#H-111

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04/28/88

First Supplement to Memorandum 88-35

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--comments on policy issues)

Attached is a letter from Ronald P. Denitz of Tishman West Management Corp. addressed to policy issues involved in the commercial lease law/assignment and sublease study. Mr. Denitz stresses the importance of certainty in this area of law and the need for the Commission to act to propose clarifying legislation. Mr. Denitz endorses the basic conclusions of Professor Coskran in the background study. He also indicates his belief that commercial and residential leases should receive separate statutory treatment, that subleases may need to be treated differently from assignments in some respects, and that the Kendall case should not be applied retroactively.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

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April 27, 1988

California Law Revision Commission
4000 Middlefield Road
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Attention: Nathaniel Sterling
Assistant Executive Secretary

Re: Study H-111: Restrictions on Lease Transfers

Ladies and Gentlemen:

At your meeting on May 6, 1988 you will consider policy decisions regarding, among other things, whether the captioned Study should continue at all, whether the Study should extend to residential lease transfer restrictions (in addition to commercial lease transfer restrictions), and various policy issues raised by Professor William G. Coskran in his scholarly Background Study as revised March 22, 1988.

As a member of the California State Bar specializing in commercial lease transactions (particularly negotiation, drafting and enforcement) for Tishman West Management Corp. and its predecessor-entity, I can assure you that questions revolving around a lessor's ability to restrict a transfer by a tenant almost invariably are issues with which lessors in the commercial real estate field grapple on a weekly if not a daily basis. Those confrontations not only impinge upon the initial negotiation of commercial leases of all sizes and varieties but also occur as "cross-roads" decisions when a tenant either is (a) failing in his business (in which case he wishes to shrink his own size of operation in the lessor's building or move from the lessor's building), (b) moving his business to a different location, or (c) surprisingly succeeding in his business (whereupon the tenant desires to expand his demised premises elsewhere than lessor's building and therefore [i] seeks to assign his lease or [ii] decides that he would like to become a sublandlord in his own right).

Superimposed upon the desires of the tenants in any one or more of the aforementioned turn of events is the commercially desirable motivation of the lessor to succeed in his own business, both in the quantitative dollars and cents regard and also in the qualitative sense as regards possibly selling his building, keeping it full, keeping it profitable, and, most

important, minimizing the unpredictable consequences which have flowed from the line of judicial decisions beginning with Cohen case and culminating (at least for the present) in the Kendall case.

1. THE TOPIC SHOULD CONTINUE TO BE STUDIED: Our need as commercial lessors in the field of office buildings and shopping centers (we now are managing approximately 70 office buildings and one shopping center, not to mention various store-tenancies on the ground floors of many of the office buildings) is for certainty in both leases now or hereafter in negotiation but also, of equal importance, as to leases which are already executed and in place. Even for itself alone, the question of retroactivity must be answered, preferably by your Commission and by the legislative arm of government rather than by the Courts.

2. "COMMERCIAL" AND "RESIDENTIAL", IF BOTH ARE STUDIED, SHOULD HAVE SEPARATE RECOMMENDATION SECTIONS: As in the case of Repairs (Civil Code Sections 1941 et seq.), Security Deposits (Civil Code Sections 1950.5 and 1950.7), and Liquidated Damages (Civil Code Sections 1671 and 1675), the residential tenancy is almost different in kind from a commercial tenancy. The lease of a residential tenant is not normally negotiated at arms length by parties each represented by counsel, is emotionally and actually more a "home as one's castle" than merely one of a number of contractual assets of a tenant's business, and in California is not normally the subject of assignment (much less multiple sub-tenancies); thus the validity of restrictions and guidelines on assignment and subletting in residential leases should be separately addressed, either now or at a later date.

3. PROFESSOR COSKRAN'S ELEVEN "A" AND SEVEN "B" CONCLUSIONS SHOULD BE ADOPTED AS INITIAL POLICY DECISIONS FOR COMMERCIAL LEASES: The Commission is respectfully referred to pages 107 through 114 of Professor Coskran's revised Study (which accompanied Memorandum 88-35), which we heartily endorse.

4. SUBLEASES REQUIRE SOMEWHAT DIFFERENT TREATMENT THAN DO ASSIGNMENTS: Assignments necessarily, of their nature, involve transfer of the entire demised premises for the entire term of the lease; subleases, on the other hand, very

frequently in the commercial field are the product of either a so-called "land bank" projection (where the prime tenant initially leases more space than he then-requires and bargains for the right to fill the presently unneeded portions of demised premises with one or more suitable subtenants) or arises when a seasoned tenant suffers business reversals or changes the nature of his business or space-requirements and desires to directly or indirectly be relieved of the burden of paying for square footage which he himself need not or cannot occupy. At the Commission's meeting on May 6 (or, if the Commission so desires, privately with staff), I stand ready to offer suggestions on this subject. Suffice it to say, for the purposes of this letter, that we as lessors or lessor's Agent believe that sublease-rights must be more closely controlled by lessor than in the case of assignments, as witness the professional lessor's nightmare of (i) an unwarranted and unexpected large number of subtenants occupying a single user's space or (ii) a large single space-user suddenly vacating the demised premises and itself going into the "business" of subletting portions of his space in direct competition with the lessor itself.

