1967

Resolving Disputes under Percentage Leases

Minn. L. Rev. Editorial Board

Resolving Disputes Under Percentage Leases

I. INTRODUCTION

Leases extending for a considerable period of time frequently contain provisions entitling the lessor to a percentage of the lessee's income from operation of the leased premises.[1] The lessor usually requires a percentage clause[2] because it will provide a hedge against inflation[3] and will adjust the rent upwards if the location becomes more valuable. On the other hand, the lessee may benefit from such a clause in the form of a reduction in rent if the location proves undesirable or his enterprise proves unsuccessful. In either case the lessee ordinarily pays only a minimum rental,[4] which is somewhat below the current market level.

Since the rental is dependent upon several variable factors frequently within the lessee's control, disputes often arise with regard to the rights of the parties under the lease. Those rights most frequently involved in litigation deal with the rental base, conduct of the business, mechanics of payment, bookkeeping responsibilities, and the right to sublet or assign.

Because lease provisions dealing with these rights are usually ambiguous, courts, in applying general contract principles to resolve the parties' differences, turn to extrinsic evidence.[5] In

---

1. The percentage lease is a modern version of the English feudal land lease, substituting a percentage of cash income for a share of the crops. The popularity of such leases increased significantly during the Depression because of their peculiar suitability to fluctuating business conditions. See Denz, *Percentage, Cost of Living and Revaluation Leases*, 44 ILL. B.J. 312 (1956) [hereinafter cited as *Denz*].

2. The lessor is usually in a position to insist upon such a clause, since location is an increasingly dominant factor in retail business. To obtain a desirable location, the lessee is generally willing to give the lessor a share of the earnings his property helps to create. McMICHAEL, LEASES: PERCENTAGE, SHORT AND LONG TERM 33 (5th ed. 1959) [hereinafter cited as McMICHAEL].

3. Landis, *The Drafting of Percentage Leases*, 11 U. TORONTO L.J. 43 (1955) [hereinafter cited as *Landis*].

4. Comment, 26 KAN. B.J. 121, 122 (1957). The low minimum rental is also a means of attracting tenants to untried or rehabilitated locations, while providing the lessor with the possibility of an increased yield from his property if it proves to be valuable. Note, 61 HARV. L. REV. 317, 320 (1948).

5. The purpose of contract interpretation is to discover the intent of the parties when they executed the agreement. WILLISTON, CONTRACTS § 601 (3d ed. 1961) [hereinafter cited as WILLISTON]. Although the initial point of inquiry is the language of the lease, even in a contract which is clear and unambiguous a court does not confine itself to inspection of the document. It examines "all relevant incidents bearing on the

this endeavor, since the courts have been overly concerned with the equities of the immediate parties, they have failed to establish uniform principles to guide prospective litigants. The purposes of this Note are to survey the general problem areas and to suggest more appropriate means for resolving and preventing resultant disputes.

II. A SURVEY OF THE PROBLEM AREAS

A. Rental Base

Almost all percentage leases use "gross receipts" as the rental base.[6] The difficulty arises in defining this term. General definitional clauses invite litigation because the includibility of innumberable items in the rental base is not clear.[7] On the other hand, if the elements comprising gross receipts are stipulated in great detail, elements not included may not be implied by a court, no matter how logical their inclusion may appear.[8]

The courts have not assigned any definite and inflexible meaning to gross receipts but, in keeping with general contract principles, have attempted to define the term in such a way as to reflect the intent of the parties.[9] The includibility of proceeds from operations incidental to the main business of the lessee and from operations off the premises have been the issues most often raised in the rental base cases.[10]

---

intent of the parties;" extrinsic evidence is therefore the decisive factor. See Williston §§ 600A, 601.

6. Note, 61 Harv. L. Rev. 317, 320-21 (1948). This term is generally defined in the lease to include receipts from services as well as sales. If the lessee's business is one in which receipts from services are insignificant, the rental base is often merely gross sales. In those few leases which use net sales as the rental base, the obvious controversy concerns the nature of expenses which may be deducted from gross receipts. Deductibility is usually governed by custom and usage, whether or not the parties knew of the custom. Newcomb & Co. v. Sainte Claire Realty Co., 55 Cal. App. 2d 437, 130 P.2d 793 (1942). Where the parties stipulate to the deductibility of certain items and also provide a deduction for usual and reasonable expenses, such provisions have been construed to allow deduction of the stipulated items whether or not reasonable, and not to limit the general deductions in any way. *Ibid.* Income taxes and the percentage rent itself are not deductible, Lowenstein v. Becktold Co., 362 Mo. App. 1089, 246 S.W.2d 780 (1952), but all other taxes on the business may be deducted. International Hotel Co. v. Libbey, 158 F.2d 717 (7th Cir. 1946).

