets credit for the sale. The very existence of these issues means that the wise company has embraced Omnichanneling retailing in order to cultivate and retain its customers. Whether bricks and mortar is a store or a showroom may be irrelevant when four-wall profit is no longer the barometer of success and percentage rent calculations are rendered moot with new business modeling. And our Lease documents must contemplate this new reality and be drafted for the future that is now.

II. RECRAFTING KEY LEASE PROVISIONS

There are several sections of the lease that should be reevaluated as Omnichannel expands and matures. Most obviously gross sales inclusions and exclusions for the calculation of percentage rent must be adjusted to reflect retailers accounting and landlord's interests. Other sections of the lease, such as operating requirements, radius clauses and kickouts are also ripe for reconsideration.

Percentage Rent

Gross Sales Definition: Maximizing retailer success means maximizing sales from all pathways and insuring that they are mutually complimentary. Traditionally, Gross Sales have been a narrow measure of one store's success. If percentage rent is tracking real success, the definition of Gross Sales needs to change with the changes in retailer operation.

TRADITIONAL RETAIL LEASE CLAUSE	OMNICHANNEL FRIENDLY LEASE CLAUSE
Gross Sales: the entire amount of the actual sales price, whether wholly or partly in cash or for credit, of all merchandise sold, and the charges for all services performed at, in, or from the Demised Premises, including without limitation, all sales by any sublessee, licensee or concessionaire at, in, or from the Demised Premises.	Gross Sales: the entire amount of the actual sales price, whether wholly or partly in cash or for credit, of all merchandise sold, delivered, mailed, fulfilled, ordered and the charges for all services performed at, in, from, upon or through the Demised Premises, including without limitation, all sales by any sublessee, licensee or concessionaire at, in, from, upon or through the Demised Premises. Internet sales whether made from a mobile, stationary, store or customer-owned device, shall be counted as Gross Sales from the Demised Premises if either the device on which they are made or the location of the product from which they are fulfilled is the Premises. Additionally, all internet or mobile application or like sales made following access from a link from the Center or Landlord website shall be considered Gross Sales.
Exclusions: There shall be excluded from Gross Sales, as applicable: …(a) the exchange or transfer of merchandise between stores or warehouses of Tenant, between stores or warehouses of any subtenant, licensee or concessionaire, or between stores or warehouses of Tenant or any subtenant, licensee or concessionaire and stores or warehouses of their respective affiliates (including any parent, subsidiary or controlling corporation), when such exchange is made solely for the convenient operation of the business of Tenant of such subtenant, licensee, concessionaire or affiliate and not for the purpose of consummating a sale at, in, from or upon the Demised	Exclusions: There shall be excluded from Gross Sales, as applicable: … (a) the exchange or transfer of merchandise between stores or warehouses of Tenant, between stores or warehouses of any subtenant, licensee or concessionaire, or between stores or warehouses of Tenant or any subtenant, licensee or concessionaire and stores or warehouses of their respective affiliates (including any parent, subsidiary or controlling corporation), when such exchange is made solely for the convenient operation of the business of Tenant of such subtenant, licensee, concessionaire or affiliate and does not avoid the inclusion of a sale in Gross Sales which otherwise would be so included, … (b) cash or credit refunds, but only to the extent that the merchandise sold, was

Premises, … (b) cash or credit refunds, but only to the extent that the merchandise sold, was originally included in Gross Sales, … (c) delivery charges and wrapping charges where such service is provided at cost for the convenience of Tenant's customers,… (d) proceeds of vending machines that are used exclusively by Tenant's employees, and not situated on the sales floor area), … (e) workroom or alteration charges, …(f) mail order sales if the order relating thereto is not received, placed or filled at the Demised Premises.

originally included in Gross Sales (returns of internet sales which are then exchanged for or fulfilled by store product shall be included in Gross Sales), …, (c) delivery charges and wrapping charges where such service is provided at cost for the convenience of Tenant's in-store customers wrapping of internet product in-store shall be included in Gross Sales, … (d) proceeds of traditional product containing vending machines that are used exclusively by Tenant's employees and do not contain product sold on the store sales floor, and are not situated on the sales floor area, …(e) workroom or alteration charges except if performed on merchandise not physically purchased from the store or otherwise included in Gross Sales,… (f) mail order or internet sales only if the order relating thereto is not received, placed or filled at the Demised Premises.

