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People and Property

EMANUEL B. HALPER

TENANTS' RECORDKEEPING AND REPORTING OBLIGATIONS UNDER PERCENTAGE LEASES

Percent rent is no mystery, and it's not just a way for a landlord to squeeze a few extra pennies from his tenants. Some landlords will never see a nickel from their percentage rent clauses, but others will receive percentage rents that dwarf all the other amounts their tenants are required to pay.

Ironically, chain store tenants were the ones who popularized percentage rent during the modern real estate era. During the Great Depression of the 1930s, tenants wanted to avoid paying fixed rents. They suggested that the only fair rent for a given store was a percentage of the sales volume.

At the end of World War II, a time of prosperity and of an unprecedented expansion of America's retail facilities, most retailers dropped their opposition to fixed rental rates. But landlords had come to love and cherish percentage rent. They were delighted to get the fixed rent too, and so they demanded both. The usual retail space lease clause required that the tenant pay the higher of a fixed rental rate or a percentage of the volume of gross sales.

THE LEASE CLAUSE'S BOOKS AND RECORDS REQUIREMENT

Once the parties to a lease decide to tie rent to the volume of gross sales, the lease must require that the tenant keep books and records with respect to the sales, send certificates and statements to the landlord that summarize the sales, and permit the landlord to make audits and inspections of the appropriate books and records.

Most merchants keep books and records even if they aren't obligated to pay percentage rent. Certainly all

chain stores do. But many operators of local stores are known to be extremely inadequate recordkeepers. Some are reputed to keep three sets of books—one for the Internal Revenue Service, one for themselves, and one for the landlord. Given this less-than-wholesome attitude of some retailers about their debt obligations, percentage leases must require every retailer to establish sensible recordkeeping systems to support the obligation to pay percentage rent. In fact, a percentage rent clause would hardly be meaningful unless the tenant keeps books and records from which the parties can determine gross sales and deductions from gross sales.

The Obligation to Keep Books

A lease's recordkeeping provision should require the tenant to keep books and records that reflect each sale or service transaction that takes place at the store and each delivery from the store. These records should also reflect all transactions that result in deductions from gross sales.



Although most of us assume that the obligation to keep books and records implies that the records should be accurate and complete, there's no harm in adding an explicit statement to that effect.

No time should be wasted with a requirement that books and records be maintained in accordance with generally accepted accounting principles. Knowledgeable accountants smile when they see such provisions. Generally accepted accounting principles are not religious principles and don't provide solutions to all problems. There simply is no accepted principle of accounting that tells how to keep one's books. A businessman may learn something about bookkeeping by taking a good accounting course, but the generally accepted accounting principles that he learns do not offer him a comprehensive guide to recordkeeping practices.

Where Should the Books Be Kept?

Landlords need to know where the books and records will be kept. They cannot audit these books and records if they don't know where to find them. Many

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landlords insist that the books and records be maintained within a reasonable traveling distance from the landlord's headquarters. A New York City landlord does not want to gather his accounting staff and fly to Beirut, Lebanon to check up on the honesty of a merchant who is selling pizza in a Bismarck, North Dakota shopping center. On the other hand, a chain store organization with principal offices in Honolulu will not usually agree to keep its books and records in Labrador—even if its landlord lives there and refuses to fly.

How Long Must the Tenant Save His Records?

A percentage lease should provide that the books and records be maintained for a significant period of time after the lease year on which they report. If the tenant can destroy the books and records shortly after they are created, the landlord will never have the opportunity to inspect them and check the accuracy of the statements of gross sales. Nobody really argues that the books and records should not be maintained for a significant period of time. But the parties do argue about the appropriate length of that time period.

Some landlords have demanded that my tenant clients maintain their books and records for as long as ten years after the lease year to which a statement of gross sales relates. At this moment, I am trying to humor a landlord who insists that the books and records for every lease year be maintained for the entire lease term. I haven't agreed and won't.

Practically, a merchant can be expected to maintain its books and records for at least three years because it needs the books and records to support tax returns. However, many tenants resist even a requirement that the books and records be kept for three years. Most chain stores will go along with a one-year period, but some will argue that one month is enough. Such disputes are usually resolved by clauses that provide for a one- or two-year period.