7. See *Landis.*

8. Note, 61 Harv. L. Rev. 317, 321 (1948).

9. See, *e.g.,* Marlton Operating Corp. v. Local Textile Mills, Inc., 137 N.Y.S.2d 438 (Sup. Ct. 1954).

10. See *Denz; Landis;* Note, 61 Harv. L. Rev. 317 (1948); Comment, 26 Kan. B.J. 121 (1957).

1. Incidentals

Occasionally a court finds a lease unambiguous as to includibility of proceeds from operations incidental to the lessee's main business activity.[11] At least one court has resolved an ambiguity by considering other terms of the lease.[12] It found that receipts from a candy concession in a movie theatre were excludable, basing its conclusion upon a clause in the lease which gave the lessor the right to examine the lessee's books, box office receipts, and ticket machine. The court assumed that these records did not include the candy concession and reasoned the failure to provide a means of verification to indicate an intent not to include such sales in the rental base.

Typically, however, the courts find it necessary to look to the conduct of the parties in order to determine their intent, especially when incidental operations are conducted by third persons. Thus, where the lessee could conduct the business himself but chooses to license or sublet it to a third person, a court is likely to find the proceeds includible in the rental base.[13] If the incidental business is one which the lessee could not have conducted himself, the courts are reluctant to include the proceeds.[14]

11. In Taft Realty Corp. v. Yorkhaven Enterprises, Inc., 146 Conn. 338, 150 A.2d 597 (1959), the rental base was "box office receipts." The court held that this did not include receipts from concessions because these receipts were not from the box office. This rather formalistic reasoning was supported by the fact that the lessor had not challenged the exclusion of concession receipts for fourteen years. Compare note 5 *supra*. In Hempstead Theatre Corp. v. Metropolitan Playhouses, Inc., 6 N.Y.2d 311, 160 N.E.2d 604 (1959), the lease provided for inclusion of gross receipts from operation of the business and income from concessions. The intermediate court, affirming the trial court, held that the parties intended the concessions clause to refer only to concessions operated by third persons, since lessee-operated concessions were part of the lessee's business, 7 App. Div. 2d 625, 179 N.Y.S.2d 306 (1958). The court of appeals reversed, holding that the plain meaning of the clause was that it should apply to all concessions whether operated by the lessee or by others.

12. Taylor v. Rosenthal, 308 Ky. 4, 213 S.W.2d 435 (1948).

13. Thus in Elfstrom v. Brown, 229 Ore. 595, 366 P.2d 728 (1961), where the lessee licensed a third person to operate a glass department in his department store, the court held that the gross sales of the glass department were includible in the rental base. The decision was undoubtedly influenced by the fact that the parties had given a very liberal interpretation to the rental base in the past.

14. See, *e.g.*, Marlton Operating Corp. v. Local Textile Mills, Inc., 137 N.Y.S.2d 438 (Sup. Ct. 1954) (telephone service in hotel); Greene County Bldg. & Loan Ass'n v. Milner Hotels, Inc., 240 Mo. App. 1048, 227 S.W.2d 111 (1950) (laundry service in hotel). In both cases the courts relied heavily upon the conduct of the parties who themselves had excluded the proceeds for several years. *Cf.* 277 Park Ave. Corp. v.

2. Operations Off the Premises

The includibility of transactions conducted in whole or in part off the premises is generally resolved by determining how closely related the transactions are to the demised premises.[15] Thus, where the lessee maintained a showroom off the premises, but customers were contacted and served by salesmen based on the premises, the proceeds of that operation were includible in the rental base.[16] Similarly, sales by itinerant salesmen based in the demised premises have been held to be includible.[17] If the lessee expands into adjoining quarters and operates the expanded business independently with a separate sales force and inventory, sales therefrom have been held to be excludable.[18]

B. LESSEE'S CONDUCT OF THE BUSINESS

In a fixed rental lease the lessee may conduct his business within very wide limits, so long as he pays the rent and does not damage the premises. In a percentage lease, however, the lessor is entirely dependent upon the lessee's efforts for his percentage rental, and the lessee's interest may be adverse to that of the lessor.[19] When disputes arise concerning the lessee's conduct of the business, courts have in effect looked first to the lease and then to the fundamental requirement of good faith.

