#H-112

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06/05/90

Second Supplement to Memorandum 90-50

Subject: Study H-112 - Commercial Lease Law: Use Restrictions (Further Comments on Tentative Recommendation)

Attached to this memorandum are copies of letters we have received concerning the tentative recommendation on use restrictions.

Exhibit 1 contains remarks of Ernest E. Johnson of Los Angeles. In brief, Mr. Johnson believes that a tenant acquires a property interest that has inherent in it the ability to use the property for any use that would be commercially reasonable. Thus, Mr. Johnson would oppose provisions of the tentative recommendation that would allow the landlord to enforce an agreement between the landlord and tenant that prohibits change in use or gives the landlord discretion whether or not to consent to a change in use. He would also oppose the provision of the tentative recommendation that makes prospective only the requirement that the landlord act reasonably in consenting to a change in use if the lease provides no standards for the landlord's consent.

Exhibit 2 is a letter from Michael P. Carbone of San Francisco. Mr. Carbone is concerned with the provision of the recommendation that allows the landlord to recover damages from a breaching tenant based on a use restriction in the lease. Mr. Carbone believes the law should be that the landlord is required to mitigate damages based on any reasonable use of the premises. As an alternative, the use restriction could be taken into account, subject to the right of the tenant to prove that the facts and circumstances no longer justify continued imposition of otherwise enforceable use restrictions contained in the lease. Thus, the landlord's duty to mitigate would be based on both the reasonable use of the property "and any enforceable use restriction unless the tenant proves that under the circumstances it would be unreasonable to enforce the restriction. This is similar to the approach suggested by Ronald P. Denitz of Los Angeles who, in Exhibit 3, notes a typo in his earlier letter on this matter.

Mr. Carbone also raises an issue not previously considered by the Commission. He notes that many leases contain inconsistent use clauses and assignment and sublease clauses. For example, a lease may limit use of the premises for a single purpose, but then go on to allow assignment or sublease with the landlord's consent, which may not unreasonably be withheld. How are these two clauses meant to be read together? Arguments can be made both ways. Mr. Carbone does not advocate a particular position on this issue, but merely points out it is a problem frequently overlooked in the preparation of leases. "It would be useful to have a statutory rule specifying how such a lease should be interpreted. In many cases it may be possible to show what the intent of the parties was, but in just as many cases (if not more) the parties completely fail to consider the issue, let alone discuss it. I have been involved recently in two cases where a serious dispute arose because of an ambiguity of this nature in the lease."

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

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May 26, 1990

Mr. Nathaniel Sterling
Assistant Executive Secretary
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Re: Kendall legislation, etc.

Dear Mr. Sterling:

As we discussed, it is not possible to accept your invitation to appear at the session to discuss the tentative recommendations on use changes and reconsideration of the Kendall legislation. This letter supplements my previous letters on the matter and comments on the comments you sent me.

Professor Coskran emphasizes "freedom of contract." But a lease is more than a contract: it is also a conveyance of property. Thus for example in condemnation, both the landlord's property interests and the lessee's property interests receive compensation. As the American Law Institute said in the 1977 Restatement of Property, Second at page 86:

> "a. Rationale. A lease divides ownership of the leased property between the landlord and the tenant. Any curtailment of the freedom of alienability of these separate interests involves a restraint on alienation. Restraints on alienation of property interests normally stand in the way of making maximum use of such interests and hence are against public policy, except in circumstances where some countervailing public interest may justify them in particular situations. The freedom of alienability rule stated in this section gives general recognition to the undesirability of restraints on alienation."

Essentially my approach focuses upon this property nature of the lease transaction and expresses concern over the "taking" of property rights. To me restrictions on assignment and changes of use not based on commercially reasonable objections constitute unreasonable restraints on alienation. The Introductory Note to the 1977 Restatement of Property, Second, Part V, Chapter 15 (at page 85), notes:

> "Over the years there has been a constant battle between the forces that seek to restrain the alienation of property interests and the forces that regard any impediment to the free transferability of property interests as detrimental to society. In only a few instances have restraints on alienation survived this long battle. The extent to which restraints on alienation have survived in the context of the landlord-tenant relationship is described in Chapter 15."

