#50 10/2/68

Memorandum 68-98

Subject: Study 50 - Leases

Attached are two copies of a revised tentative recommendation relating to leases. It incorporates the changes made at the last meeting and other revisions suggested by Commissioners who turned in edited copies of the previous recommendation. In addition, it includes some nonsubstantive staff revisions. We must approve this recommendation for printing at the October meeting if we are to submit it to the 1969 Legislature. Accordingly, please mark your suggested editorial revisions on one copy and return it to the staff at the October meeting.

The staff has two major problems with the tentative recommendation in its present form. These problems are the discount rate provision and the treatment of "advance payments." The following are the matters noted for your attention.

Section 1951.2 (page 17)

This section has been revised in accord with instructions given the staff at the last meeting to make clear when interest begins to accrue and on what amounts and to provide a presumption concerning the discount rate. This has been accomplished by revising subdivision (a) and adding a new subdivision (b).

The staff strongly urges that subdivision (b) be revised to read:

> (b) The worth at the time of award of the amounts referred to in paragraphs (1) and (2) of subdivision (a) is computed by allowing interest at such lawful rate as may be specified in the lease or, if no such rate is specified in the lease, at the legal rate. The worth at the time of award of the amount referred to in paragraph (3) of subdivision (a) is computed by discounting such amount to reflect prepayment. The rate of such discount is a rate equal to the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent.

The effect of the suggested revision is to eliminate the presumption and make the statutory discount rate apply in all cases. We make this suggestion because we are unable to develop any general standard or test that a party must meet to establish the discount rate that is not best satisfied by the statutory discount rate. There are a number of standards that might be used. We suggest one in the Comment:

> Discounting in this situation is simply a substitute for payment as rent installments accrue. The rate of discount must therefore permit the lessor to invest the award at interest rates currently available in the investment market and recover over the period of the remaining term of the former lease an amount equal to the unpaid future rentals less the amount of rental loss that could be reasonably avoided plus interest from the time these rentals would have accrued. The discount rate of the Federal Reserve Bank of San Francisco plus one percent satisfies this test. Moreover, it provides a rate subject to judicial notice under Evidence Code Section 452(h) and one that adjusts automatically to changes in the investment market.

Several standards or tests have been considered and rejected. For example, the discount rate might be determined by the rate of return that could be expected if the prepaid rent were invested in property similar to the leased property. This, however, is a poor test. Often the rate of return on money invested in leased property is very low. In some cases, we suspect that the investment shows no "profit" over expenses. The tax advantages of being able to deduct depreciation on the property and, upon resale of the property, to have everything over the depreciated value recognized as a capital gain cause purchasers of rental property to pay more than the rate of yield on the money invested would justify.

It was suggested that the discount rate take into account the likelihood that the rent would be received from the lessee. Whether this determination be made at the time the lease is made or at the time of the award, the test is unsatisfactory. It would result in a financially

sound lessee's paying a substantial amount and a financially unstable or insolvent lessee's paying next to nothing since it would be unlikely that he would pay the rent. A variation of this test is that one should determine the amount the lessor would receive if he were selling the right to receive the money under the lease as it became payable. Again, the purchaser would base the amount he was willing to pay primarily on the credit rating of the lessee. This test would be further complicated if the lessor guaranteed payment of rent by the lessee because then the lessor's credit rating also would be involved. Moreover, this ignores the basic point that the lessor has in the lease bargained for a certain rent. He is entitled to no more and no less than his bargain. Discounting is simply the method used to determine what present lump sum equals future installment payments plus interest. In other words, the staff believes that the individual circumstances of the lessee and the lessor should be ignored in determining the discount rate. The discount rate should be determined on the assumption that the payment of the rent is certain and the only consideration is the discount for prepayment, i.e., assuming that the amount received by the lessor will be invested in a safe investment, what rate of interest can the lessor be expected to receive on the investment so that he will be certain to receive the equivalent of the rent as it would have become due. Since this is the standard we think should apply, the staff recommends that the discount rate now provided in the statute be made applicable in all cases and not be merely a presumption. If this suggestion is not acceptable to the Commission, we suggest that some standard be incorporated into the statute so that the parties will know whether the individual circumstances of the lessee and lessor are to be taken into account, whether the rate

of return on money invested in property similar to the leased property is to be taken into account, and what other factors are to be taken into account.

Of course, conforming changes should be made in Civil Code Section 3308. The staff has checked with the attorney appearing at the last meeting on behalf of U.S. Leasing, and we feel that the same fixed rate would also be satisfactory for leases of personal property.

The staff has deleted from what is now subdivision (c) the sentence that formerly appeared stating that the lessor was entitled to the profit on reletting but that the rent received on reletting was to be offset against damages under subdivision (a). This sentence caused a number of problems. For example, certainly the profit on reletting should be offset against the consequential damages provided in subdivision (a)(4). Since the lease is terminated under subdivision (a), the tenant no longer has an interest in the property and has therefore no right to the profit on reletting. This is now made clear in the Comment to Section 1951.2 (paragraph that begins on middle of page 21).

Section 1951.4 (page 26)

At the last meeting, Commissioner Uhler suggested a revision of subdivision (b) of Section 1951.4 that is designed to accomplish the same purpose as the revised version of this subdivision in the new draft. The Commission suggested that Commissioner Uhler's redraft of subdivision (b) be set out in the memorandum so it would be available for comparison with the one adopted by the Commission. Commissioner Uhler's redraft of subdivision (b) reads:

(b) A lease of real property continues in effect after the lessee has breached the lease and abandoned the property for so long as the lessor does not terminate the lessee's right to possession, and the lessor may enforce all his rights and remedies under the lease, including the right to recover the rent as it becomes due under the lease, if the lease permits the lessee to do any of the following:

(1) Without reservation, to sublet the property or to assign his interest in the lease, or both.

(2) With any of the below listed reservations which are reasonable or which are not unreasonably withheld or imposed by the lessor, to sublet or assign his interest in the lease:

(i) Consent of lessor.

(ii) Various standards or conditions set forth in the lease. The lessor may comply with this provision by waiver of any standards or conditions.

Section 1951.5 (page 31)

In accordance with the Commission's instruction at the last meeting, we have added Section 1951.5 to make clear that liquidated damage provisions are valid if they meet the requirements applicable to contracts generally. This section does not represent a change in Commission policy; formerly, the Comment indicated that this is the result that followed from providing for an immediate action for damages upon termination of a lease. The Comment to Section 1951.5 is substantially the same as the Comment contained in the former draft of the recommendation.

Section 1951.8 (page 33)

The staff has redrafted this section in conformity with the decisions reached at the last meeting. However, after thorough and critical review, the staff has concluded that this section is unsound and perhaps even unnecessary. Its unsoundness results perhaps from (1) a failure to define adequately the policy being effectuated and (2) an attempt to group too many different elements under a single concept. To demonstrate: subdivision (a) defines "advance payment" to include (1) advance payments of rent, (2) bonuses for execution of the lease, and (3) security deposits. Subdivision (b) then attempts to provide identical treatment for all "advance payments."

In fact, it seems clear that advance payments of rent and security deposits should properly be offset against rent and damages recoverable by the lessor under Section 1951.2. Advance payments of rent are no different for this purpose than rent that can be obtained from third persons by reletting. Security deposits must by their very nature be offset. The lessee should be entitled to any amount advanced in this fashion that is not required to compensate the lessor under the measure of damages provided by Section 1951.2. On the other hand, a true bonus for the execution of the lease is earned by and at the time of execution. The lessee has received the quid pro quo for this bonus and is entitled to no return or offset. Suppose, for example, that prior to execution of the lease, the lessor had two parties willing to execute the lease on the same terms and conditions. One (A), however was willing to make a flat additional payment of $500 to obtain the lease; the other (B) was not. Analytically, it seems that this "bonus" is earned by the lessor by executing the lease with A. It should not be subsequently offset against rent or other damages recoverable by the lessor. Finally,

there will be many variations of "advance payments" that will not fit conveniently into any of the categories above. For example, (1) the parties may have contemplated some initial compensation for special preparation of the property by the lessor. If the lessor has completed this work prior to the lessee's breach, obviously the lessee should not be entitled to the return of any of this payment, nor is it really proper to consider it as an offset against damages; it is simply consideration for a part of the lessor's performance that has been received by the lessee. (2) The parties may have understood that the rental value of the property would rise during the term of the lease and provided for this with an "advance payment" in place of an escalating rent clause. In this situation, if the parties were correct in their forecast and the lease is subsequently terminated because of the lessee's breach, the lessor will certainly be able to relet at a rent equal to that reserved in the lease, but the lessor will not be made whole if the advance payment is offset or he has to return the "advance payment" because the advance payment was, in effect, a part of the total rent. The variations are countless, and it seems that what is really sought is a statutory directive to the courts to analyze each "advance payment" for what it is, to disregard labels, and to consider the substance of what the parties contemplated. Perhaps, because of the very great practical difficulties often thwarting such an analysis, some courts have let the label dictate the result; some persons would perhaps approve this approach so long as the result did not constitute a forfeiture or was not so harsh as to be unconscionable or unreasonable. The existing section seems to endorse the latter position, and to this extent, precludes a careful analysis and decision based on all the relevant facts of the case. However, even this position is left

unclear because the section adopts a test of forfeiture that refers to Section 1671 relating to liquidated damages. By such reference, retention of advance payments could easily be limited to situations where liquidated damages are proper, and all other advance payments would be offset. Moreover, the section might permit the lessor to retain all of a true security deposit in a case where it is in excess of the actual damages. If Section 1951.8 is to be retained, the staff suggests that the section and Comment might be revised as set out in Exhibit I (pink) attached.