New York Cent. R.R., 106 N.Y.S.2d 338 (Sup. Ct. 1951), where the issue was the includibility of proceeds from a valet service operated in a hotel by a third person. The court excluded the proceeds even though the parties had included them for several years, holding that the lease was clear and unambiguous.

15. A related problem arises when the lessee has been in business elsewhere and receives payments derived from operations at the prior location after commencement of the lease. See, *e.g.*, Galperin v. Michelson, 301 Mich. 491, 3 N.W.2d 854 (1942).

16. Gamble-Skogmo, Inc. v. McNair Realty Co., 98 F. Supp. 440 (D. Mont. 1951). The lessee operated a department store and showed farm implements in an adjacent building not covered by the lease. Notwithstanding the fact that the agreement to buy was made in the adjacent premises, the court found that there was really only one store.

17. S. P. Dunham & Co. v. 26 East State St. Realty Co., 134 N.J. Eq. 237, 35 A.2d 40 (1943). It is interesting to note that the court found it necessary to rely upon evidence from the lessor's attorney that such was the intent of both parties.

18. See, *e.g.*, Alstores Realty Co. v. Twain, 167 So. 2d 601 (Fla. 1964). *But see* note 27 *infra* and accompanying text.

19. The lessee may make more profit by cutting costs and sales, thereby making a larger per unit profit. *Landis* 65-66. In some cases he may wish to avoid a losing venture by reducing his sales. Note, 60 Nw. U.L. REV. 677, 678 (1965). Nevertheless, a few commentators adhere to the old idea that the two parties have similar rather than conflicting interests. See, *e.g.*, *Denz;* Comment, 26 KAN. B.J. 121 (1957).

In assessing the lessee's good faith, the size of the guaranteed minimum rent is significant. Since the lessor is more dependent upon the lessee for a fair return on his investment if the minimum is low, the courts generally vary the restrictiveness of the good faith requirement inversely with the size of the minimum rent.[20]

1. Curtailing Operations

Unless the lease contains a provision as to the manner of conducting the lessee's business,[21] the lessor must seek judicial implication of a covenant to use best efforts. Where there is a substantial minimum rent,[22] or where the level of sales has been so low that the percentage has never become operative, the courts have been reluctant to find such a covenant.[23] These decisions may have been based upon a belief that if full-scale operations fail to yield a percentage return, the requirement of good faith should not prevent the lessee from curtailing his business; and if the minimum rent is high, there is little dependence upon the lessee and therefore no reason to restrict his conduct of the business. Where there is no minimum rent, the lessee is generally held to the standard of other store operators in the same general locality and type of business.[24]

---

20. Compare notes 29-39 *infra* and accompanying text.

21. Even a general clause will restrict the lessee's freedom considerably. In Mayfair Operating Corp. v. Bessemer Properties, Inc., 150 Fla. 132, 7 So. 2d 342 (1942), the lease provided that the lessee use its best efforts to obtain and maintain the highest possible volume of business on the premises. The court held that the lessee could not suspend operations during the slack season.

22. The resultant problem in this area is what constitutes a "substantial" minimum. With the exception of recent cases involving vacating the premises, see notes 29-39 *infra* and accompanying text, courts have generally found any amount more than a mere token to be substantial. See, *e.g.*, Hicks v. Whelan Drug Co., 131 Cal. App. 2d 110, 280 P.2d 104 (1955).

23. See, *e.g.*, Fay v. Montgomery Ward & Co., 19 Ill. App. 2d 302, 153 N.E.2d 421 (1958) (full scale operations unavailing); Hicks v. Whelan Drug Co., *supra* note 22 (substantial minimum).

24. See, *e.g.*, Marvin Drug Co. v. Couch, 134 S.W.2d 356 (Tex. 1939). The standard is apparently imposed to protect the lessor who is completely dependent upon the lessee for his rent and who could not have intended to give the lessee a "free trial." It is ironic that in *Marvin Drug* the lessee used its superior bargaining position against a sole proprietor to exclude any minimum rent, only to discover that the exclusion required it to forego the freedom of operation which it had sought to establish.

2. Changing Class of Business

Three cases have been found which raised the issue of the lessee's right to change the class of his business. Each involved the acquisition of new premises to which the business was transferred and the substitution of a "budget" store in the demised premises.[25] Each case involved a substantial minimum rent,[26] and each held that the requirement of good faith is not violated if the lessee shows that the change was motivated by, and was in accordance with good business judgment.

