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Design Center Leasing - A Hybrid Approach

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By Richard J. Sobelsohn

When discussing the nuanced leasing for design centers, one must first understand what a design center is. Unlike shopping centers, where a retailer is open for business to the general public, most design centers are occupied by companies desiring to show their products to the trade, wholesalers, or others that, in turn, sell to the public. They are typically referred to as

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showrooms. The tenants and landlords of design centers have unique issues. This article discusses lease provisions that are in most office and shopping center leases and how they differ from those in the design center lease.

When negotiating and drafting a design center lease, the principles that are used are an amalgamation of office leasing, retail leasing for shopping centers, and a bit more. The guts of the lease are predominantly from the familiar office lease, but some elements derive specifically from the shopping center lease. Moreover, some provisions typically found in shopping center leases are noticeably absent from design center leases. The provisions that are materially different follow.

Rent, Additional Rent

The rent provision in any lease typically lays out the minimum rent or base rent for the premises, usually on an annual and monthly basis. In some cases, rent includes the cost of electricity, and in others it does not. When the cost of electricity is included in the rent, the landlord may state in the lease that a part of the rent attributable to electricity is an amount certain, and by doing so, if the electric utility increases its rates, then the landlord would have the right to pass that increase on to the tenant as well.

As for other amounts payable to the landlord (usually characterized as “additional rent”), this typically includes the tenant’s

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proportionate share of the property's operating expenses and real estate taxes (whether based on current expenses or an increase above a base year). Additional rent also could include any other charge for which a tenant would be liable, such as late fees, interest on late rent or additional rent payments, overtime services provided by landlord, and so on. In a design center lease, additional rent also may include any costs related to landlord's promotional efforts for the benefit of tenants offering their products for sale to the interior design or wholesale trade. These costs are usually prorated among the tenants and typically cover marketing events arranged by the landlord, a showroom directory listing the tenant, and other seasonal events.

Permitted Use

The permitted use provision of the design center lease states what a tenant can and, quite often, cannot do in the premises. The tenant is often restricted to the display and sale of the tenant's products at wholesale to the trade and, in some cases, also incidental use of the premises for retail sale to the public. Prohibited uses may include anything for which another tenant may have secured an exclusive right, and the usual laundry list that landlords have, such as no cooking or selling food to the public, manufacturing or printing, conducting a school, having auctions, or using or storing hazardous materials.

Because a design center (whether it be a stand-alone building or a group of buildings) is similar to a shopping center in that both the landlord and the tenant encourage a single location at which tenants' customers can see a variety of products from different suppliers, the design center lease will typically have (1) required building hours during which the tenant must have its doors open and (2) a prohibition on the tenant having its doors closed with the lights off and not conducting its business from its premises (i.e., "going dark"). As an exception to the going dark prohibition, landlords usually permit a time period after execution of the lease

within which the tenant must initially start its showroom activities. This clause could enumerate an "opening of business," "target opening date," and possibly an "outside permissible opening date." The construction work to prepare the showroom can be a major variable here, especially if the tenant is performing the build-out instead of the landlord.


Regarding the initial alterations, if the landlord is performing the bulk of the work, the aforementioned deadlines can be different than if the tenant were performing most of the work itself. Landlords want to know by a date certain that the tenant will be in operation and open for business ("open for business"), which is a benefit not only to the landlord but also to other tenants in the building. As in a shopping center, the more tenants occupying space in the design center property, the more foot traffic occurs. Some design center landlords require a tenant to place a "coming soon" sign on the premises window or door almost immediately after the lease is signed so that prospective customers and other tenants are apprised of the new tenant showroom that will soon be opening its doors. The "Default" section of this article below discusses what happens if the tenant fails to meet the target opening date or outside opening date.



The tenant's hours of operation, often not addressed in an office lease, are usually included in a design center lease. Quite often a tenant has to covenant that it will comply with the landlord's building operating hours (and reasonable modifications to such hours) and that any breach of this would be a violation of the use provision and a material default under the lease.

