

Memorandum 88-44

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--
more initial policy decisions)

At the May 5-6, 1988, meeting the Commission made a few initial policy decisions concerning the commercial lease law study. The most significant of these policies is that if a lease requires the landlord's consent to the tenant's assignment or sublease, but does not specify a standard, there will be an implied standard that the landlord's consent may not be unreasonably withheld. This rule should only apply prospectively, though the Commission did not determine as of what date.

Attached to this memorandum as Exhibit 1 is a staff draft implementing the decisions made so far. The staff has tentatively used the date of the Kendall decision as the transitional date on the basis that (1) the date of the Kendall case is in practical reality the date the law changed for most of the state, and (2) the rule in Kendall has been the law of the state since that date.

At the next meeting the Commission should review the draft statute and then continue with the initial policy decisions on this study. Attached as Exhibit 2 is Professor Coskran's summary of issues and recommendations. We should proceed through the summary starting with issue number 6 on page 109.

Respectfully submitted,

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EXHIBIT 1

Staff Draft

Tentative Recommendation
relating to
Commercial Real Property Leases:
Assignment and Sublease

An act to add Chapter 6 (commencing with Section 1995.010) to Title 5 of Part 4 of Division 3 of the Civil Code, relating to commercial real property leases.

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

Civil Code §§ 1995.010-1995.050 (added). Assignment and sublease

SECTION 1. Chapter 6 (commencing with Section 1995.010) is added to Title 5 of Part 4 of Division 3 of the Civil Code, to read:

CHAPTER 6. ASSIGNMENT AND SUBLEASE

§ 1995.010. Scope of chapter

1995.010. This chapter applies to transfer of a tenant's interest in a lease of real property other than for residential purposes.

Comment. Section 1995.010 limits the scope of this chapter to commercial real property leases. Assignment and sublease issues concerning personal property leases and residential real property leases involve different public policies than commercial real property leases, and therefore are governed by the common law and not by this chapter.

Note. *This section is intended, for now, as a reminder that we are working through the assignment and sublease issues in a commercial context. Whether any of the rules developed should apply to residential leases, or whether separate rules should be developed for residential leases, is an issue the Commission has not yet addressed.*

This chapter is concerned only with restrictions on transfer. There may be an argument that the failure to deal with issues involving other lease restrictions, including use restrictions, creates an implication as to the law governing the other lease restrictions. We need to address this issue directly during the course of the project.

§ 1995.020. Definitions

1995.020. As used in this chapter:

(a) "Landlord" includes a tenant who makes a sublease or other person in the position of a landlord under a lease.

(b) "Lease" means a lease of real property other than for residential purposes, and includes a sublease.

(c) "Restriction on transfer" means a provision in a lease that limits free transfer of the tenant's interest in the lease.

(d) "Tenant" includes a subtenant or other person in the position of a tenant under a lease.

(e) "Transfer" of a tenant's interest in a lease means an assignment, sublease, or other voluntary or involuntary transfer of all or part of a tenant's interest in the lease.

Comment. Section 1995.020 provides definitions for drafting convenience.

Subdivision (a) is consistent with subdivision (b) (lease includes sublease).

Subdivision (b) is consistent with Section 1995.010 (scope of chapter). The provisions of this chapter apply between parties to a sublease and between parties to an assigned lease, as well as between original parties to a lease.

Subdivision (c) refers to lease restrictions on transfer. A restriction agreed to by the parties outside the "lease" is nonetheless a part of the lease for purposes of this chapter, since a lease consists of the totality of the agreement of the parties.

Subdivision (d) is consistent with subdivision (b) (lease includes sublease).

Subdivision (e) applies to involuntary transfers of the tenant's interest, including transfer pursuant to execution sale or tax sale.

Note. These definitions will need to be refined as the drafting proceeds. In particular, the inclusion of involuntary transfers in subdivision (e) will need to be reviewed in light of whatever substantive rules are ultimately developed. Also in connection with subdivision (e) it should be noted that no distinction is drawn between assignments and subleases at this time, although that decision also may be subject to later review.

§ 1995.030. Right to transfer absent a restriction

1995.030. (a) Subject to the limitations in this chapter, a lease may include an express restriction on transfer of the tenant's interest in the lease.

(b) Unless a lease includes an express restriction on transfer, a tenant's rights under the lease include free transfer of the tenant's interest in the lease.

Comment. Subdivision (a) of Section 1995.030 is a specific application of general principles of freedom of contract. Subdivision (a) is limited by the specific provisions of this chapter governing restrictions on transfer. See, e.g., Section 1995.050 (transfer restriction requiring landlord's consent). The provisions of this chapter are intended to completely supersede the law governing unreasonable restraints on alienation (see, e.g., Civil Code § 711) and the law governing good faith and fair dealing (see, e.g., Cal. Lettuce Growers v. Union Sugar Co., 45 Cal. 2d 474, 289 P. 2d 785 (1955)) as they relate to restrictions on transfer of a tenant's interest in a lease. See Comment to Section 1995.050. It should be noted, however, that subdivision (a) remains subject to general principles limiting freedom of contract. See, e.g., Witkin, Summary of California Law, Contracts §§ 23-36 & 743-52 (9th ed. 1987) (adhesion contract doctrine).