While Professor Coskran is correct that the Restatement recognizes the possibility of an absolute right to withhold consent, the Restatement requires that this be a "freely negotiated provision" and defines that term on pages 106 and 107, to apply only where the party has "significant bargaining power in relation to the terms of the lease." In the real world I suggest this simply is not true of most tenants. In the absence of a "freely negotiated provision" (despite language giving the landlord absolute rights to withhold consent), the Restatement takes the position that the provision would be operative only if the consent was "not withheld unreasonably."

I disagree with Professor Coskran's reiteration that the law clearly allowed absolute discretion to the landlord prior to the Cohen case in 1983. Not only was there the Restatement in 1977 but there were several cases which questioned the Richard case and assumed that a commercially reasonable objection was required; these cases did not rule on the point but did question the continuing vitality of the Richard case. Further the Richard case was weak authority and as Mr. Behr emphasized in his 1980 State Bar Journal article, it would be unwise for any attorney to rely upon the authority of the Richard case.

Unless there is some advantage to be gained, a landlord will not normally object to a reasonable assignment or change of use; the problems of assignments and use changes in my experience and opinion are insignificant except in a context where the value of the leasehold has appreciated materially. And consequently, I view the "repeal" of Kendall/Pestana as a landlord effort to "take" from long-term tenants the appreciation in their leasehold property.

To repeat, it is my opinion that a lessee owns a property interest and should be entitled to assign that property interest under reasonable circumstances and to change the use of that

property interest in a reasonable manner without having to pay tribute or increased rent for the right to do so.

And this is particularly so in cases of technical or inconsequential transfers or changes where the landlord is not prejudiced except in an inability to "mark to market."

Sincerely,

Ernest E. Johnson, P.C.
of OVERTON, LYMAN & PRINCE

EEJ:kla

cc: Arthur K. Marshall
William G. Coskran

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May 25, 1990

VIA MAIL

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Re: Commercial Property Leases: Use Restrictions

Gentlemen:

Thank you for providing me with copies of Memorandum 90-50 and the First Supplement to Memorandum 90-50. I have also read Professor Coskran's memorandum of May 14, 1990.

Upon review of this material, I have some additional thoughts which I hope will be useful to the Commission.

1. Proposed Section 1997.040(a). On pages 32-34 of his memorandum, Professor Coskran raises an interesting issue concerning the relationship between Civil Code Section 1951.2 and proposed Civil Code Section 1997.040(a). He says, "... assume that under the terms of the breached lease the tenant could not have changed the use because the terminated lease contained an express absolute restriction or a sole discretion standard for consent. Can the tenant avoid the express restriction by having a reasonable change in use considered in avoiding damages?" He then poses a hypothetical situation whereby a tenant might attempt to do so and suggests also the possibility that a tenant might demand the landlord's consent to a change in use and threaten the landlord with going into default if consent were refused.

In my view Professor Coskran's discussion points out a conflict between two public policies, namely: (1) the policy favoring freedom of contract and (2) the policy requiring mitigation of damages. A balance must be struck between the demands of these two competing policies. The policy which requires mitigation of damages for breach of a commercial lease is implemented by Civil Code Sections 1951.2 and 1951.4. Under

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Section 1951.2 if the landlord terminates the lease, then the landlord has the responsibility for mitigating the damages resulting from the tenant's default, although the tenant has the burden of proving the extent to which the damages could have been reasonably avoided. On the other hand, if the lock-in remedy of Section 1951.4 is used, then the landlord is relieved of the responsibility of mitigating damages, and it is up to the tenant to minimize the loss through assignment or subletting. Either way the law affords a method whereby the tenant's liabilities may be reduced to a reasonable level.

The concept of mitigation of damages as applied through Section 1951.2 clearly contemplates reasonable conduct on the part of the landlord. The words "reasonable" and "reasonably" appear throughout the Code section and throughout the Legislative Committee Comment which follows it. I do not favor carving out an exception to this policy for cases in which the lease contains an absolute prohibition on change of use or in which such change is governed by the landlord's sole and absolute discretion. That would be a major (and in my opinion unwarranted) change in the law.

Whether it is reasonable to take such a restriction into account when measuring damages is a question that ought to be determined on a case-by-case basis. The court ought to examine in each case the reason why the restriction was written into the lease and whether the reason is still valid. Many leases are written with this type of use clause simply because the landlord does not wish to be approached with a request for change of use and to be in the position of having his business judgment second-guessed by a judge or jury. The reason is perfectly valid and is supported by the principle of freedom of contract. But once the lease is terminated, this reason no longer applies, or if it continues to apply, it should yield to the policy favoring mitigation of damages.