3. Diverting Sales

Although a lessee may not divert sales from the demised premises if the "sole object" is to reduce gross receipts,[27] very little is required to justify the diversion on the grounds of good business judgment. Thus, the same court which announced the "sole object" test has held that a lessee who moved a lucrative fur department from the demised premises to a newly acquired floor of the same building could not be said to have violated the good faith requirement, since the change was good for business.[28]

4. Vacating the Premises

The litigation which poses the most difficulty in the area of percentage leases and which best illustrates the lack of uniformity and consistency in the area involves the right of the lessee to vacate the premises.[29] Until recently, most courts held that where the lease provided for a substantial minimum rent,

25. Selber Bros., Inc. v. Newstadt's Shoe Stores, 194 La. 654, 194 So. 579 (1940); William Berland Realty Co. v. Hahne & Co., 26 N.J. Super. 477, 98 A.2d 124 (Ch. 1953), *aff'd*, 29 N.J. Super. 316, 102 A.2d 686 (App. Div. 1954); Palm v. Mortgage Ins. Co., 229 S.W.2d 869 (Tex. 1950).

26. In both *Selber Bros.* and *Berland Realty* it was noted in dicta that the result would have been different absent the minimum. However, it is interesting to note that in both cases the lessor had been receiving more from the percentage rent than would be provided by the minimum rent.

27. Goldberg, 168-05 Corp. v. Levy, 170 Misc. 292, 9 N.Y.S.2d 304 (Sup. Ct. 1938), *aff'd*, 256 App. Div. 1086, 11 N.Y.S.2d 315 (1939) (such conduct a breach of good faith); see Seggebruch v. Stosor, 309 Ill. App. 385, 33 N.E.2d 159 (1941).

28. Mutual Life Ins. Co. v. Tailored Woman, Inc., 283 App. Div. 173, 126 N.Y.S.2d 573 (1953).

29. In this area, as in diverting sales, it must be assumed that the level of sales in the premises has been high enough, or is potentially high enough to provide some percentage rent; otherwise vacating would do no harm.

the parties did not intend to place the lessee under an obligation to continuously operate his business on the premises.[30] These cases proceeded on the theory that the lessor, by virtue of a substantial minimum rent, was guaranteed a fair return from his property, and the percentage clause merely provided a bonus or windfall in the event the business was successful.[31] On the other hand, where there is only a nominal rent or none at all, the courts have had no difficulty implying such a covenant.[32]

Recent decisions, however, have indicated a willingness to examine more closely the circumstances surrounding execution and performance of the lease, in an effort to ascertain whether the parties themselves considered the "substantial" minimum rent an adequate return to the lessor.[33] For example, if the fixed rent was below the fair rental value of the premises, the parties may well have intended the lessor to have the benefit of a percentage return throughout the term of the lease.[34] If the lessee's business was a new venture, the parties may have had nothing on which to base an estimate of the return to be generated by the percentage rental, and the courts have found it reasonable to assume that the minimum rent was intended to be adequate in itself.[35] On the other hand, if the lessee had an established business, the percentage was probably based upon the past history of sales. Therefore the percentage provision may have been the essence of the agreement, and the minimum simply a safety feature.[36] A provision whereby the lessee has

30. See, *e.g.*, William Berland Realty Co. v. Hahne & Co., 26 N.J. Super. 477, 98 A.2d 124 (Ch. 1953), *aff'd*, 29 N.J. Super. 316, 102 A.2d 686 (App. Div. 1954); Jenkins v. Rose's 5, 10 & 25¢ Stores, 213 N.C. 606, 197 S.E. 174 (1938); Parrish v. Robertson, 195 Va. 794, 80 S.E.2d 407 (1954).

31. See, *e.g.*, Masciotra v. Harlow, 105 Cal. App. 2d 376, 233 P.2d 586 (1951).

32. See, *e.g.*, Fox v. Fox Valley Trotting Club, 8 Ill. 2d 571, 134 N.E.2d 806 (1956). See McMICHAEL 36.

33. See, *e.g.*, Professional Bldg. of Eureka, Inc. v. Anita Frocks, Inc., 178 Cal. App. 2d 276, 2 Cal. Rptr. 914 (1960); Stop & Shop, Inc. v. Ganem, 347 Mass. 697, 200 N.E.2d 248 (1964); Tuttle v. W.T. Grant Co., 5 App. Div. 2d 370, 171 N.Y.S.2d 954 (1958).

34. See, *e.g.*, Stop & Shop, Inc. v. Ganem, 347 Mass. 697, 702, 200 N.E.2d 248, 251 (1964).

35. See, *e.g.*, Hicks v. Whelan Drug Co., 131 Cal. App. 2d 110, 280 P.2d 104 (1955); Masciotra v. Harlow, 105 Cal. App. 2d 376, 233 P.2d 586 (1951); Jenkins v. Rose's 5, 10 & 25¢ Stores, Inc., 213 N.C. 606, 197 S.E. 174 (1938); Palm v. Mortgage Inv. Co., 229 S.W.2d 869 (Tex. Civ. App. 1950).