Respectfully submitted,

Jack Horton
Junior Counsel

EXHIBIT I

§ 1951.8. Advance payments

Sec. 7. Section 1951.8 is added to the Civil Code, to read:

1951.8. (a) As used in this section, "advance payment" means moneys paid to the lessor of real property (1) as an advance payment of rent, (2) as a bonus or consideration for the execution of the lease, (3) as a deposit to secure faithful performance of the terms of the lease, or (4) as the substantial equivalent of any of these.

(b) To the extent that an advance payment is in substance rent which has not been earned or a deposit to secure faithful performance of the terms of the lease, the advance payment shall be applied toward any amount recoverable by the lessor under Sections 1951 to 1951.6 inclusive, and the lessee is entitled to recover so much of the advance payment as he proves is in excess of that amount.

(c) To the extent that an advance payment is in substance a bonus or consideration for the execution of the lease, the lessor is entitled to retain the advance payment.

Comment. Section 1951.8 makes clear the extent to which the lessee may recover an advance payment when the lease terminates prior to the end of the term. The court must consider the entire agreement, the circumstances under which it was made, and the understanding of the parties in determining whether an advance payment or a portion thereof is "is substance" a security deposit, advance payment of rent, or bonus or consideration for the execution of the lease. The factual variants are countless. The parties may have understood that the rental value of the property would rise during the term of the lease and the advance payment

was intended to be a substitute for an "escalating rent" clause. The parties may have intended some initial compensation for special preparation of the property or compensation for the surrender of an opportunity to lease to someone else. The designation given the advance payment in the lease should, of course, be considered in determining the nature of the payment but the designation is not controlling.

Where the advance payment is in substance a "deposit to secure faithful performance of the terms of the lease," the lessee is entitled to recover any amount deposited in excess of the lessor's damages. Similarly, where rent has been paid in advance and is unearned at the time of termination, it is to be offset against the damages recoverable under Section 1951.2 and the lessee is entitled to any excess. However, any portion of an advance payment that is in fact consideration for the execution of the lease may be retained by the lessor.

Under the prior California law, the right of a lessee to recover an advance payment depended on whether the advance payment was designated a security deposit (lessee could recover), an advance payment of rental (lessee could not recover), or a bonus or consideration for the execution of the lease (lessee could not recover). Compare Warming v. Shapiro, 118 Cal. App.2d 72, 257 P.2d 74 (1953)($12,000 forfeited because designated as both a bonus and an advance payment of rental), with Thompson v. Swiryn, 95 Cal. App.2d 619, 213 P.2d 740 (1950) (advance payment of $2,800 held recoverable as a security deposit). See discussion in Joffe, Remedies of California Landlord Upon Abandonment by Lessee, 35 So. Cal. L. Rev. 34, 44 (1961); Note, 26 Cal. L. Rev. 385 (1938). Commentators have suggested that the cases involving prepaid rent and bonuses are now of doubtful authority. See Harvey, A Study to Determine Whether the Rights and Duties Attendant Upon the Termination of a Lease Should be Revised, 54 Cal. L. Rev. 1141, 1173-1174 (1964);Smith, Contractual

Controls of Damages, 12 Hastings L. J. 122, 139-140 (1960); Note, 43 Cal. L. Rev. 344, 349 n.32 (1955). Section 1951.8 eliminates this uncertainty.

It should be noted that this section is concerned solely with "advance payments." Liquidated damages provisions in leases fixing in advance the amount of damages recoverable by the lessor are in appropriate circumstances enforceable. See Section 1951.5.

#50

Revised October 1, 1968

STATE OF CALIFORNIA

C A L I F O R N I A L A W

R E V I S I O N C O M M I S S I O N

TENTATIVE RECOMMENDATION

relating to

LEASES

CALIFORNIA LAW REVISION COMMISSION
School of Law
Stanford University
Stanford, California 94305

WARNING: This tentative recommendation is being distributed so that interested persons will be advised of the Commission's tentative conclusions and can make their views known to the Commission. Any comments sent to the Commission will be considered when the Commission determines what recommendation it will make to the California Legislature.

The Commission often substantially revises tentative recommendations as a result of the comments it receives. Hence, this tentative recommendation is not necessarily the recommendation the Commission will submit to the Legislature.

NOTE

This recommendation includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were enacted. They are cast in this form because their primary purpose is to undertake to explain the law as it would exist (if enacted) to those who will have occasion to use it after it is in effect.

LETTER OF TRANSMITTAL

The California Law Revision Commission was directed by Resolution Chapter 130 of the Statutes of 1965 to make a study to determine whether the law relating to the rights and duties attendant upon termination or abandonment of a lease should be revised.

The Commission published a recommendation and study on this subject in October 1966. See Recommendation and Study Relating to Abandonment or Termination of a Lease, 8 CAL. LAW REVISION COM'N REPORTS 701 (1967). Senate Bill No. 252 was introduced at the 1967 session of the Legislature to effectuate this recommendation. The bill passed the Senate but was not enacted. Problems that had not been considered by the Commission were brought to its attention after the bill had passed the Senate and the Commission withdrew its recommendation in order that the topic could be given further study.

This recommendation takes into account the problems that caused the Commission to withdraw its previous recommendation.

TENTATIVE

RECOMMENDATION OF THE CALIFORNIA

LAW REVISION COMMISSION

relating to

LEASES

BACKGROUND

Section 1925 of the Civil Code provides that a lease is a contract. Historically, however, a lease of real property has been regarded as a conveyance of an interest in land. The influence of the common law of real property remains strong despite the trend of recent years to divorce the law of leases from its medieval setting of real property law and to adapt it to modern conditions by means of contract principles. The California courts state that a lease is both a contract and a conveyance and apply a blend of contract and conveyance law to lease cases. This blend, however, is frequently unsatisfactory and harsh, whether viewed from the standpoint of the lessor or the lessee.

RECOMMENDATIONS

Right of Lessor to Recover Damages Upon Lessee's Abandonment of Leased Property

Under existing law, when a lessee abandons the leased property and refuses to perform his remaining obligations under the lease, his conduct does not--absent a provision to the contrary in the lease--give rise to an immediate action for damages as it would in the case of an ordinary contract. Such conduct merely amounts to an offer to surrender the remainder of the term. Welcome v. Hess, 90 Cal. 507, 27 Pac. 369 (1891). As stated in Kulawitz v. Pacific Woodenware & Paper Co., 25 Cal.2d 664,

671, 155 P.2d 24, 28 (1944), the lessor confronted with such an offer has three alternative courses of action:

(1) The lessor may refuse to accept the offered surrender and sue for the accruing rent as it becomes due for the remainder of the term. From the lessor's standpoint, this remedy is seldom satisfactory because he must rely on the continued availability and solvency of a lessee who has already demonstrated his unreliability. Moreover, he must let the property remain vacant, for it still belongs to the lessee for the duration of the lease. In addition, repeated actions may be necessary to recover all of the rent due under the lease. This remedy is also unsatisfactory from the lessee's standpoint, for it permits the lessor to refuse to make any effort to mitigate or minimize the injury caused by the lessee's default. See De Hart v. Allen, 26 Cal.2d 829, 832, 161 P.2d 453, 455(1945).