Because an important part of the permitted use provision is what cannot be done in the premises, most leases—showroom, office, retail, design center—address this issue with a long list of prohibited uses, some of which are stated above. These are important because they reflect not only on the tenant itself but also on the landlord and other tenants in the building. In some cases, a few uses typically prohibited for most tenants could be permitted for some, but with some qualifications. For example, most tenants in a building want the right to consume food and permit their employees to warm up food for their own consumption (unless, of course, the tenant sells appliances such as ovens and stoves, for which serving food may be necessary). If the tenant wishes to serve food to its guests, however, many design center landlords will permit this with the following qualification: "Tenant may

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provide complimentary food (and even alcohol), provided that tenant complies with all laws and, if they are serving liquor to their guests, to provide notice to landlord prior to doing so, and to maintain a "host liquor liability insurance policy."

Another restriction in this section could be that the tenant may not change the use of the premises or materially change the quality and type of the products it displays in the premises. Although most landlords are concerned about the maintenance, repair, and appearance of the premises, their interest in the tenant maintaining the quality and type of the tenant's products in the showroom is important as well. Because most showrooms have large pane glass storefronts and the interior of the premises is typically visible from the exterior of the premises, landlords often require a high standard for interior displays, and sometimes the tenant must obtain the landlord's approval for them. In either case, if the showroom or the displays appear to be run-down, landlords want the right to consider it a default under the lease.

Most landlords want to control the tenant mix in their buildings and be able to modify the structure. Because of changing markets, the landlord

may wish to explicitly state in the lease that the design center, though primarily a property devoted to showrooms, also can contain general and professional offices, as a "mixed use" property. For these instances, the landlord should state in the lease that there is no express or implied covenant as to the tenant makeup of the property, which could change in the landlord's sole discretion (especially in the case in which a landlord converts some of the showroom premises to offices). The same would be true if the landlord's property is primarily an office building and the market influences the landlord to convert some or all of the office areas to showroom spaces.

If not in a separate provision of its own, signage is another issue that can be covered in the permitted use provision. Because many design center tenants have glass partitions facing the common hallways of the building, a landlord typically prohibits tenants from placing signs on the exterior of the doors or windows of the showroom premises or even deeper in the interior of the premises without the landlord's prior approval, in many cases in the landlord's "sole and absolute discretion."

Even the type of merchandise sold by a tenant (as distinguished

from a product's appearance) may be restricted to only that of the tenant's own manufacture or under subcontract, or produced by a supplier for which the tenant acts as an agent or sales representative, or purchased directly from the manufacturer by the tenant as an authorized distributor. And, because of the nature of design center tenants, most landlords prohibit these tenants from allowing any sales agents, sales representatives, or vendors, other than the tenant's employees, to conduct business in the premises or share space or services with other parties in the premises. Lastly, no solicitation in the building is permitted, which is fairly typical for all types of leases.

Temporary or Long-Term Showcases

Retail display spaces on the first floor, unique to design centers and hotels, are often referred to as "Showcases." In some design centers, there are Showcases on other floors as well. Showcases are a good source of income for landlords, and, in a design center, a vehicle for a tenant to catch the eye of the passersby in the lobby or elsewhere and direct them to their own showroom. Usually the tenant is required to pay an extra fee for the use of the Showcase,

which sometimes is a sizable amount. Sometimes landlords do not include a Showcase provision in the lease itself and use a separate agreement, providing that a default under the Showcase agreement will be construed as a default under the lease and vice-versa. In other cases, the Showcase has its own provision within the lease.

Design centers with Showcases may have two types available for the tenant: temporary ones and those for long-term use. The temporary ones are typically for short duration (a month or two) and provide the tenant additional exposure when it is about to open its showroom. Long-term Showcases are for lengthy periods of display of a tenant's products (typically for the entire lease term) and often drive additional foot traffic to the showroom. Furthermore, because of the limited number of Showcases in a building's lobby or on a given floor, those tenants lucky enough to obtain the right to occupy those Showcases have the prominence of being "seen" when most other tenants are not (in at least the same way).