36. Since the newness of the lessee's venture has been emphasized, see cases cited note 35 *supra* and accompanying text, it is reasonable to assume it is significant if the business is established.

been given the power to sublet without significant restraint by the lessor has been held to be inconsistent with reliance on the percentage provision, since the lessee might sublet to someone in a business which would not generate a significant percentage return to the lessor.[37]

The present trend is to restrict the lessee's right to vacate the premises. For example, one recent case held that even if the minimum is adequate as well as substantial, the percentage provision clearly indicates that the lessee is to operate continuously in the demised premises.[38] However, it is impossible to predict which factors the court will consider, and the weight each will be given, when the endeavor is to ascertain the intent of the parties.[39]

C. Payment of Rent

In most percentage leases the percentage rental is calculated on the basis of a one year rental period. The percentage rent, if any, is paid shortly after the end of the year.[40] The alternative is to determine the percentage due each month and pay either that amount or the minimum, whichever is greater. The latter method does not allow the lessee to offset his bad months against his good.[41]

Frequently, the issue arises as to whether the lease envisions offsetting, especially when the clause relating to payment contains a suggestion of both methods. Thus, when the lease provided for payment of the percentage for the entire term, but in addition required the lessee to furnish monthly statements of

37. Tuttle v. W.T. Grant Co., 5 App. Div. 2d 370, 171 N.Y.S.2d 954 (1958).

38. Simhawk Corp. v. Egler, 52 Ill. App. 2d 449, 202 N.E.2d 49 (1964).

39. Williston emphasizes this unpredictability in commenting on Fox v. Fox Valley Trotting Club, 8 Ill. 2d 571, 134 N.E.2d 806 (1956):

> The tribunals which tried or reviewed the case placed different interpretations on the obligations of the parties: The master in chancery, upon an extensive hearing, recommended a decree allowing plaintiff more than $100,000; the chancellor determined that the plaintiff had no cause of action; the appellate court affirmed; the state supreme court reversed, but held that the "master in chancery was in error in some of his calculations."

4 Williston § 610B, at 546.

40. *Landis* 53.

41. See Comment, 26 Kan. B.J. 121, 128 (1957). The result may be to require the lessee to pay more than the given percentage of all sales for the entire period, since that percentage may be less than the minimum for several months during the entire period. See Gluck v. Commercial Merchants Nat'l Bank & Trust Co., 85 F. Supp. 287 (S.D. Ill. 1949), *aff'd*, 181 F.2d 773 (7th Cir. 1950).

his sales, it has been held that the lessee must pay the percentage monthly.[42] Consequently, no offsetting was allowed. Although in some cases the lease is clear,[43] more often it will be ambiguous, and a court must base its decision upon a reasoned guess.[44]

D. Bookkeeping

Since rent is a function of sales, it is necessary that adequate records be maintained.[45] If the lease fails to describe the essential records, some courts require the lessee to obtain an independent audit,[46] while others make their own determination as to what is required.[47]

In cases where inadequate records have been kept, but the lessor has acquiesced, the courts have been willing to apply estoppel principles.[48] Similarly, if the lessee erroneously includes items of income but is unable to demonstrate the error conclusively, it has been presumed that all income reported is subject to the percentage.[49]

E. Subleases and Assignments

Because most percentage leases are based in part upon the lessee's business ability and integrity,[50] the lessor is likely to

42. Hamden Holding Corp. v. United Men's Shops, Inc., 127 Conn. 500, 18 A.2d 356 (1941).

43. Although the language of the lease may appear contradictory, the parties' intent may be clear. Thus, in City Hotel Co. v. Aumont Hotel Co., 107 S.W.2d 1094 (Tex. Civ. App. 1937), the lease provided that the lessee was to pay a given percentage each month, but if the rent so paid was less than an *average* of $250 per month for the three year period in question, he was to pay the difference. The court held that since the minimum was to be averaged over the period, the lessee was entitled to average his sales over the period.

44. In Hamden Holding Corp. v. United Men's Shops, Inc., 127 Conn. 500, 18 A.2d 356 (1941), the court's basis for its decision was that its conclusion was "fair, reasonable, and rational."

45. *Landis* 57; Note, 61 Harv. L. Rev. 317, 324 (1948).