(2) The lessor may accept the lessee's abandonment as a surrender of the remainder of the term and regard the lease as terminated. This amounts to a cancellation of the lease or a rescission of the unexpired portion of the lease. Because in common law theory the lessee's rental obligation is dependent on the continuation of his estate in the land, the termination of the lease in this manner has the effect of terminating the remaining rental obligation. The lessor can recover neither the unpaid future rent nor damages for its loss. Welcome v. Hess, supra. Moreover, the courts construe any conduct by the lessor that is inconsistent with the lessee's continued ownership of an estate in the leased property as an acceptance of the lessee's offer of surrender, whether or not such an acceptance is intended. Dorcich v. Time Oil Co., 103 Cal. App.2d 677, 230 P.2d 10 (1951). Hence, efforts by a lessor to minimize his damages frequently result in the loss of the right to

unpaid future rent as well as the right to damages for its loss.

(3) The lessor may notify the lessee that the leased property will be relet for the benefit of the lessee, take possession and relet the property, and sue for the damages caused by the lessee's default. This remedy, too, is unsatisfactory because the courts have held that the cause of action for damages does not accrue until the end of the original lease term. Treff v. Gulko, 214 Cal. 591, 7 P.2d 697 (1932). Hence, an action to recover any portion of the damages will be dismissed as premature if brought before the end of the original term. This may result in leaving the lessor without an effective remedy where the term of the lease is of such duration that waiting for it to end would be impractical as, for example, where the tenant under a 20-year lease abandons the property after only one year. In addition, any profit made on the reletting probably belongs to the lessee, not the lessor, inasmuch as the lessee's interest in the property theoretically continues. Moreover, the lessor must be careful in utilizing this remedy or he will find that he has forfeited his right to the remaining rentals from his original lessee despite his lack of intent to do so. See, e.g., Neuhaus v. Norgard, 140 Cal. App. 735, 35 P.2d 1039 (1934); A. H. Busch Co. v. Straus, 103 Cal. App. 647, 284 Pac. 966 (1930).

The Commission has concluded that when a lessee breaches the lease and abandons the property, the lessee should be entitled to sue immediately for all damages--present and future--caused by the abandonment of the property or the termination of the lease. This is in substance the

remedy that is now available under Civil Code Section 3308 if the parties provide for this remedy in the lease. Absent such a provision in the lease, the lessor under existing law must defer his damage action until the end of the term and run the risk that the defaulting lessee will be insolvent or unavailable at the end of the term. The availability of a suit for damages would not abrogate the present right to rescind the lease or to sue for specific or preventive relief if the lessor has no adequate remedy at law. Rather, an action for damages would provide the lessor with a reasonable choice of remedies comparable to that available to the promisee when the promisor has breached a contract.

Right of Lessor to Recover Damages Upon Breach by Lessee Justifying Termination of Lease

Under the existing law, the lessor whose lessee commits a sufficiently material breach of the lease to warrant termination has a choice of the following remedies:

(1) He may treat the breach as a partial breach, decline to terminate the lease, and sue for the damages caused by the particular breach. In such a case, he must continue to deal with a lessee who has proven to be unsatisfactory.

(2) He may terminate the lease and force the lessee to relinquish the property, resorting to an action for unlawful detainer to recover possession of the property if necessary. In such a case, his right to the remaining rentals due under the lease ceases upon the termination of the lease. Costello v. Martin Bros., 74 Cal. App. 782, 241 Pac. 588 (1925).

(3) Under some circumstances, he may decline to terminate

the lease but still evict the lessee and relet the property for the account of the lessee. Lawrence Barker, Inc. v. Briggs, 39 Cal.2d 654, 248 P.2d 897 (1952); Burke v. Norton, 42 Cal. App. 705, 184 Pac. 45 (1919). See Code Civ. Proc. § 1174. As previously stated this remedy is unsatisfactory.

The courts have considered the lessee's obligation to pay rent as dependent on the continued existence of the term under common law property concepts. When the term is ended, whether voluntarily by abandonment and repossession by the lessor or involuntarily under the compulsion of an unlawful detainer proceeding, the rental obligation also ends. In the case where the lessor has no reason to expect the lessee to remain available and solvent until the end of the term, continued adherence to this rule denies the lessor any effective remedy for the loss caused by a defaulting lessee.

The Commission has concluded that the lessor should be able to sue for the loss of present and future rentals at the time that the lease is terminated because of a substantial breach by the lessee. This remedy, the substance of which is now available under Civil Code Section 3308 if the lease so provides, would be an alternative to other existing remedies that would continue to be available: (1) the right to treat the breach as a partial breach, regard the lease as continuing in force, and recover damages for the detriment caused by the breach and (2) the right to rescind or cancel the lease, i.e., declare a forfeiture of the lessee's interest.

Duty of Lessor to Mitigate Damages

Existing Law

Under existing law, when the lessee breaches the lease and abandons the property, the lessor may refuse to accept the lessee's

offer to surrender his leasehold interest and may (1) sue for the accruing rent as it becomes due for the remainder of the term or (2) notify the lessee that the property will be relet for the benefit of the lessee, retake possession and relet the property, and sue at the end of the lease term for the damages caused by the lessee's default. Kulawitz v. Pacific Woodenware & Paper Co., supra. Thus, although the lessor may mitigate damages--by reletting for the benefit of the lessee--he is not required to do so. Moreover, if the lessor does attempt to mitigate damages, he may lose his right to the future rent if the court finds he has accepted the lessee's offer to surrender his leasehold interest when he did not mean to do so as, for example, when his notice to the lessee is found to be insufficient. Dorcich v. Time Motor Co., supra. The result is that the existing law tends to discourage the lessor from attempting to mitigate damages.

Recommendations

General duty to mitigate damages. Absent a provision in the lease to the contrary, when the lessee has breached the lease and abandoned the property or has been evicted by the lessor because of the lessee's failure to perform his lease obligations, the lessor should not be permitted to let the property remain vacant and still recover the rent as it accrues. Instead, the lessor should be required to make a reasonable effort to mitigate the damages by reletting the property.

To achieve this objective the basic measure of the lessor's damages should be made the loss of the bargain represented by the lease--i.e., the worth at the time of award of the amount by which the remaining

unaccrued rentals provided in the lease exceeds the amount of rental loss that the lessee proves could have been or could be reasonably avoided. In other words, the lessor should at the time of award be entitled to recover (1) the accrued unpaid rentals less the amount of rental loss that could have been reasonably avoided plus interest from the time of accrual of each installment and (2) the unpaid future rentals less the amount of rental loss that could be reasonably avoided, the difference discounted to reflect prepayment to the lessor. Discounting in this situation is a substitute for payment as installments accrue. The rate of discount should therefore permit the lessor to invest the lump sum award at interest rates currently available in the investment market and recover over the period of the former term of the lease an amount equal to the unpaid future rentals less the amount of rental loss that could be reasonably avoided plus interest from the time these rentals would have accrued. The Federal Reserve Bank discount rate plus one percent satisfies this test. Moreover, it provides a rate subject to judicial notice under Evidence Code Section 452(h) and one that automatically adjusts to changes in the investment market. The parties may be permitted to prove that a different rate should be applicable in their case but the Federal Reserve Bank discount rate should satisfy the basic substitution principle. The burden of proof to show the amount of rental loss that could have been or could be obtained by acting reasonably in reletting the property should be placed on the lessee. This burden of proof rule is similar to the one

applied in actions for breach of employment contracts. See Erler v. Five Points Motors, Inc., 249 Cal. App.2d 560, 57 Cal. Rptr. 516 (1967). The recommended measure of damages is essentially the same as that now provided in Civil Code Section 3308, but the measure of damages provided by that section applies only when the lease so specifies and the section is silent as to burden of proof.

In addition, the lessor should be entitled to recover any other damages necessary to compensate him for all the detriment caused by the lessee's breach or which in the ordinary course of things would be likely to result therefrom. This is the rule applicable in contract cases under Civil Code Section 3300 and would permit the lessor to recover, for example, his expenses in retaking possession of the property, making repairs that the lessee was obligated to make, and in releting the property.

The requirement of existing law that the lessor notify the lessee before releting the property to mitigate the damages should be eliminated. This requirement has discouraged lessors from attempting to mitigate damages and serves no useful purpose in view of the recommended requirement that the lessor be required to relet the

property to mitigate damages in any case where he seeks to recover damages from the lessee for the loss of future rents.