Showcase leases are no different from any lease for an office or showroom where there are tenant obligations relating to the premises. Landlords typically include the following requirements, and failure to satisfy the same could jeopardize the tenant's right to use the Showcase: (1) no default may occur under the lease; (2) the original named tenant must occupy the premises; (3) the original named tenant must stay open for business in the premises (that is, not go dark—see "Permitted Use," above); (4) applicable insurance must be in place not only for the premises but also the Showcase; (5) the tenant must display the actual merchandise it has for sale in the showroom rather than any representation thereof (such as a picture or monitor showing the products); and (6) the tenant must maintain and clean the Showcase, illuminate the Showcase, and, in some cases, modify the Showcase with different merchandise on a periodic basis.

The surrender condition of the Showcase is also similar to that of

the premises. The Showcase must be in broom-clean condition, and failure to surrender the Showcase to the landlord at the expiration or earlier termination of the showroom lease term (or Showcase agreement term) would result in a holdover.

Alterations

As with most leases, the alterations provision deals with what improvements the tenant may wish to make to the showroom. Usually, this speaks to those alterations after the initial build-out, which is often covered in an exhibit or schedule to the lease. As one would imagine, because of the nature of the over-abundance of glass in the showroom facing a

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common hallway, design center landlords retain consent rights for most alterations. Landlords often dovetail any tenant alteration provisions to be consistent with the landlord's building standard specifications for paint colors, doors, door hardware, trim, and other elements. Keep in mind that in most leased space in an office building, these items are interior and mostly unseen by a passerby. With all that glass in a design center showroom frontage, however, everyone sees everything. It is interesting to note that in a design center lease, the "front door and those parts adjacent to the door" of the premises are commonly referred to as the "storefront."

Initial Showroom Construction

When discussing the initial construction of the showroom, as opposed to an alteration after the initial build-out, both the landlord and the tenant usually negotiate certain issues. Not unlike other office lease initial construction jobs, a design center tenant typically has the choice of performing this work using its own contractors or having the landlord perform the work instead. One of the main differences between the office lease and the design center lease, however, is the requirement that the tenant be open for business by a date certain (as described in the Permitted Use and Default discussions in this



article). The design center lease typically states a “target” opening date (the optimal date) and an “outside” opening date. Opening the showroom after the earlier date may trigger a per diem penalty, and opening the showroom after the later date, a default. The key to any alteration provision for which an opening is dependent is the party causing such delay. If the delay is tenant caused, there would be no change to the open for business deadline as a result of the delay; however, if the delay is landlord caused, that is a different matter. In that case, the deadlines would be pushed back for obvious reasons. Landlord’s counsel is encouraged to state explicitly what is a tenant delay as opposed to a landlord delay, so that there are no questions about liability. As with any alteration, keep in mind that the landlord has supervisory duties for which it usually wants to be compensated. It is not uncommon for a landlord to charge a percentage of the cost of the alteration for such services and require a bond or cash collateral/letter of credit as well. The bond, cash, or letter of credit provides the landlord protection if the tenant does not have sufficient funds to satisfy the contractor’s fee for the alteration, so that no mechanic’s liens are filed against the landlord’s property.

Maintenance and Repairs

Most leases provide for the landlord to maintain and repair the external parts of the building and its common areas, the systems supporting the building (heating, ventilation, air-conditioning (HVAC), electrical, plumbing, life-safety, and so on) and for this to be done without liability to the landlord if it temporarily inconveniences, annoys, interrupts, or injures the tenant’s business in doing so. It is commonplace for landlords to have the right, in their sole discretion and without incurring any liability to a tenant, and without it constituting an eviction, to modify the size or appearance or arrangement of the common areas, including access and egress to the common areas from leased spaces. In addition, landlords like to retain the right to expand or reduce parking areas and to temporarily block common areas to maintain, expand, and renovate them. Although these rights may concern a tenant when a temporary blocking of common areas occurs (after all, it may block the tenant’s storefront), a tenant can do little to avoid this. Presumably the landlord is performing this exercise to improve the property, which will ultimately benefit the tenant. Tenant’s counsel, although mindful that this may occur, should be guided by the

understanding that most landlords are unwilling to qualify these rights.