46. See, *e.g.*, Macina v. Magurno, 100 So. 2d 369 (Fla. 1958).

47. *E.g.*, Morehead Hotel & Apartment Co. v. Lampkin, 267 Ky. 147, 101 S.W.2d 670 (1937). The lease did not mention bookkeeping, but the court ordered the lessee to prepare monthly statements showing every room, its rental rate, the name of the occupant, the amount collected, the amount uncollected, and the amount of repairs deducted from gross receipts.

48. Macina v. Magurno, 100 So. 2d 369 (Fla. 1958); Gamble-Skogmo, Inc. v. McNair Realty Co., 98 F. Supp. 440 (D. Mont. 1951).

49. City Council of Augusta v. Air Maintenance & Sheet Metal, Inc., 92 Ga. App. 584, 89 S.E.2d 214 (1955).

50. *Landis* 62.

resist the lessee's assertion of an unrestricted right to sublet or assign. At the same time, the lessee may wish to dispose of his business but be able to do so without transferring his rights under the lease.[51] In an attempt to balance these competing interests courts generally find an implied promise not to sublet,[52] but often refuse to deny the right to assign.[53]

Where there is a specific clause prohibiting assignment or subleasing, a controversy may develop as to what constitutes violation of the clause, especially where closely held or subsidiary corporations are involved. The tendency has been to emphasize strict legal incidents. Thus, where a lessor objected when the lessee corporation changed hands pursuant to a sale of stock by the sole owner, the court refused to pierce the corporate veil and find an assignment.[54] However, where the lessee formed a wholly owned subsidiary to which it assigned the lease, an assignment was recognized, since the subsidiary was considered to be a separate legal entity.[55]

III. THE NEED FOR NEW INTERPRETIVE PRINCIPLES

The express language of a percentage lease is rarely dispositive of the parties' controversy. When this is the only tool used by courts in determining the parties' rights, any decision is usually the result of a strained interpretation.[56] If the language of the lease is considered in relation to the parties' conduct, their original intent may become more evident. However, in many cases their actions are not an indication of original intent, but rather a compromise forced upon one or both by an unantici-

51. *Ibid.*

52. Note, 26 KAN. B.J. 121, 130 (1957).

53. See, *e.g.*, MacFadden-Deauville Hotel, Inc. v. Murrell, 182 F.2d 537 (5th Cir. 1950). *Contra,* William Berland Realty Co. v. Hahne & Co., 26 N.J. Super. 477, 98 A.2d 124 (Ch. 1953), *aff'd,* 29 N.J. Super. 316, 102 A.2d 686 (App. Div. 1954). See also Gruman v. Investors Diversified Servs., 247 Minn. 502, 78 N.W.2d 377 (1956), where the lessor was given the right to reject any assignee, no matter how suitable, under a clause which prohibited assignment without the lessor's consent.

54. Burrows Motor Co. v. Davis, 76 A.2d 163 (D.C. Munic. Ct. App. 1950).

55. Food Fair Stores, Inc. v. Blumberg, 234 Md. 521, 200 A.2d 166 (1964).

56. *E.g.*, Hempstead Theatre Corp. v. Metropolitan Playhouses, Inc., 6 N.Y.2d 311, 160 N.E.2d 604 (1959). The lease provided that the rental base was to include gross receipts from the lessee's business and income from concessions. The trial court, affirmed by the appellate division, interpreted this to mean that the concessions clause referred only to those operated by third persons, but the court of appeals held that it likewise applied to concessions owned by the lessee.

pated situation. If their conduct is clearly contrary to the general spirit of the lease, a court may ignore it,[57] but more often it is considered decisive of the controversy.[58] Thus, the party who desires an amicable settlement may be forced to bypass that opportunity if his actions would provide evidence for the opposition. Another factor considered by the courts in arriving at a solution is the amount of minimum rent provided for in the lease. However, the weight given this factor varies. For example, in considering the lessee's right to vacate, one court may decide that if the minimum rent is substantial the lessee may vacate.[59] However, another court may require that the minimum rent be adequate as well as substantial,[60] while a third court may feel that the amount of minimum rent is immaterial.[61]

Because it is the courts' attempt to ascertain the parties' original intent which has caused the unpredictability in percentage lease cases, the best way to avoid the problems engendered is to imply what their intent should have been. Thus when the parties' original intent is not clear, courts should be willing to apply legal presumptions consistent with the underlying purposes of percentage leases. For example, virtually all persons entering into a percentage lease have the same fundamental intent: the business is to be operated diligently and continuously so long as it is moderately successful; all receipts representing profitmaking transactions reasonably related to the location are to be included in the rental base; adequate records are to be kept; and the parties are to continue to deal with each other rather than with an arbitrary substitute. Therefore, any decision consistent with these general assumptions should not unduly violate what probably would have been the parties' intent, had they anticipated the subject of their present controversy. Of course, these presumptions may not hold true in ev-