Lease provisions relieving lessor of burden of mitigating damages. The parties should be permitted to include provisions in the lease that will guarantee to the lessor that the lessee will remain obligated to pay the rent provided in the lease for the entire term of the lease if the lease also includes a provision giving the lessee the right to assign the lease or to sublet the property. If the lease contains such provisions, the lessor would be permitted to collect the rent as it accrues so long as he does not terminate the lessee's right to possession of the property. These lease provisions would allow the lessor to guard against the loss of the rentals provided in the lease and at the same time would allow the lessee to protect his interests by obtaining a new tenant.

The lessor should be permitted to impose reasonable restrictions on the right to sublet or assign so that he can exercise reasonable control over the types of businesses and persons who will be occupying his property.

The need to provide the lessor with this remedy arises primarily as a result of the advent of "net lease financing," a practice which has turned the lease into an important instrument for investment and for the financing of land acquisition and building.

An essential requirement in net lease financing is that there be no termination except for a taking of the whole property by eminent domain, rejection of the lease by the tenant's trustee in bankruptcy, or a complete destruction of the land and building by a flood which does not recede. Williams, The Role of the Commercial Lease in Corporate Financing, 22 BUS. LAW. 751, 752-53 (1967). Thus, it is necessary that any change in the law of leases in California preserve the ability of the lessor under such a financing agreement to hold the lessee unconditionally to the payment of the rent.[1]

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[1] Such agreements are often complex. One example of such an arrangement is described in Williams, The Role of the Commercial Lease in Corporate Finance, 22 BUS. LAW. 751, 762, (1967): A Co. needs a new building to expand its operations. It arranges for X to purchase the land for the building. X purchases the land and leases it to A Co. on a short term lease. A Co. builds the improvement and sells it to X. X makes payment by means of an unsecured promissory note. X then sells the land at cost to Investment Co., but retains the fee in the improvement. Investment Co. leases the land to X on a long term lease with a net term basis which will return a fair rate of interest on the investment of Investment Co. X leases the improvement back to A Co. on a net lease basis, and subleases the land to A Co. on the same basis. X then mortgages the ground lease and the improvement to Investment Co. for an amount equal to the cost of the building. X uses the proceeds of the mortgage transaction to pay the promissory note given by X to A Co. for the purchase of the improvement. Thus, A Co. has possession of the land and the improvement and has paid out no cash which has not been returned; the only obligation of A Co. is to pay the periodic rentals. X has spent no money which has not been returned, is the mortgagor of the improvement and the sublease and is primarily liable on the ground lease. X has security for the performance of A Co. in his ownership of the equity in the improvement. Investment Co., the investor, owns the land and has it and the improvement as security for the payment of rent by A Co. Investment Co. also has the obligation of X, as sublessor, as security. Investment Co. has an investment which is now paying interest equivalent to a mortgage in the form of rent.

Where the lease is used as a financing arrangement, the "rent" is in substance interest and return of capital investment and the rate of the rent depends on the credit rating of the lessee. Ordinarily, a major lessee with a prime credit rating will be given a long term lease at a lower rent than would be asked of another lessee without a prime credit rating. If the original lessee abandons, the lessor may be able to relet at a higher rental, but the new lessee may not have the credit rating of the prior lessee and, if the lease had been made with the new lessee originally, a higher rent would have been charged to reflect the increased risk in loaning the money secured by the lease. In this type of case, a mitigation of damages requirement would result in the lessor's losing the benefit of the transaction since the credit rating of the lessee involved in the transaction determines the rent. Even where the lease is not part of a financing arrangement, the same consideration applies because a lessee with a prime credit rating will often be required to pay less rent than a tenant whose ability to pay the rent is suspect. In addition, where a financing arrangement is not involved, the desirability of a particular tenant may be a factor that significantly influences the amount of the rental. For example, a lessor of a shopping center may desire that a particular tenant of outstanding quality be located in the shopping center to attract customers for the entire center. In order to attract this tenant, the rent may be very favorable to the tenant. If the tenant later wishes to leave the location, there may be no equivalent store willing to come in. A store which caters to a different type of clientele may be available, but the lessor may not want that store because he wishes to preserve the quality of the merchandising in the shopping center. At the present time, the coercive

effect of the full rental obligation can be used by the lessor to make the original tenant live up to its bargain. The recommended remedy will permit the parties to retain this effect of the existing law.

Forfeiture of Advance Payments

Adherence to common law property concepts in the interpretation of leases has caused hardship to lessees as well as to lessors. Under the existing law, lessees may be subjected to forfeitures that would not be permitted under any other kind of contract. Where an advance payment is designated as a deposit to secure faithful performance of the terms of the lease, the lessor may retain the deposit only to the extent of the amount of damage actually suffered. But if the lessee makes a payment to the lessor as an "advance payment of rent" or "in consideration for the execution of the lease," the lessor is entitled to keep the payment regardless of his actual damages when the lease is terminated by reason of the lessee's breach. See Warming v. Shapiro, 118 Cal. App.2d 72, 75, 257 P.2d 74, 76 (1953).

In contrast, where the buyer repudiates a contract for the sale of real property, any advance payments made to the seller in excess of his actual damages are recoverable by the buyer. Freedman v. The Rector, 37 Cal.2d 16, 230 P.2d 629 (1951). Moreover, even though a contract for the sale of property recites that an initial payment is in consideration for entering into the agreement," the courts permit the buyer to recover so much of the payment as exceeds the seller's damages if, in the light of the entire transaction, there was in fact no separate consideration supporting the payment. Caplan v. Schroeder, 56 Cal.2d 515, 15 Cal. Rptr. 145, 364 P.2d 321 (1961).

The Commission recommends that a defaulting lessee be entitled to relief from the forfeiture of an advance payment, regardless of the label attached to the payment by the provisions of the lease. A lessor should not have the right to exact forfeitures by the artful use of language in a lease.

Effect on Unlawful Detainer

Code of Civil Procedure Section 1174 provides that the lessor may notify the lessee to quit the premises, and that such a notice does not terminate the leasehold interest unless the notice so specifies. This permits a lessor to evict the lessee, relet the property to another, and recover from the lessee at the end of the term for any deficiency in the rentals. The statutory remedy falls short of providing full protection to the rights of both parties. It does not permit the lessor to recover damages immediately for future losses; it does not require the lessor to mitigate damages; and it does not protect the lessee from forfeiture.

An eviction under Section 1174 should terminate the lessee's rights under the lease and the lessor should be required to relet the property to minimize the damages. The lessor's right to recover damages for loss of the benefits of the lease should be independent of his right to bring an action for unlawful detainer to recover the possession of the property. The damages should be recoverable in a separate action in addition to any damages recovered as part of the unlawful detainer action. Of course, the lessor should not be entitled to recover twice for the same items of damages.

Civil Code Section 3308

Section 3308 of the Civil Code should be revised to limit its application to personal property. Section 3308 provides, in effect, that a lessor of real or personal property may recover the measure of damages recommended above if the lease so provides and the lessor chooses to pursue that remedy. Enactment of legislation effectuating the other recommendations of the Commission would make Section 3308 superfluous insofar as real property is concerned. Section 3308 should also be revised to clarify its provisions and to eliminate the implication that arises from its terms that a lessor of personal property cannot sue for all of his prospective damages unless the lease so provides.

Effective Date: Application to Existing Leases

The recommended legislation should take effect on July 1, 1970. This will permit interested persons to become familiar with the new legislation before it becomes effective.

The legislation should not apply to any leases executed before July 1, 1970. This is necessary because the parties did not take the recommended legislation into account in drafting leases now in existence.

PROPOSED LEGISLATION

The Commission's recommendations would be effectuated by enactment of the following measure:

An act to add Sections 1951, 1951.2, 1951.4, 1951.5, 1951.6, 1951.8, 1952, 1952.2, 1952.4, and 1952.6 to, and to amend Section 3308 of, the Civil Code, and to add Sections 337.5 and 339.5 to the Code of Civil Procedure, relating to leases.

The people of the State of California do enact as follows:

SECTIONS ADDED TO CIVIL CODE

§ 1951. "Rent" and "lease" defined

Section 1. Section 1951 is added to the Civil Code, to read:

1951. As used in Sections 1951.2 to 1951.8, inclusive:

(a) "Rent" includes charges equivalent to rent.

(b) "Lease" includes a sublease.