In some cases, there may have been a special reason for the restriction, but the circumstances no longer exist. An example would be a site that was leased for a particular purpose, such as a supermarket, but in subsequent years has become suitable for other uses as well. Another example would be a use restriction of a prohibitory nature which forbids the tenant to compete with another business. Should that other business cease to exist,

then the reason for the restriction would no longer apply. Other examples would be the children's book store mentioned in my letter of March 1, 1990 or the T-shirt store mentioned in Martin Zankel's letter of March 30, 1990.

In advocating this view I do not mean to suggest that the use clause should be completely ignored. Should it appear that the landlord's rejection of an alternative use suggested by the tenant would be justified in order to protect some legitimate interest of the landlord, then the landlord's rejection should be upheld. It should be remembered that in all events the tenant will have the burden of proof under Civil Code Section 1951.2 to show the extent to which damages could have been reasonably avoided. In carrying this burden, the tenant should have to address the effect of the use restriction if it has a reasonable basis.

In accordance with the foregoing views, I recommend that the phrase "except to the extent the lease includes a restriction on use that is enforceable under this Chapter" be deleted from proposed Section 1997.040(a).

I note that Mr. Denitz's letter of May 11, 1990 appears to suggest on page 2 that the language of proposed Section 1997.040(a) could be modified in order to afford the tenant the opportunity to prove that the facts and circumstances no longer justify continued imposition of otherwise enforceable use restrictions contained in the lease. This concept would be acceptable to me, but I would suggest saying (in place of the deleted language) "... and any enforceable use restriction unless the tenant proves that under the circumstances it would be unreasonable to enforce the restriction."

2. Relationship Between Assignment and Use Clauses. Another important issue arises from the unique relationship between the use clause and the assignment clause of a commercial lease. It is quite common to find leases which contain restrictive use clauses such as "for the sale of shoes and for no other purpose" and then to turn a few pages and to find an assignment clause which states that the landlord's consent to a proposed assignment or subletting "shall not be unreasonably withheld or delayed." When read together these two clauses raise the issue whether a request for consent to change in use in connection with a proposed assignment or sublease would be subject to a standard of reasonableness. In most cases each side could probably present a credible argument in support of its

position.

I do not advocate one position or the other on this issue. I merely point out that it is a problem which is frequently overlooked in the preparation of leases and that it would be useful to have a statutory rule specifying how such a lease should be interpreted. In many cases it may be possible to show what the intent of the parties was, but in just as many cases (if not more) the parties completely fail to consider the issue, let alone discuss it. I have been involved recently in two cases where a serious dispute arose because of an ambiguity of this nature in the lease.

Thank you for the opportunity to present these comments. I will be happy to respond to any questions that you may have.

Very truly yours,

Michael P. Carbone

MPC:spm

cc: William G. Coskran (via Mail)
Martin I. Zankel
Pat Frobes (via Mail)

C-040-5-4

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May 21, 1990

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Re: Tentative Recommendation Relating to Use Restrictions in Commercial Real Property Leases - (Study H-112) - First Supplement to Memorandum 90-50

Dear Mr. Sterling:

Thank you for the captioned First Supplement dated May 16, 1990. I agree with the proposed revised language which the First Supplement suggests on page 2 thereof regarding protection of the Landlord's right to use restrictions in the Court's measuring the mitigation of damages pursuant to §1951.2 when a Tenant's lease is terminated for breach by that Tenant.

The same applies to §1997.040 (Remedies for Breach) in connection with the use-restriction study itself.

So that the "record" will be straight, there was (as I indicated to you on the telephone last week) a minor typographical error in my proposed version of §1997.040, which typographical error it is hoped the Commission members will ignore and simply refer to your language-version; however for that record the word "except" should be deemed strickened as the next-to-the-last-word on the fourth line of my proposed version of §1997.040.

With many thanks, I am

Sincerely,

RONALD P. DENITZ
Vice President and
General Counsel
TISHMAN WEST COMPANIES

RPD:hm

cc: W.J. Coskran, Esq.
E.E. Johnson, Esq. (Overton, Lyman & Prince)