Access

When a landlord reserves the right to enter the premises for inspections, repair, and maintenance (“Work”), or to show the space to prospective tenants, lenders, and purchasers, the landlord should make sure it is not restricted by how the Work may affect the exposure of the storefront to the common areas. Though for a tenant this could pose an issue, from the landlord’s perspective there are myriad reasons why it may need to perform Work in the common areas of the building. The landlord probably will not agree to limit how the Work is carried out, even if the tenant’s exposure is affected, so that the landlord can preserve the most expeditious way to perform the Work.

Surrender

In most office leases, the surrender of premises provision speaks to the condition of the space at the expiration or earlier termination of the lease term. Many landlords in all types of properties require some form of “restoration” of the premises, especially if structural alterations were made to the premises. Most leases require tenants to remove



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cabling and wiring that they installed. In a design center lease, because many tenants install custom display features, landlords may require these to be removed as well, even if they permit the partitions and interior doors to remain.

Default

Adding to the long list of what constitutes a default under any commercial lease, the nuanced design center lease considers it a default for not being open for business by the outside permissible opening date. Here, the landlord could have this type of a default automatically trigger termination, or it could provide for a notice and cure period (depending on the length of the time period involved). Landlords quite often penalize a tenant for its tardiness in opening the doors for business by charging a per diem penalty, commencing with the day after the projected opening date and ending when the space is actually open for business.

Clever tenant's counsel concerned about the concept of going dark may try to carve out as permissible periods after the tenant is open for business during which the tenant can perform subsequent alterations to the showroom (to spruce up the place), and to close the premises for a vacation or to attend the "must be at" trade show out of town. Most landlords agreeing to these exceptions to going dark usually still consider it a default under the lease if the tenant exceeds the timeline negotiated for in these instances.

Security Interest

In most office leases, although a landlord may wish to retain a security interest in the tenant's personal property in case of a termination of the lease to mitigate some of the landlord's damages from such termination, in many cases this may be eliminated. In a design center lease, however, it is more important to the landlord to retain this right. In office tenancies, the personal property is typically furniture, fixtures, and equipment, all of which may not necessarily be worth a lot compared to the rent that is due. In design center tenancies, the tenant quite often has its top-of-the-line products on display and, in that instance, the personal



property may be worth a great deal. Keep in mind, however, that because of this greater-than-normal personal property value, design center tenants may wish to finance their ownership in those items and, as such, preclude the landlord from having the security interest at all. So, in many design center leases, for the reasons stated above, it is not uncommon for a landlord to refuse to permit such financing. Within this provision, landlords also may restrict removal of the collateral from the premises unless it has been sold to a customer. Similarly, in many jurisdictions, a landlord will wish to state that the statutory lien for rent is not waived and recite a security interest in addition and supplemental to such lien. Accordingly, most design center landlords file UCC-1 financing statements to perfect this security interest.

Amendments

Lease amendments in the design center realm are similar to those for office tenants, except it is much more common to find a showroom tenant downsizing or upsizing with some regularity. Similarly, the design center tenant may find itself needing alternative premises, which would necessitate a move within the landlord's building or perhaps to another adjacent building. Here, the tenant would have the typical construction issues discussed above but also have the added pressure of closing the original premises and moving to the new one. As a result, a new concept of "holdover" has been introduced to the design center lease transaction. In most holdover cases, a tenant that remains in its premises after the expiration or

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early termination of the term of the lease faces additional rent charges (usually 150%–300% of the last rent paid), plus consequential damages if another tenant has already leased the space or the landlord is demolishing the building. With a move within the landlord's building, the design center tenant must open the new showroom before shutting down the old one so that there is no "dark" time between the two premises. Often a tenant needs to move furniture, fixtures, and equipment from the original space to the new one and all of this is dependent on the new space being timely built. The same issues discussed with initial showroom construction (that depend on which party, landlord or tenant, is performing the construction) exist.

Conclusion

Design center leases are part office lease, part shopping center lease, and part another form of lease. Although there are differences among the documents, a practitioner paying attention to those differences will be in a better position to protect his client's interests. Furthermore, understanding why something is drafted in a document sometimes helps the attorney to better understand the reasons behind a party's lease requirements and, therefore, avoid the knee-jerk reaction to automatically reject a particular position. Design center leases are interesting, and those involved in negotiating and drafting them on a regular basis have the benefit of seeing the commercial leasing world in a new light. ■