Comment. Subdivision (a), defining "rent" to include "charges equivalent to rent," makes clear that rent includes all the obligations the lessee undertakes in exchange for use of the leased property. For example, if the defaulting lessee had promised to pay the taxes on the leased property and the lessor could not relet the property under a lease either containing such a provision or providing sufficient additional rental to cover the accruing taxes, the loss of the defaulting lessee's assumption of the tax obligation would be included in the damages the lessor is entitled to recover under Section 1951.2. The same would be true where the lease imposes on the lessee the obligation to provide fire, earthquake, or liability insurance.

Subdivision (b) makes clear that the provisions of the statute apply to subleases as well as leases.

§ 1951.2. Termination of real property lease; damages recoverable

Sec. 2. Section 1951.2 is added to the Civil Code, to read:

1951.2. (a) Except as otherwise provided in Section 1951.4, if a lessee of real property breaches the lease and abandons the property before the end of the term or if his right to possession is terminated by the lessor because of a breach of the lease, the lease terminates. Upon such termination, the lessor may recover from the lessee:

(1) The worth at the time of award of the unpaid rent which had been earned at the time of termination;

(2) The worth at the time of award of the amount by which the unpaid rent for the balance of the term after termination until the time of award exceeds the amount of such rental loss that the lessee proves could have been reasonably avoided;

(3) The worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award exceeds the amount of such rental loss that the lessee proves could be reasonably avoided; and

(4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease or which in the ordinary course of things would likely to result therefrom.

(b) The worth at the time of award of the amounts referred to in paragraphs (1) and (2) of subdivision (a) is computed by allowing interest at such lawful rate as may be specified in the lease or,

if no such rate is specified in the lease, at the legal rate. The worth at the time of award of the amount referred to in paragraph (3) of subdivision (a) is computed by discounting such amount to reflect prepayment. The rate of such discount is presumed to be equal to the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent. This presumption is a presumption affecting the burden of producing evidence.

(c) Efforts by the lessor to mitigate the damages caused by the lessee's breach of the lease do not waive the lessor's right to recover damages under this section.

(d) Nothing in this section affects the right of the lessor under a lease of real property to indemnification for liability arising prior to the termination of the lease for personal injuries or property damage where the lease provides for such indemnification.

(e) Nothing in this section affects the right of the lessor under a lease of real property to equitable relief in any case where such relief is appropriate.

Comment. Section 1951.2 states the measure of damages where the lessee breaches the lease and abandons the property or when his right to possession is terminated by the lessor because of a breach of the lease. As used in this section, "rent" includes "charges equivalent to rent." See Section 1951.

Subdivision (a). Under paragraph (1) of subdivision (a), the lessor is entitled to recover the unpaid rent which had been earned at the time the lease terminated. To this must, of course, be added interest at such

lawful rate as may be specified in the lease or, if none is specified, at the legal rate of seven percent. Interest accrues on each unpaid rental installment from the time it becomes due until the time of award, i.e., the entry of judgment or the similar point of determination if the matter is determined by a tribunal other than a court.

Under paragraphs (2) and (3) of subdivision (a), the lessor is entitled to recover the worth at the time of award of the amount by which the unpaid rent for the balance of the term after termination exceeds the amount of such rental loss that was or could be reasonably avoided. In determining the worth at the time of award of unpaid rent that became due after the termination of the lease and before the award, interest must be added to the amount by which the rent due exceeds the amount of avoidable rental loss. Such interest again accrues on each rental installment from the time it becomes due. Where the due date of a rental payment has not occurred by the time of award, the amount by which the rental payment exceeds the amount of avoidable rental loss must be discounted to reflect the fact that it is being prepaid. See subdivision (b) (presumption as to rate of discount).

In determining the amount recoverable under paragraphs (2) and (3), the lessee is entitled to have offset against the unpaid rent not merely all sums the lessor has received or will receive by virtue of a reletting of the property which has actually been accomplished but also all sums that the lessee can prove the lessor could have obtained or could obtain by acting reasonably in reletting the property.

The general principles that govern mitigation of damages apply in determining what constitutes a "rental loss that the lessee proves . . .

could be reasonably avoided." These principles were summarized in Green v. Smith, 261 A.C.A. 423, 427-428, 67 Cal. Rptr. 796, 799-800 (1968):

> The plaintiff cannot be compensated for damages which he could have avoided by reasonable effort or expenditures. . . . The frequent statement of the principle in the terms of a "duty" imposed on the injured party has been criticized on the theory that a breach of the "duty" does not give rise to a correlative right of action. . . . It is perhaps more accurate to say that the wrongdoer is not required to compensate the injured party for damages which are avoidable by reasonable effort on the latter's part. . . .
>
> The doctrine does not require the injured party to take measures which are unreasonable or impractical or which would involve expenditures disproportionate to the loss sought to be avoided or which may be beyond his financial means. . . . The reasonableness of the efforts of the injured party must be judged in the light of the situation confronting him at the time the loss was threatened and not by the judgment of hindsight. . . . The fact that reasonable measures other than the one taken would have avoided damage is not, in and of itself, proof of the fact that the one taken, though unsuccessful, was unreasonable. . . . "If a choice of two reasonable courses presents itself, the person whose wrong forced the choice cannot complain that one rather than the other is chosen." . . . The standard by which the reasonableness of the injured party's efforts is to be measured is not as high as the standard required in other areas of law. . . . It is sufficient if he acts reasonably and with due diligence, in good faith. [Citations omitted.]

Paragraph (4) of subdivision (a) makes clear that the measure of the lessor's recoverable damages is not limited to damages for the loss of past and future rentals. This paragraph adopts language used in Civil Code Section 3300 and provides, in substance, that all of the other damages a person is entitled to recover for the breach of a contract may be recovered by a lessor for the breach of his lease. For example, to the extent that he would not have had to incur such expenses had the lessee performed his obligations under the lease, the lessor is entitled to recover his reasonable expenses in retaking possession

of the property, in making repairs that the lesses was obligated to make, in preparing the property for reletting, and in reletting the property. Other damages necessary to compensate the lessor for all of the detriment proximately caused by the lessee would include damages for the lessee's breach of specific covenants of the lease--for example, a promise to maintain or improve the premises or to restore the premises upon termination of the lease. Reasonable attorney's fees may only be recovered if they are recoverable under Section 1951.6.

If the lessee proves that the amount of rent that could reasonably be obtained by reletting after termination exceeds the amount of rent reserved in the lease, such excess is offset against the damages otherwise recoverable under paragraph (4) of subdivision (a). Subject to this exception, the lease having been terminated, the lessee no longer has an interest in the property and the lessor is not accountable for any excess rents obtained through reletting.

The basic measure of damages provided in Section 1951.2 is essentially the same as that formerly described in Civil Code Section 3308. The measure of damages described in Section 3308 was applicable, however, only when the lease so provided and the lessor chose to invoke that remedy. Except as provided in Section 1951.4, the measure of damages under Section 1951.2 is applicable to all cases in which a lessor seeks damages upon breach and abandonment by the lessee or upon termination of the lease because of the lessee's breach of the lease. Moreover, Section 1951.2 makes clear that the lessee has the burden of proving the amount he is entitled to have offset against the unpaid

rent, while Section 3308 was silent as to the burden of proof. In this respect, the rule stated is similar to that now applied in actions for breach of employment contracts. See discussion in Erler v. Five Points Motors, Inc., 249 Cal. App.2d 560, 57 Cal. Rptr. 516 (1967).

Subdivision (b). As indicated above in the Comment to subdivision (a), the worth of the accrued unpaid rentals at the time of award is computed by adding interest at such lawful rate as may be specified in the lease or, if no such rate is specified in the lease, at the legal rate. On the other hand, the lump sum award of future rentals must be discounted to reflect prepayment. Discounting in this situation is simply a substitute for payment as rent installments accrue. The rate of discount must therefore permit the lessor to invest the award at interest rates currently available in the investment market and recover over the period of the remaining term of the former lease an amount equal to the unpaid future rentals less the amount of rental loss that could be reasonably avoided plus interest from the time these rentals would have accrued. The discount rate of the Federal Reserve Bank of San Francisco plus one percent satisfies this test. Moreover, it provides a rate subject to judicial notice under Evidience Code Section 452(h) and one that adjusts automatically to changes in the investment market. This rate is given presumptive effect as a presumption affecting the burden of producing evidence. See Evidence Code Section 604 which describes the manner in which a presumption affecting the burden of producing evidence operates. Such a presumption is merely a preliminary

assumption in the absence of contrary evidence, i.e., evidence sufficient to sustain a finding of the nonexistence of the presumed fact. If evidence sufficient to sustain a finding that the discount rate in a particular case is different than the presumed rate is introduced, the presumption disappears from the case and the discount rate is to be determined on the basis of the evidence introduced.