57. See, *e.g.*, Taylor v. Rosenthal, 308 Ky. 4, 213 S.W.2d 435 (1948).

58. See, *e.g.*, Taft Realty Corp. v. Yorkhaven Enterprises, Inc., 146 Conn. 338, 150 A.2d 597 (1959); Greene County Bldg. & Loan Ass'n v. Milner Hotels, Inc., 240 Mo. App. 1048, 227 S.W.2d 111 (1950).

59. Masciotra v. Harlow, 105 Cal. App. 2d 376, 233 P.2d 586 (1951).

60. Stop & Shop, Inc. v. Ganem, 347 Mass. 697, 200 N.E.2d 248 (1964).

61. Simhawk Corp. v. Egler, 52 Ill. App. 2d 449, 202 N.E.2d 49 (1964). This position is the most logical, especially in shopping center leases. In those cases the minimum rent is usually dictated by the institution lending the builder-lessor the money to finance his center and has little or no relation to the intent of the parties. See Goldstein, *Practical Aspects of Real Estate Developments*, N.Y.U. 18TH INST. ON FED. TAX. 119, 126 (1960).

ery case, and *clear* evidence to the contrary should rebut them. However, in most cases an equitable solution should result. Moreover, these presumptions could provide the parties with a basis for negotiation as an alternative to litigation. A brief review of the five problem areas will illustrate the advantages of such an approach.

A. Rental Base

Since the return to the lessor is supposed to reflect the value of the location, the rental base should be presumed not to include sales to employees, transfers to branch stores, and sales to other stores at wholesale. In these situations the physical location of the business plays an insignificant role.[62] Sales from concessions and incidentals should be included, however, because they are closely related to the main business, the success of which is dependent upon location.[63] Sales by sublessees should be included, since they result from the location as if made by the lessee himself. An exception to this general rule should arise if the lessee were actually unable to conduct the incidental operation. For example, by providing a location for a pay telephone the lessee is merely an agent for the person equipped to provide the service, and only the income to him from the service should be includible.

B. Conduct of the Business

The lessor agrees to a percentage rent in part so that his return will not be drastically diminished by inflation, and so that he will share in the prosperity of the business. Since the lessor is dependent upon the efforts of the lessee for a full return on his investment, the good faith requirement should take the

62. An alternative presumption is that all sales which yield at least some profit are to be included. This is predicated upon a belief that the dominant motive behind percentage leases is risk sharing, *i.e.*, the lessor accepts a fixed minimum which is below the market rental value of the property in return for an "investment" in the business. Therefore, sales which do not yield a profit should be excluded.

63. The earlier discussion of cases involving concessions illustrates that the proposed presumptions would often lead to the same results as the *ad hoc* approach used by the courts. See, *e.g.*, Hempstead Theatre Corp. v. Metropolitan Playhouses, Inc., 6 N.Y.2d 311, 160 N.E.2d 604 (1959); Marlton Operating Corp. v. Local Textile Mills, Inc., 137 N.Y.S.2d 438 (Sup. Ct. 1954). *But see* Taft Realty Corp. v. Yorkhaven Enterprises, Inc., 146 Conn. 338, 150 A.2d 597 (1959). The presumptions are not a radical change; rather they are an attempt to secure a uniform and fair result in all cases.

form of a reasonable and prudent businessman standard, tempered by a recognition of the fact that the interests of the lessor must be considered. Such a rule is of course neither precise nor altogether predictable, but it would result in greater uniformity of decision as the standard became defined through judicial interpretation, and it would serve as a deterrent to unconscionable conduct. In applying the standard, the inquiry should include whether development of the business requires the conduct; and whether such development was the primary motivation of the lessee, or whether the motivation was reduction of the rent.[64] If such an inquiry results in the conclusion that the lessee's conduct is justified in the case of expansion beyond the leased premises, the lessor should nevertheless be entitled to a continued percentage rent based on the operations of the demised premises prior to expansion. Similarly, if the business fails or barely survives, the lessee should be entitled to vacate and pay only the minimum rental, provided the lessor has the right in such an event to terminate the lease.