5. RETROACTIVE APPLICATION OF THE KENDALL CASE SHOULD BE AT LEAST PRESUMPTIVELY OVERRULED: It is our opinion that the parties to a commercial lease should, and perhaps must, be entitled to base their negotiations and business bargain on the state of the statutory and case law existent at the time of execution of the lease. The Kreisher case (cited and discussed by Professor Coskran at pages 86 through 88 of his March 22, 1988 revised Study, which accompanied Memorandum 88-35) went only part way (but an absolutely necessary part way) in the direction we recommend: most surely a lessor's granting or denying consent to an assignment should not be at his peril.

The proof of the success of your deliberations in the commercial leasing field are best exemplified by three of the areas in which I was privileged to assist you in the past: Sections 1951.2 et seq. (Lessor's remedies and the recognition of commercial leases as contracts rather than merely estates in land), 1951.3 (providing a simplified method of establishing when and when not a tenant has abandoned lease premises) and, last but far from least, sections 1980 et seq. (Disposition of personal property remaining on lease premises after expiration or other termination

of a lease). Those statutes have saved lessors, tenants, and the Courts literally millions of dollars in both time and money. All of us in the commercial leasing field (whether lessors, tenants, owners or managers of commercial real property) need your help now to turn uncertainty into an understandable and acceptable statute.

Very truly yours,

TISHMAN WEST MANAGEMENT CORP.

By _____
Ronald P. Denitz
Corporate Counsel

cc: Prof. William G. Coskran, Esq.

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XVII. SUMMARY OF CONCLUSIONS.

A. Relating to Commercial Lease Transfer Restrictions.

The following conclusions are based on the assumption that, although they are not necessarily equal in bargaining power, the parties are not involved in a contract which would be invalidated in whole or part under the adhesion doctrine in California.

1. The freedom of the parties to negotiate and contract concerning restrictions on leasehold transfers should be preserved unless there is a compelling public policy reason to interfere.

2. Disclosure of restrictions by express provisions should be encouraged in order to provide clear expectations for the parties.

3. A tenant may freely transfer unless the lease imposes a restriction.

4. Restrictions on leasehold transfers are permitted but strictly construed. Ambiguities are construed in favor of transferability.

5. A "Silent Consent Standard" clause is one which requires the lessor's consent to a leasehold transfer by a tenant, but which does not contain an express standard governing the lessor's consent. The clause does not expressly state that the lessor is subject to a reasonableness standard nor does it expressly state that the lessor has the freedom of a sole discretion standard.

The traditional common law and majority view holds that the lessor is free to use subjective sole discretion in withholding consent. There are several recent out-of-state cases which imply into this type of clause a reasonableness standard to govern the lessor. These cases still represent a minority view but might be considered to indicate a trend. However, there are also some recent cases which decline to adopt the minority view. The Restatement of Property, Second, implies a reasonableness standard into this type of clause. The California Supreme Court, in Kendall v. Pestana, adopted the minority view and implied a reasonableness standard into this type of clause.

The implication of a reasonableness standard into the "Silent Consent Standard" clause is justified by public policy. However, careful consideration should be given to the possibility of unfairness resulting from the retroactive application of this rule.

6. An "Express Reasonableness Standard" clause is one which requires the lessor's consent to a leasehold transfer by the tenant, and which by express agreement of the parties imposes a standard of reasonableness on the lessor.

The common law and majority view, the minority view, and the Restatement of Property, Second, consider this type of clause valid.

If the reasonableness standard is complied with, this clause does not violate the covenant of good faith and fair dealing and it does not violate the rule against restraints on alienation.

7. An "Express Sole Discretion Consent Standard" clause is one which requires the lessor's consent to a leasehold transfer by the tenant, and which by express agreement of the parties gives the lessor the sole discretion to refuse consent. An "Absolute Prohibition" type clause is one in which express agreement of the parties absolutely prohibits leasehold transfers by the tenant.

The common law and majority view consider these types of clauses valid. There is no trend of holdings in out of state cases rejecting this view. The clauses are valid according to the Restatement of Property, Second, if "freely negotiated." Although

there is some language in Kendall criticizing the common law and majority view in general, the holding of that case does not prevent the use of such clauses.