Subdivision (c). Under prior law, attempts by the lessor to mitigate damages sometimes resulted in an unintended acceptance of the lessee's surrender and a resultant loss by the lessor of his right to future rentals. See Dorcich v. Time Motor Co., 103 Cal. App.2d 677, 230 P.2d 10 (1951). One of the purposes of Section 1951.2 is to require mitigation by the lessor and subdivision (c) is included to insure that efforts by the lessor to mitigate do not result in a waiver of his right to damages under Section 1951.2.

Subdivision (d). The determination of the lessor's liability for injury or damage may be subsequent to a termination of the lease, even though the cause of action arose prior to termination. Subdivision (d) makes clear that, in such a case, the right to indemnification is unaffected by the subsequent termination.

Subdivision (e). In rare cases, the lessor may seek specific performance of the lessee's obligations under the lease, or he may seek injunctive relief to prevent the lessee from interfering with his rights under the lease. For example, the lessor's recovery of damages under Section 1951.2 for loss of rent would not necessarily preclude him from obtaining preventive relief

to enforce the lessee's convenant not to compete. Such equitable remedies are available even though the lease has terminated pursuant to subdivision (a).

Effect on other remedies. Section 1951.2 is not a comprehensive statement of the lessor's remedies. When the lessee breaches the lease and abandons the property or the lessor terminates the lessee's right to possession because of the lessee's breach, the lessor may simply rescind or cancel the lease without seeking affirmative relief under Section 1951.2. Where the lessee is still in possession but has breached the lease, the lessor may regard the lease as continuing in force and seek damages for the detriment caused by the breach, resorting to a subsequent action if a further breach occurs. Section 1951.2 makes no change in these remedies. See 30 Cal. Jur.2d Landlord and Tenant § 344 (1956). See also subdivisions (d) and (e) of Section 1951.2.

Section 1951.4 permits the parties to provide an alternative remedy in the lease--recovery of rent as it becomes due. See also Section 1951.5 (liquidated damages) and Section 1951.8 (retention of advance payment as damages).

One result of the enactment of Section 1951.2 is that, unless the parties otherwise agree, the lessor is excused from further performance of his obligations after the lease terminates. In this respect the enactment of Section 1951.2 changes the result in Kulawitz v. Pacific Woodenware & Paper Co., 25 Cal.2d 664, 155 P.2d 24 (1944).

Statute of limitations. The statute of limitations for an action under Section 1951.2 is four years from the date of termination in the

case of a written lease and two years in the case of a lease not in writing. See Code of Civil Procedure Sections 337.5 and 339.5.

§ 1951.4. Continuance of lease in effect after breach and abandonment

Sec. 3. Section 1951.4 is added to the Civil Code, to read:

1951.4. (a) The remedy provided in this section is available only if the lease provides for this remedy.

(b) A lease of real property continues in effect after the lessee has breached the lease and abandoned the property for so long as the lessor does not terminate the lessee's right to possession, and the lessor may enforce all his rights and remedies under the lease, including the right to recover the rent as it becomes due under the lease, if the lease permits the lessee to do any of the following:

(1) Either to sublet the property or to assign his interest in the lease, or both.

(2) Either to sublet the property or to assign his interest in the lease, or both, subject to standards or conditions, and the lessor does not require compliance with any unreasonable standard for, nor any unreasonable condition on, such subletting or assignment.

(3) Either to sublet the property or to assign his interest in the lease, or both, with the consent of the lessor and the lease provides that such consent shall not unreasonably be withheld.

(c) For the purposes of subdivision (b), the following do not constitute a termination of the lessee's right to possession:

(1) Acts of maintenance or preservation or efforts to relet the property.

(2) The appointment of a receiver upon initiative of the lessor to protect the lessor's interest under the lease.

(d) Nothing in this section affects any right the lessor may have to:

(1) Terminate the lessee's right to possession.

(2) Recover damages under Section 1951.2 after the lessor has terminated the lessee's right to possession.

Comment. Even though the lessee has breached the lease and abandoned the property, Section 1951.4 permits the lessor to continue to collect the rent as it becomes due under the lease rather than to recover damages based primarily on the loss of future rent under Section 1951.2. This remedy is available only if the lease so provides and contains a provision permitting the lessee to mitigate the damages by subletting or assigning his interest in the property. The lease may give the lessee unlimited discretion in choosing a subtenant or assignee. See subdivision (b)(1). However, generally the lease will set some standards for or conditions on such subletting or assignment or require the consent of the lessor. See subdivision (b)(2), (3). In the latter case, the lessor may not require compliance with an unreasonable standard or condition nor unreasonably withhold his consent. Occasionally, a standard or condition, although reasonable at the time it was included in the lease, is unreasonable under circumstances existing at the time of subletting or assignment. In such a situation, the lessor may resort to the remedy provided by Section 1951.4 if he does not require compliance with the now unreasonable standard or condition. Some of the common factors that may be considered in determining whether standards or conditions on subletting or assignment are reasonable include: the credit rating of the new tenant; the similarity of the proposed use to the previous use; the nature or character of the new tenant--the use may be similar, but the quality of the tenant quite different; the requirements of the new tenant for services furnished by the lessor; the impact of the new tenant on common facilities.

The right to continue to collect the rent terminates when the lessor evicts the lessee; in such case, the damages are computed under Section 1951.2. The availability of a remedy under Section 1951.4 does not preclude the lessor from terminating the right of a defaulting lessee to possession of the property and then utilizing the remedy provided by Section 1951.2. Nothing in Section 1951.4 affects the rules of law that determine when the lessor may terminate the lessee's right to possession. See subdivision (d) of Section 1951.4.

Where the lease complies with Section 1951.4, the lessor may recover the rent as it becomes due under the terms of the lease and at the same time has no obligation to retake possession and relet the property in the event the lessee abandons the property. This allocation of the burden of minimizing the loss will be most useful where the lessor does not have the desire, facilities, or ability to manage the property and to acquire a suitable tenant and for this reason desires to avoid the burden that Section 1951.2 places on the lessor to mitigate the damages by reletting the property.

The allocation of the duty to minimize damages feature of Section 1951.4 is important. It will permit arrangements for financing the purchase or improvement of real property that might otherwise be seriously jeopardized

if the lessor's only right upon breach of the lease and abandonment of the property were the right to recover damages under Section 1951.2. For example, because the lessee's obligation to pay rent under a lease can be enforced under existing law, leases have been utilized by public entities to finance the construction of public improvements. The lessor constructs the improvement to the specifications of the public entity-lessee, leases the property as improved to the public entity, and at the end of the term of the lease all interest in the property and the improvement vests in the public entity. See, e.g., Dean v. Kuchel, 35 Cal.2d 444, 218 P.2d 521 (1950); County of Los Angeles v. Nesvig, 231 Cal. App.2d 603, 41 Cal. Rptr. 918 (1965). Similarly, a lessor may, in reliance on the lessee's rental obligation under a long term lease, construct an improvement to the specifications of the lessee for the use of the lessee during the lease term. The remedy available under Section 1951.4 gives the lessor, in effect, security for the repayment of the cost of the improvement in these cases.

Section 1951.4 also permits the lessor under a long term lease to assign the right to receive the rent under the lease in return for the discounted value of the future rent. The Section 1951.4 remedy makes the right to receive the rental payments an attractive investment since the assignee is assured that the rent will be paid if the tenant is financially responsible.

Subdivision (c) has been included in Section 1951.4 to make clear that certain acts by the lessor do not constitute a termination of the lessee's right to possession. The first paragraph of the subdivision permits the lessor, for example, to show the leased premises to prospective tenants after the lessee has breached the lease and abandoned the property.

The second paragraph of subdivision (c) makes clear that the appointment of a receiver upon initiative of the lessor to protect the lessor's rights under the lease does not constitute a termination of the lessee's right to possession. For example, an apartment building may be leased under a "master lease" to a lessee who then leases the individual apartments to subtenants. The appointment of a receiver may be appropriate if the lessee under the master lease collects the rent from the subtenants but fails to pay the lessor the rent payable under the master lease. The receiver would collect the rent from the subtenants on behalf of the lessee and pay to the lessor the amount he is entitled to receive under the master lease. This form of relief would protect the lessor against the lessee's misappropriation of the rent from subtenants and at the same time would preserve the lessee's obligation to pay the rent provided in the master lease.