EXISTING TENANT STORE LANGUAGE

"**Gross Sales**" means the aggregate amount, expressed in dollars, of all sales of goods, whether in full or discount prices or for cash or credit, made in, on, or from the Premises by Tenant, provided, however, that the following shall be excluded or deducted from Gross Sales:

(A) all credit, refunds, and allowances granted to customers;

(B) exchanges of merchandise between Tenant's warehouse or other stores and other similar movements of merchandise;

(C) returns;

(D) the proceeds from vending or other machines and commissions on such proceeds;

(E) delivery charges;

(F) internet or catalog sales.

REVISIONS TO REALIGN WITH PRACTICE

"**Gross Sales**" means the aggregate amount, expressed in dollars, of all sales of goods, whether in full or discount prices or for cash or credit, originating from Tenant operated devices within the Premises, provided, however, that the following shall be excluded or deducted (as appropriate) from Gross Sales:

(A) all credit, refunds, and allowances granted to customers until used to purchase goods otherwise included in Gross Sales;

(B) exchanges of merchandise between Tenant's warehouse or other stores and other similar movements of merchandise excepting only deliveries from the store of goods otherwise included in Gross Sales;

(C) returns, including exchanges;

(D) the proceeds from traditional vending machines and commissions on such proceeds;

(E) delivery charges except for product fulfilled from Premises but not sold from Premises;

(F) internet or catalog sales except if fulfilled from Premises.

Reporting Requirements. Landlord's lease forms generally contain reporting requirements that are far more comprehensive than Tenant's requirements.

LANDLORD FORM LANGUAGE

A) Within twenty (20) days after the end of

DRAFTING NOTES

If the definition of Gross Sales accounts for Omnichannel, monthly reporting may be onerous.

each calendar month, Tenant shall submit to Landlord a statement signed by an agent of Tenant stating the Gross Sales for such month. Within sixty (60) days after the end of each Lease Year, Tenant shall furnish Landlord with a statement of Gross Sales attained by Tenant during the preceding Lease Year, certified by Tenant, which statement shall be accompanied by a check for payment of percentage rent, if any, due.

Even 60 days may be too short and Lease Years or even calendar years may not make sense if the company is re-evaluating stores on a different basis.

B) Tenant shall utilize, or cause to be utilized, an accounting system (or systems) in accordance with good retail practice, which will accurately record all Gross Sales. For at least twenty-four (24) months after the expiration of each Lease Year (including any partial Lease Year at the beginning of the Term), Tenant shall keep and maintain (and shall cause all subtenants, concessionaires and licensees to keep and maintain) in the Demised Premises or the main office of Tenant records conforming to such accounting system showing all Gross Sales for such Lease Year.

The more complex the standards of Gross Sales, the more difficult these requirements become to satisfy. These requirements are there to permit simplified Landlord auditing. As we layer Omnichannel into Gross Sales, auditing becomes an onerous challenge.

Operation Of Business Landlord's desire to regulate Tenant's operations has always been a point of contention. Omnichannel exacerbates the issue because it expands the potential methods of store operations.

TRADITIONAL RETAIL LEASE CLAUSE

Except as otherwise set forth herein, Tenant shall (a) fully stock and adequately staff the Demised Premises, and shall continuously and uninterruptedly use, occupy, operate and conduct Tenant's business in the Demised Premises (which business may include areas of the Demised Premises for storage and office purposes, as is reasonably deemed necessary for Tenant's business therein and not for any other business or store); (b) use for office, clerical, storage or other non-selling purposes only such space as is reasonably required for the proper operation of Tenant's business in the Demised Premises, (c) include the address, phone number and name of Center in its advertising.

Tenant shall not (i) permit the use of any portion of the Premises for solicitations, demonstrations or the like.

OMNICHANNEL FRIENDLY LEASE CLAUSE

Except as otherwise set forth herein, Tenant shall adequately stock and staff the Demised Premises, to maximize Gross Sales from the Premises, but shall not be obligated to continuously use, occupy, operate and conduct Tenant's business in the Demised Premises (which business may include areas of the Demised Premises for storage and office purposes). Tenant shall further not be obligated to (a) link the Tenant's website to the Center's website; (b) cause its computer and mobile internet access devices (and any future technological replacements or evolutions) located within the Premises to track all sales made therefrom; and/or (c) include the address, phone number and name of Center on website and mobile platforms as the first option to any search.

Further, Tenant may (i) direct any customers to its website for out of stock product and (ii) operate its website and physical retail store in any way that Tenant deems necessary in order to operate its own business.

Getting Out Of Our Own Way

How landlords, brokers and lawyers can help retailers stay alive.