Public policies do not justify prohibiting the freedom to contract for these types of clauses. The Restatement position presents a fair balance between policy and freedom of contract. However, the phrase "freely negotiated" should be clarified.

It is unlikely that a tenant in a freely negotiated long term lease would agree to this type of restriction for the full term. Thus, negotiations usually take care of avoiding such a long term sole discretion or absolute prohibition restriction. However, there may be concern that such restrictions on a lease term approaching fee simple characteristics could cause substantial adverse consequences. If this is a realistic concern, it could be solved by a time limit after which a mandatory reasonableness standard would govern the lessor. A time limit would be a more direct solution than an absolute prohibition of such clauses in all leases, regardless of term. The particular time chosen for the limit would, however, be largely arbitrary.

Note: the "Sole Discretion Standard" and "Absolute Prohibition" type clauses do not comply with Cal. Civ.Code Section 1951.4, so the lessor would not be able to use the lock-in remedy provided in that section.

8. The recent litigation over this area of the law has been generated in large measure by lessors' attempts to "sweeten," rather than preserve, the deal made in the lease. The lessor's demand comes as an apparent surprise at the time of the proposed transfer. Consideration should be given to requiring an express lease clause to support a lessor's demand for participation in bonus value profit by increase in rent or otherwise. If the express provision is present, it has been negotiated and provided for at the time the lease is entered into. The express provision converts the demand from a surprise into one of the reasonable expectations of the parties. However, a prohibition against a lessor's demand for money in exchange for consent might create more problems than it solves. It could deter legitimate compromises, and it could create difficult litigation over motivations. These problems are mentioned in Study Section XIV above.

9. Specific requirements or conditions for a leasehold transfer by the tenant, expressly agreed to by the parties in the lease, should be free from attack as unreasonable, unless and until the lessor exercises the lock-in remedy pursuant to Cal. Civ. Code Section 1951.4.

10. A lessor's right to elect to recover possession of the premises when a tenant proposes a leasehold transfer, expressly

agreed to by the parties in the lease, should not be considered an unreasonable restraint on alienation nor a violation of the covenant of good faith and fair dealing.

11. A lessor's right to receive part or all of the profit generated by a leasehold transfer by a tenant, expressly agreed to by the parties in the lease, should not be considered an unreasonable restraint on alienation nor a violation of the covenant of good faith and fair dealing.

B. Relating to the Lock-In Remedy in C.C. 1951.4

Cal. Civ. Code Section 1951.4 allows the lessor to keep the lease in effect and enforce its terms after the tenant has breached the lease and abandoned the premises. However, this remedy is available only "if the lease permits" the tenant to make a leasehold transfer subject only to reasonable limitations. The following conclusions relate to that code section.

1. If a lease does not restrict transfer, the tenant is automatically free to assign or sublet without the lessor's consent. It should not be necessary to expressly grant the right to assign or sublet in order to comply with section 1951.4.

2. If a lessor's consent is subject to an implied reasonableness standard (e.g. a "Silent Consent Standard" clause above), it should be considered in compliance with the requirements of section 1951.4. It should not be necessary to have the reasonableness standard expressed in the lease.

3. For purposes of compliance with section 1951.4, specific requirements or conditions for a leasehold transfer by the tenant, expressly agreed to by the parties in the lease, should be presumed to be reasonable. An example is the "Express Specific Requirements" type of clause. If there is a later dispute over reasonableness, the tenant should have the burden of proving that a particular standard or condition is unreasonable at the time and in the manner it is applied.

4. It is possible that a particular requirement or condition, although reasonable at the time of entering the lease, becomes unreasonable due to changed circumstances. As long as the lessor does not require compliance with the unreasonable standard or condition, the existence of an unreasonable requirement or condition in the lease should not prevent the lessor from using the remedy in section 1951.4.

5. A lease might provide that the tenant can transfer subject only to reasonable restrictions if, but only if, the lessor is exercising the remedy provided in section 1951.4. In

all other respects, the lease provides for a sole discretion standard or an absolute prohibition against transfer. It is not clear whether this combination is permissible under the present statute. There are competing considerations in resolving the issue, but it should be resolved and clarified.

6. The remedy in section 1951.4 should not be denied to a lessor just because of the presence in the lease of an expressly agreed provision giving the lessor the right to elect to recover possession of the premises when a tenant proposes a leasehold transfer. Note, however, that the exercise of this right would terminate the lease and deny the lessor the lock-in remedy.

7. The remedy in section 1951.4 should not be denied to a lessor just because of the presence in the lease, or the exercise, of an expressly agreed provision giving the lessor the right to receive part or all of the profit generated by a leasehold transfer by a tenant.