Under this section, in contrast to Section 1951.2, the lessor, so long as he does not terminate the lease, is obliged to continue to perform his obligations under the lease.

§ 1951.5. Liquidated damages

Sec. 5. Section 1951.5 is added to the Civil Code, to read:

1951.5. Civil Code Sections 1670 and 1671, relating to liquidated damages provisions, apply to a lease of real property.

Comment. Under prior law, provisions in leases for liquidated damages upon repudiation of the lease by the lessee were held to be void on the ground that there could be little prospective uncertainty over the amount of the lessor's damages. Jack v. Sinsheimer, 125 Cal. 563, 58 Pac. 130 (1899). Such holdings were proper as long as the lessor's cause of action upon breach of the lease and abandonment of the property or upon termination of the lessee's right to possession was either for the rent as it became due or for the rental deficiencies as of the end of the lease term. Under Section 1951.2, however, the lessor's right to damages accrues at the time of the breach and abandonment or when the lease is terminated by the lessor, and the amount of the damages may be difficult to determine in some cases. This may be the case, for example, where the property is leased under a percentage lease or where the property is unique and its fair rental value cannot be determined. Accordingly, the prior decisions holding liquidated damages provisions in leases to be void are no longer authoritative and, if the parties wish, they may in an appropriate case provide for liquidated damages which will be in lieu of the damages provided in the other sections of the statute. Such a liquidated damage provision will be valid only if it meets the requirements of Civil Code Sections 1670 and 1671.

So far as provisions for liquidated damages upon a lessor's breach are concerned, such provisions were upheld under the preexisting law if reasonable. See Seid Pak Sing v. Barker, 197 Cal. 321, 240 Pac. 765 (1925). Nothing in Section 1951.5 changes this rule.

§ 1951.6. Attorney's fees

Sec. 6. Section 1951.6 is added to the Civil Code, to read:

1951.6. Section 1717 of the Civil Code, relating to attorney's fees, applies to leases of real property and the attorney's fees described in Section 1717 shall be recoverable in addition to any other relief or amount to which the lessor or lessee may be entitled.

Comment. Leases, like other contracts, sometimes provide that a party is entitled to recover reasonable attorney's fees incurred in successfully enforcing or defending his rights in litigation arising out of the lease. Section 1951.6 makes clear that nothing in the other sections of the statute impairs a party's rights under such a provision and that Civil Code Section 1717 (added by Cal. Stats. 1968, Ch. 266) applies to leases of real property.

§ 1951.8. Advance payments

Sec. 7. Section 1951.8 is added to the Civil Code, to read:

1951.8. (a) As used in this section, "advance payment" means moneys paid to the lessor of real property (1) as advance payment of rent, (2) as a bonus or consideration for the execution of the lease, (3) as a deposit to secure faithful performance of the terms of the lease, or (4) as the substantial equivalent of any of these.

(b) An advance payment shall be applied toward any amount recoverable by the lessor. The lessee is entitled to recover so much of an advance payment as he proves would result in a forfeiture if retained by the lessor. For the purposes of this section, the amount in excess of what would be reasonable as liquidated damages pursuant to Section 1671 of the Civil Code is a forfeiture.

Comment. Section 1951.8 changes the California law so that--regardless of label--an advance payment may be recovered by the lessee if its retention by the lessor would result in a forfeiture.

Where the advance payment is a "deposit to secure faithful performance of the terms of the lease," the lessee is entitled to recover any amount deposited in excess of the lessor's damages. Similarly where an advance payment of rent has been received it will be offset against rent and other damages recoverable under Section 1951.2 and the lessee is entitled to any excess. However, where the court finds that an advance payment is in fact consideration for the right of possession under the lease, the advance payment may be recovered only if its retention by the lessor would result in a forfeiture. In determining whether there is a forfeiture, a pro rata allocation of the total

consideration is not required. The court must consider the entire agreement, the circumstances under which it was made, and the understanding of the parties. For example, the parties may have understood that the rental value of the property would rise during the term of the lease. The parties may have contemplated some initial compensation for special preparation of the property or to compensate for the surrender of a now-vanished opportunity to lease to someone else.

Under the prior California law, the right of a lessee to recover an advance payment depended on whether the advance payment was designated a security deposit (lessee could recover), an advance payment of rental (lessee could not recover), or a bonus or consideration for the execution of the lease (lessee could not recover). Compare Warming v. Shapiro, 118 Cal. App.2d 72, 257 P.2d 74 (1953) ($12,000 forfeited because designated as both a bonus and an advance payment of rental), with Thompson v. Swiryn, 95 Cal. App.2d 619, 213 P.2d 740 (1950)(advance payment of $2,800 held recoverable as a security deposit). See discussion in Joffe, Remedies of California Landlord Upon Abandonment by Lessee, 35 So. Cal. L. Rev. 34, 44 (1961); Note, 26 Cal. L. Rev. 385 (1938). Commentators have suggested that the cases involving prepaid rent and bonuses are now of doubtful authority. See Harvey, A Study to Determine Whether the Rights and Duties Attendant Upon the Termination of a Lease Should Be Revised, 54 Cal. L. Rev. 1141, 1173-1174 (1966); Smith, Contractual Controls of Damages, 12 Hastings L. J. 122, 139-140 (1960); Note, 43 Cal. L. Rev. 344, 349 n.32 (1955). Section 1951.8 eliminates this uncertainty, for it makes clear that an advance payment can be recovered to the extent that it

constitutes a forfeiture. The conduct of the lessee must be considered in determining whether there is a forfeiture, but the mere fact that the lessee willfully breaches the lease does not necessarily deprive him of his right to recover an advance payment where a forfeiture would result if it were retained by the lessor. Cf. Freeman v. The Rector, 37 Cal.2d 16, 230 P.2d 629 (1951); Caplan v. Schroeder, 56 Cal.2d 515, 15 Cal. Rptr. 145, 364 P.2d 321 (1961). In every case, the court must consider all the facts in determining whether to grant the defaulting lessee relief under Section 1951.8.

It should be noted that this section is concerned solely with "advance payments." Liquidated damages provisions in leases fixing in advance the amount of damages recoverable by the lessor are in appropriate circumstances enforceable. See Section 1951.5.

§ 1952. Effect on unlawful detainer, forcible entry, and forcible detainer actions

Sec. 9. Section 1952 is added to the Civil Code, to read:

1952. (a) Except as provided in subdivision (c), nothing in Sections 1951 to 1951.8, inclusive, affects the provisions of Chapter 4 (commencing with Section 1159) of Title 3 of Part 3 of the Code of Civil Procedure, relating to actions for unlawful detainer, forcible entry, and forcible detainer.

(b) The bringing of an action under the provisions of Chapter 4 (commencing with Section 1159) of Title 3 of Part 3 of the Code of Civil Procedure does not affect the lessor's right to bring a separate action to recover damages under Section 1951.2, but no damages shall be recovered in the subsequent action for any detriment for which a claim for damages was made and determined on the merits in the previous action.

(c) Whether or not the judgment referred to in Section 1174 of the Code of Civil Procedure declares the forfeiture of the lease, the lessor's right to damages after the lessor evicts the lessee is limited to the remedy that the lessor is provided under Section 1951.2.

Comment. Section 1952 is designed to clarify the relationship between Sections 1951-1951.8 and the chapter of the Code of Civil Procedure relating to actions for unlawful detainer, forcible entry, and forcible detainer. The actions provided for in the Code of Civil Procedure chapter are designed to provide a summary method of recovering possession of property. Those actions may be used by a lessor whose defaulting lessee refuses to vacate the property after termination of the lease.

Subdivision (b) of Section 1952 provides that the fact that a lessor has recovered possession of the property by an unlawful detainer action does not preclude him from bringing a separate action to recover the damages to which he is entitled under Sections 1951.2, 1951.5, 1951.6, and 1951.8. Some of the incidental damages to which the lessor is entitled may be recovered in either the unlawful detainer action or in an action to recover the damages specified in Sections 1951.2, 1951.5, 1951.6, and 1951.8. Under Section 1952, such damages may be recovered in either action, but the lessor is entitled to but one determination of the merits of a claim for damages for any particular detriment.

Subdivision (c) does not preclude the lessor from recovering damages under Sections 1951.2, 1951.5, 1951.6, and 1951.8 or obtaining equitable relief to enforce a covenant not to compete. However, when the lessor has evicted the lessee under the unlawful detainer provisions, he cannot proceed under the provisions of Section 1951.4; a lessor cannot evict the tenant and refuse to mitigate damages. In effect, the lessor is put to an election of remedy in such a case.