Nina L. Kampler

Despite the hyperbolic headline-grabbing hysteria ringing the death knell of stores, the retail industry is very much alive. For as long as mankind breathes, we will need supplies. Humans are hardwired to shop. Consumerism, as examined through the periscope of history, is really just an elevated form of our pre-civilization survival skills of hunt-ing and gathering. We collect, we acquire, we devour, we display.

Understanding how we shop today requires reflecting on how we have shopped during other times in history; Only then can we begin to properly envision the shopping of tomorrow. In this context, it becomes clear that mankind will forever shop — shop until we drop, in this literal sense of the word. Rather than contributing to the free fall of retail and helping perpetuate those misconceptions, perhaps we should pause and examine the evolution of retail to help preserve its future viability.

IN THE BEGINNING

Contrary to what an alien landing on our planet today might think, shopping centers are not part of the earth's crust. They grew over time. Historically, retail was limited to a set physical location. Ever been to Pompeii? Or the archeological Roman bazaar ruins in Jerusalem? There you see gathering and bartering places where our ancestors exchanged stories and goods. We left our homes — be they caves or rudimentary huts at the time — to meet up with others: to find love, source food, gain knowledge, and trade goods. For thousands of years, long before the modern mall was manufactured or credit cards invented, and eons before currency was systematized or transportation efficiencies made the entire world accessible, we walked and rode camels and found what we needed and exchanged what we had for what we desired. And all of our transactions occurred at a specific physical place.

Out-of-store retail was first introduced with catalog sales in the late 1800s when Sears, Roebuck and Company issued its inaugural catalog. And for the next 100 years, retail was transacted either at a specific store or through a catalog sale, with an order placed by mail, or later by telephone. In the early 1990s, with the advent of safe encryption of credit card numbers, early experimental online sales began to take root. The launch of Amazon.com in 1994 completed the stage for the dramatic revolution that has drastically changed — and continues to change — the way we shop today. And shopping went from being place-driven to space-driven: We can now shop anywhere and everywhere.

E-COMMERCE, NOW AND THEN

As e-commerce took on life, the retail real estate, legal and brokerage communities were initially concerned with how this would impact existing business models. With rent valuations traditionally based on sales origination, and calculation of gross sales and percentage rents to landlords, how would online sales change this structure? Early confusion quickly quieted down: The volume of online transactions was not enough to be transformative. E-commerce was somewhat limited to books and music, and other tangible goods, that were easily acquired at a desktop computer. The traditional shopping patterns stuck, with online just another venue to purchase certain categories of goods.

Until those patterns didn't stick anymore. The confluence of a drastic recession, and a rising young, technologically savvy demographic all combined to significantly modify shopping behavior.

First, the creation of the iPhone in 2007 was the catalyst for rapidly advancing mobile technology,and it quickly opened channels for smarter, faster, targeted, and interactive e-tail.

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Then, the global economic meltdown resulted in the shuttering of thousands of stores, and the reshaped environment became populated by stronger retailers who used the recession to curate their brands.

Thirdly, the emergence of the millennial class (roughly defined then 18 to 35-year-olds) translated to a preference for digital shopping for the instant-gratification generation. The smartphone also aided them with comparing pricing instantly during struggling economic times. Constituting approximately 25 percent of the U.S. population, this powerful segment has demonstrated that we can shop with our fingers rather than our feet.

Clearly, same store sales — the traditional barometer by which Wall Street measures retailers' successes — continue to experience muted growth across all channels. Even luxury players, who were responsible for much of the success of urban retail during the period from 2010 through 2015, have been experiencing setbacks during the past few years. Their struggles have been the result of international exchange rates favoring the U.S. dollar, stratospheric real estate valuations in New York City and other high-street gateway marketplaces, and more cautious spending behavior among consumers of all classes.

As online shopping grows, both the size and the sheer number of retail real estate brick-and-mortar establishments will continue to contract. The retailer positioned to survive and thrive is one who embraces the new omni-channel universe.

(continued)

THE HUMAN TOUCH OF IN-STORE

For some retailers, the best use of brick-and-mortar space is as a showroom: a space to see, touch, and try products and services. The store may also be a space to return goods ordered on an iPad on the couch and delivered by FedEx that the consumer can't bear to rebox. It can give the retailer the old fashioned chance to capture the customer's fancy and transact a serendipitous sale. Savvy retailers know that no merchandise, no matter how spectacularly displayed, can be truly Amazon-proofed. Yet, certain classifications require a store setting — a computer can never hand you a glass of wine — and our technology does not yet allow a prospective purchaser to feel the soft fibers of cashmere through a screen. What has emerged is the world of omni-channel, where the silos of bricks and clicks sit not side by side, but integrated as an organic whole.