THE ELECTRONIC REVOLUTION

Sometimes, landlords that are in a position to do so, insist that records include actual tax returns, bank deposits, sales slips, cash register tapes, sales books and bank statements. These requirements ignore the electronic revolution. Chain store tenants who do not use sales slips or tapes in cash registers would be surprised to discover that they are in default under a great many leases.

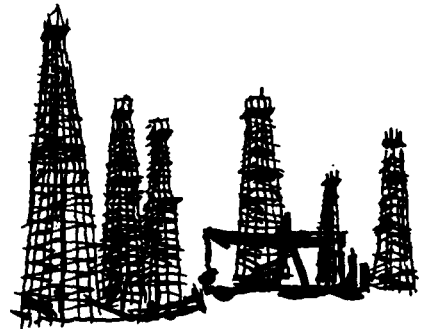
Although electronic recordkeeping is spreading rapidly, and many tenants keep no paper records, some landlords have yet to adapt percentage lease clauses to deal with computer memory and electronic filing. Ten-

ants should avoid agreeing to clauses that require them to maintain archaic recordkeeping systems. However, landlords who agree to computer recordkeeping should also require that the electronic data be printed periodically and that the tenant retain either the printouts or microfilm copies of the printouts. Much electronic data is stored on discs, but some discs are small and prone to damage. When discs are damaged, all the information stored on them might be lost forever.

SALES REPORTS

All percentage leases should require the tenant to send statements of gross sales to the landlord. Statements of gross sales serve two functions. They are evidential support for required payments of percentage rent, and they inform the landlord of the success (or lack of success) of the store. They should include the amount of gross sales and all claimed deductions.

Although chain store leases customarily provide that the statements should be sent annually, many other leases require that statements be sent more frequently. Semiannual and quarterly statements are not unusual, and some landlords insist that statements be sent monthly. The landlords usually require these more frequent reports even if percentage rent is only to be paid annually.



The frequent statements help the landlord understand what is happening in his property. But although it may be useful to the landlord, the frequent statement may be a burden to the tenant. Unless the tenant prepares interim statements for a number of landlords, he may find a requirement to prepare such statements in a single lease to be an extremely expensive and cumbersome obligation.

Certifying Sales Reports

The landlord should insist that the tenant offer appropriate verification of each statement. He may require that a responsible person involved in the tenant's

business certify that the statement is complete and correct, or he may require that the tenant submit an accountant's opinion.

If the lease requires that a responsible person certify the statement, who should that person be? If the tenant is a corporation, the statement should be certified by a corporate officer. (Some landlords are not satisfied with mere officers and insist on a financial officer, chief financial officer, or even a chief executive officer.) However, very large chain store organizations often ask the landlord to be satisfied with the certification of an in-house accountant or regional manager who is not a corporate officer.

If the tenant is an individual proprietorship, the lease should require that individual to certify in his own behalf. If the tenant is a trust or a partnership, the trustee of the trust, a general partner of a limited partnership, or any partner of a general partnership is the appropriate person to certify that a statement of gross sales is complete and accurate.

Many landlords also insist that the annual statements be "certified" by a certified public accountant. That's a problem. Certified public accountants aren't in the business of certifying things. The word "certified" in

their title refers to the fact that their local state certifies that they are competent professionals. An accountant can render an *opinion* as to the statement of gross sales. The opinion should inform the landlord that the accounting firm has conducted an audit of the tenant's books and records for the store in accordance with generally accepted auditing standards. It should then state whether the statement of gross sales complies with the requirements of the lease. (Don't confuse "generally accepted *auditing* standards" with generally accepted *accounting* principles. They deal with different issues.)

PAYMENT

The last step in the process is the most important. Usually, store leases require that the tenant pay percentage rent at the time that it renders the annual statement of gross sales. Whether or not this clause appears in the lease, the envelope that transmits the annual statement of gross sales, unfortunately, may not contain anything but the statement. But many landlords receive a delightful present in the envelope, and its arrival is a cause for rejoicing.