C. Payment of Rent

Since the percentage rent is a risk sharing device, there should be a presumption that offsetting is to be allowed within each one year period. This eliminates the possibility that the lessee will pay more than the percentage over the entire term. Moreover, this presumption recognizes the possibility that the value of the location may decrease sharply over a period of time. It is also consistent with the concept that the percentage is a substitute for a fixed sum and envisions a sharing of prosperity.

D. Bookkeeping

The problem in this area is to provide adequate protection for the lessor without unduly burdening the lessee. The purposes of the percentage lease offer no assistance in formulating a presumption in this regard, but the customary intent of all parties must be that adequate records be kept.[65] Since most

64. The courts have often subjected the lessee's conduct to this standard. See, *e.g.*, Selber Bros., Inc. v. Newstadt's Shoe Stores, 194 La. 654, 194 So. 579 (1940); William Berland Realty Co. v. Hahne & Co., 26 N.J. Super. 477, 98 A.2d 124 (Ch. 1953), *aff'd*, 29 N.J. Super. 316, 102 A.2d 686 (App. Div. 1954). However, they have failed to articulate or to consistently follow it.

65. Complete records are also necessary to determine whether the lessee's conduct, such as expansion or curtailment of the business, was justified under a reasonable and prudent businessman standard.

leases merely provide that the lessor has the right to audit, if a controversy arises as to what records are required the court should appoint an accountant to study the lessee's business and determine what records are necessary. Since accountants require substantially the same records for the preparation of an audit, the accountant's determination should be presumed final.

E. Sublease and Assignment

The integrity, ability, and type of business of the lessee are central to the efficacy of a percentage lease. Therefore, it should be presumed that no sublease or assignment is proper without consent of the lessor. This rule would eliminate the problems surrounding includibility of gross receipts of a sublessee in the rental base, since it requires parties who wish to allow subleasing or assignment to specifically so provide in the lease or to subsequently agree to the matter.

The flat prohibition of subletting or assignment should have some limitations. A merely formal change of lessee, such as incorporation of the lessee's business, should not be considered a transfer. This type of change does not defeat the lessor's reliance upon the lessee originally selected. Further, the lessor's consent must not be unreasonably withheld if the lessee has a justifiable reason for wishing to sublet or assign. Although this modification imports a measure of vagueness into the area, it is often necessary to permit the lessee to sell his rights under the lease as part of the sale of his business. The reasonableness of the lessor's refusal to consent should be measured by the sublessee's responsibility, integrity, and type of business.[66]

IV. CONCLUSION

Specific provisions can be inserted in the lease to cover the vast majority of problems arising under percentage leases.[67]

66. See Reuling v. Sergeant, 93 Cal. App. 2d 241, 208 P.2d 1046 (1949) (lessee has burden of proving the sublessee responsible); *Landis* 62.

67. "Providing against every possible contingency by express stipulation in the leasing agreement is certainly by far the cheapest and most effective method of safeguarding clients' interests." Note, 35 Mich. L. Rev. 95, 98 (1936). The commentators have unanimously recommended detailed leases with specific provisions dealing with (1) the rental base, see McMichael 49-51; *Landis* 44; Comment, 26 Kan. B.J. 121, 127 (1957); (2) the mechanics of payment, see *Landis* 53; (3) the conduct of the business, see McMichael 58-59; *Landis* 65; (4) vacating the premises, see Hemingway, *Selected Problems in Leases of Com-*

However, totally unexpected circumstances frequently arise and cannot be readily solved under the existing lease language. When litigation does result, in the absence of a clear evidence of intent courts should apply legal concepts consistent with the philosophy underlying percentage leases. However, they have been unwilling to do so, speculating instead as to the parties' intent on the basis of unreliable extrinsic evidence.

To avoid the unpredictable misfortunes of judicial gaming, the parties should insert general intent clauses in the critical provisions of their lease. For example, in providing for items includible in the rental base, the parties could state that any transaction on which the lessee makes a profit and which bears a significant relationship to the location value of the leased premises is intended to be contained in the rental base. Such provisions would in effect include the above suggested presumptions and help to limit judicial inquiry while promoting predictability. Thus, if the courts are unwilling to resolve the confusion in the area of percentage leases by applying the above presumptions under their common law power, the parties can do so themselves through careful drafting.

---

munity and Regional Shopping Centers, 16 BAYLOR L. REV. 1 (1964); *Landis* 73; Note, 61 HARV. L. REV. 317, 326 (1948); (5) bookkeeping, see MCMICHAEL 51-52; *Landis* 56; Comment, 26 KAN. B.J. 121, 129 (1957); and (6) subletting, see MCMICHAEL 60; *Landis* 64.