The interplay between internet and storefront sales, when properly crafted, creates a synergy that results in a sum greater than its separate parts. A synthesized understanding of the offline and online customer delivers a seamless layered multi-channel experience that reinforces loyalty and motivates the consumer to shop. Great brands have figured this out and are working very hard to produce an accessible and compelling shopping experience that anticipates our needs and whims as a consuming public. An excellent merchant must do much more than curate goods to display; he or she must now also deliver them into the palms of our hands wherever we may be.

Retail is not dead, it has been reshuffled and reorganized. So, why the meltdown of stores and proliferation of "for rent" signs? Because the landlords and lawyers and dealmakers are not keeping up with the changes.

VACANCY THREATENS YOUNG BRANDS

Brands collapsing because consumers' tastes are changing is hardly new; it is how the world evolves. But today, the owners, investors and managers of the next generation of retail tenants are no longer willing to be handcuffed to leases with unsustainable economics. The rent barrier to entry in many markets is insurmountable. Retailers are opting to stay local instead of growing their brand or they are limiting themselves to e-commerce instead of following the Warby Parker or Bonobos omni-channel models simply because the rent numbers threaten to kill their start-ups. One international brand, with thousands of stores across the globe, has just shelved its planned rollout in the U.S., un-nerved by the failures and resulting store-front vacancies. The solution to the problem thus disappears in this vicious cycle: the potential future occupants can't make these numbers work either. Retail real estate values have gone down: the store is no longer the entire source of sales, so its value has been diminished. Amazon is not erasing traditional retail, suffocating lease economics is the true culprit.

The families and corporations who control our nation's retail space need to work with their partners, bankers and investors to reshape the rents that are poisoning our retail future. Fifty cents on the dollar might sound low today, but it is fifty cents more than zero. Landlords are holding the golden goose in their hands: fantastic properties across our country, on small main streets and dazzling high streets, in lifestyle centers and luxury malls, in enclosed and open spaces around the country, but they are perched to kill the goose eggs because they want more gold than they can access. Landlords need to confront and accept this new reality. Economics 101 instructs that, at some point, the intersection of supply and demand is met and then the right number of loaves are baked and all people have bread to buy. What is happening in the retail real estate universe today is that the supply line hovers in the stratosphere, danger-ously far from the demand line, and the retailers' engines can't reach there safely. Many landlords are literally living in outer space: outside of the realm of possibility where the deals can be made and kept.

MEETING IN THE MIDDLE

The lawyers can help, too: We need bipartisan attorneys to bridge the gap between landlords' expectations and tenants' needs. How many panels can we listen to where each side sticks to its script that the other side no longer hears? This playbook needs to be tossed out with the large metal cash registers and non-recyclable bags. Why should a landlord, no matter how wonderful the real estate location that is being offered, be entitled to collect a percentage of the sales that are transacted on your phone, in your home, in a café or anywhere because it happens to be in the same zip code as a particular bricks-and-mortar location?

Rent should not be a complicated algorithm. Office rent is calculated by the value of what that parcel is worth, regardless of who shows up at work or what is accomplished in that space. Retailers should be entitled to do the same. Why should the corporate decisions differ for Unilever or Uniqlo? Shouldn't a business decide where to have physical stores in the same way it decides where to lease its regional and local offices — in a way that maximizes overall revenue and creates value for the brand by building its customer base and maximizing sales? It should not matter if the strollers walking into a particular door are there to browse or return or buy anew; if the pulse of the store is alive, it will generate heat. And if it does not, store management won't keep it in its portfolio. Why abort its potential for arbitrary rent reasons that once made sense but should no longer apply?

Retail CFOs and general counsels are distracted trying to resolve when a sale is recognized, where the revenue is recorded, determining the best return policies and procedures and deciding who gets credit for the sale. Why are these even issues? Whether bricks-and-mortar is a store or a showroom should be irrelevant when four-wall profits are no longer the indicator of success, and percentage rent calculations are rendered moot with new business modeling. Lawyers must also be refining the relevancy of operating requirements, radius clauses and other provisions. Our lease documents must address this new reality.

If the landlord and retailer communities come together in their understanding, there is much to be gained. Today's shopping center should not be showcased in a museum tomorrow. We should keep it relevant and viable. We can do this. We just need to keep the golden goose alive. **SCB**

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