§ 1952.2. Leases executed before January 1, 1970

Sec. 10. Section 1952.2 is added to the Civil Code, to read:

1952.2. Sections 1951 to 1952, inclusive, do not apply to:

(a) Any lease executed before January 1, 1970.

(b) Any lease executed on or after January 1, 1970.

if the terms of the lease were fixed by a lease or other contract executed before January 1, 1970.

Comment. Section 1952.2 is included to preclude the application of the new statute to existing leases.

§ 1952.4. Natural resources agreements

Sec. 11. Section 1952.4 is added to the Civil Code, to read:

1952.4. An agreement for the exploration for or the removal of natural resources is not a lease of real property within the meaning of Sections 1951 to 1952.2, inclusive.

Comment. An agreement for the exploration for or the removal of natural resources, such as the so-called oil and gas lease, has been characterized by the California Supreme Court as a profit a prendre in gross. See Dabney v. Edwards, 5 Cal.2d 1, 53 P.2d 962 (1935). These agreements are distinguishable from leases generally. The ordinary lease contemplates the use and preservation of the property with compensation for such use, while a natural resources agreement contemplates the extraction of the valuable resources of the property with compensation for such extraction. See 3 Lindley, Mines § 861 (3rd ed. 1914).

Sections 1951-1952.2 are intended to deal with the ordinary lease of real property, not with agreements for the exploration for or the removal of natural resources. Accordingly, Section 1952.4 limits these sections to their intended purpose. Section 1952.4 does not prohibit application to such agreements of any of the principles expressed in Sections 1951 to 1951.8; it merely provides that nothing in those sections requires such application.

§ 1952.6. Lease-purchase agreements of public entities

Sec. 12. Section 1952.6 is added to the Civil Code, to read:

1952.6. Where an agreement for a lease of real property from or to any public entity or any nonprofit corporation whose title or interest in the property is subject to reversion to a public entity would be made invalid if any provision of Sections 1951 to 1952.2, inclusive, were applicable, such provision shall not be applicable to such a lease. As used in this section, "public entity" includes the state, a county, city and county, city, district, public authority, public agency, or any other political subdivision or public corporation.

Comment. Section 1952.6 is included to prevent the application of any provision of Sections 1951 to 1952.2 to lease-purchase agreements by public entities if such application would make the agreement invalid.

CONFORMING AMENDMENT OF CIVIL CODE SECTION 3308

Sec. 13. Section 3308 of the Civil Code is amended to read:

3308. (a) ~~The parties to any lease of real or personal property may agree therein that if such~~ Unless the lease otherwise provides, if a lease ~~shall be~~ of personal property is terminated by the lessor by reason of any breach thereof by the lessee, the lessor shall thereupon be entitled to recover from the lessee :

(1) The worth at the time of award of the unpaid rent, including charges equivalent to rent, which had been earned at the time of termination;

(2) The ~~the~~ worth at the time of ~~such termination,~~ award of the ~~excess, if any, of the~~ amount ~~of~~ by which the unpaid rent , and including charges equivalent to rent , ~~reserved in the lease~~ for the balance of the stated term ~~or any shorter period of time over the then reasonable rental value of the premises for the same period~~ after termination until the time of award exceeds the amount of such rental loss that the lessee proves could have been reasonably avoided;

(3) The worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award exceeds the amount of such rental loss that the lessee proves could be reasonably avoided; and

(4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease or which in the ordinary course of things would be likely to result therefrom .

(b) The worth at the time of award of the amounts referred to in paragraphs (1) and (2) of subdivision (a) is computed by allowing interest at such lawful rate as may be specified in the lease or, if no such rate is specified in the lease, at the legal rate. The worth at the time of award of the amount referred to in paragraph (3) of subdivision (a) is computed by discounting such amount to reflect prepayment. The rate of such discount is presumed to be equal to the discount rate for the Federal Reserve Bank of San Francisco at the time of award plus one percent. This presumption is a presumption affecting the burden of producing evidence.

~~The rights of the lessor under such agreement shall be cumulative to all~~

(c) Nothing in this section precludes the lessor from resorting to any other rights or remedies now or hereafter given to ~~the lessor~~ him by law or by the terms of the lease . ~~; provided, however, that the election of the lessor to exercise the remedy hereinabove permitted shall be binding upon him and exclude recourse thereafter to any other remedy for rental or charges equivalent to rental or damages for breach of the covenant to pay such rent or charges accruing subsequent to the time of such termination. The parties to such lease may further agree therein that unless the remedy provided by this section is exercised by the lessor within a specified time the right thereto shall be barred.~~

Comment. Section 3308 has been revised to exclude reference to leases of real property; insofar as the section related to real property, it has been superseded by Sections 1951-1952.6. It is not intended by the elimination of real property leases here or by the enactment of

Sections 1951-1952.6 to affect any remedy or benefit available to a lessor or a lessee of personal property under Section 3300 or under the rules applying to contracts generally. The section has, however, been amended to conform substantially to Section 1951.2 and the Comment to that section should be referred to for further discussion of the remedy provided by Section 3308.

Generally, the remedies available as a matter of law (consistent with Section 3300) in the event of a breach of the entire lease agreement and repossession of the equipment permit the recovery against the lessee of the following: (1) the amount of unpaid rental installments falling due to the time of award with interest thereon at the legal rate or such higher lawful rate as may be specified in the lease from the time each falls due; (2) the amount of the rentals which would have been received after award, discounted to value at the time of award at such rate as to yield a compensatory sum; (3) if the equipment has been sold, the amounts reasonably expended prior to sale to repossess, store, insure, and pay taxes on it, the expenses of sale, and the value the equipment would have had at the end of the lease term (lessor's reversionary interest); (4) if the equipment has been relet, the amounts expended prior to reletting to repossess, store, insure, and pay taxes on it and the expenses of reletting. Against these amounts the lessee is entitled to credit for the actual proceeds of sale or reletting, or such larger amounts as the lessee can prove should have been obtained by the lessor if the lessor acted in a commercially reasonable way. Credit is to be applied as of the time of actual receipt (or when it should have been received if the lessor did not act in a commercially reasonable way), first to interest then to principal.

In the case of personal property leases--in contrast to real property leases--, it should be noted that in most instances it is impractical to relet the equipment after default by the lessee and repossession. The greatest mitigation in such cases is achieved by sale of the equipment, and nothing in Section 3308 is to be construed as prohibiting sale rather than reletting if the evidence establishes that sale was the most effective way to mitigate.

SECTIONS TO BE ADDED TO CODE OF CIVIL PROCEDURE

§ 337.5. Damages recoverable upon abandonment or termination of written lease of real property

Sec. 14. Section 337.5 is added to the Code of Civil Procedure, to read:

337.5. Where a lease of real property is in writing, no action shall be brought under Civil Code Section 1951.2 or 1951.8 more than four years after the breach of the lease and abandonment of the property, or more than four years after the termination of the right of the lessee to possession of the property, whichever is the earlier time.

Comment. The four-year period provided in Section 337.5 is consistent with the normal statute of limitations applicable to written contracts. See Code of Civil Procedure Section 337. Although the prior law was not clear, it appears that, if the lessor terminated a lease because of the lessee's breach and evicted the lessee, his cause of action for the damages resulting from the loss of the rentals due under the lease did not accrue until the end of the original lease term. See De Hart v. Allen, 26 Cal.2d 829, 161 P.2d 453 (1945); Treff v. Gulko, 214 Cal. 591, 7 P.2d 697 (1932). Under Civil Code Section 1951.2, an aggrieved lessor may sue immediately for the damages resulting from the loss of the rentals that would have accrued under the lease. Under Civil Code Section 1951.8, a lessee may recover all or a portion of an advance payment or deposit under certain circumstances.

§ 339.5. Damages recoverable upon abandonment or termination of oral lease of real property

Sec. 15. Section 339.5 is added to the Code of Civil Procedure, to read:

339.5. Where a lease of real property is not in writing, no action shall be brought under Civil Code Section 1951.2 or 1951.8 more than two years after the breach of the lease and abandonment of the property, or more than two years after the termination of the right of the lessee to possession of the property, whichever is the earlier time.

Comment. The two-year period provided in Section 339.5 is consistent with the normal statute of limitations applicable to contracts not in writing. See Code of Civil Procedure Section 339. See also the Comment to Code of Civil Procedure Section 337.5.