Subdivision (b) codifies the common law rule that a tenant may freely assign or sublease unless the right is expressly restricted by the parties. See, e.g., Kassan v. Stout, 9 Cal. 3d 39, 106 Cal. Rptr. 783, 507 P. 2d 87 (1973).

Note. We have added a remark in the Comment concerning the adhesion contract doctrine. However, the Commission has yet to review this matter. When the Commission does review this matter, it may be important to distinguish between the original parties to the lease and subsequent assignees.

§ 1995.040. Transfer restriction strictly construed

1995.040. A restriction on transfer of a tenant's interest in a lease shall be strictly construed in favor of transferability.

Comment. Section 1995.040 codifies the common law. See, e.g., Chapman v. Great Western Gypsum Co., 216 Cal. 420, 14 P. 2d 758 (1932).

§ 1995.050. Transfer restriction requiring landlord's consent

1995.050. (a) If a restriction on transfer of the tenant's interest in a lease requires the landlord's consent for transfer but provides no standard for giving or withholding consent, the restriction on transfer shall be construed to include an implied standard that the landlord's consent may not be unreasonably withheld. Whether the landlord's consent has been unreasonably withheld in a particular case is a question of fact on which the tenant has the burden of proof. The tenant may satisfy the burden of proof by showing that the landlord has not stated a commercially reasonable objection to the transfer.

(b) The Legislature finds and declares:

(1) It is the public policy of the state and fundamental to the commerce and economic development of the state to enable and facilitate freedom of contract between the parties to commercial real property leases.

(2) The parties to commercial real property leases must be able to negotiate and conduct their affairs in reasonable reliance on the rights and protections given them under the laws of the state.

(3) Until the case of Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488 (1985), the parties to commercial real property leases could reasonably rely on the law of the state to provide that if a lease restriction requires the landlord's consent for transfer of the tenant's interest in the lease but provides no standard for giving or withholding consent, the landlord's consent may be unreasonably withheld.

(4) The Kendall case reversed the law on which parties to commercial real property leases executed before December 5, 1985, the date of the Kendall case, could reasonably rely, thereby frustrating the expectations of the parties, with the result of impairing commerce and and economic development.

(5) For these reasons, the Legislature declares the law as follows. Subdivision (a) of this section applies to a lease executed on or after December 5, 1985. If a lease executed before December 5, 1985, includes a restriction that requires the landlord's consent for the tenant's transfer but provides no standard for giving or withholding consent, the landlord's consent may be unreasonably withheld. For purposes of this paragraph, a lease is deemed to be executed at the following times:

(A) The date of execution of a lease, option, or other agreement, if the terms of the lease were fixed by the lease, option, or other agreement.

(B) The date of assumption of rights under the lease by a successor of the original landlord, if any.

Comment. Section 1995.050 codifies the rule of Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P. 2d 837 (1985) and limits its retroactive application.

Under subdivision (a), some of the factors that the trier of fact may properly consider are financial responsibility of the proposed transferee, suitability of the use for the particular property, legality of the proposed use, need for alteration of the premises, and nature of the occupancy. Denial of consent solely on the basis of personal taste, convenience, or sensibility is not commercially reasonable, nor is denial in order that the landlord may charge a higher rent than originally contracted for. 40 Cal. 3d at 501.

The date of applicability of subdivision (a) is December 5, 1985, the date of the Kendall opinion. If there is a transfer of the landlord's rights after December 5, 1985, under a lease executed before that date, the rights as between the parties to the lease are governed by subdivision (a). If there is a sublease after December 5, 1985, under a lease executed before that date, the rights as between the parties to the sublease are governed by subdivision (a). See Section 1995.020(b) ("lease" includes sublease).

Limitation of retroactive operation of Kendall is supported by the public policy stated in subdivision (b), including the need for foreseeability, reliance, and fairness. See discussions in Coskran, Restrictions on Lease Transfers: Validity and Related Remedies Issues, pp. 37-45, 82-90 (1988); Kendall, supra, 40 Cal. 3d at 507-11 (dissent); Kreisher v. Mobil Oil Corporation, 198 Cal. App. 3d 389 (1988).

Note. We have tentatively selected the date of the Kendall decision as the transitional date for this provision of the statute, on the basis that it cannot be assumed that, before that date, most persons acting in reliance on the law could have reasonably foreseen the change in law and structured their leases accordingly. Professor Coskran points out that the Cohen case is a court of appeal case that adopted the same rule as Kendall, but two years earlier; it was a well-publicized case and an argument can be made for using the date of Cohen. The staff suggests Kendall rather than Cohen to provide the retroactivity date because Cohen did not have statewide application and was not as widely known as Kendall.

In subdivision (b) we have extended the Kendall rule to pre-Kendall leases where a new landlord has taken over after Kendall, on the theory that the new landlord can reasonably be assumed to be aware of the state of the law at that time. It can be argued that this denies to the original landlord the benefit of the bargain when conveying to a successor. But any successor who has taken the property after the Kendall case has done so with the knowledge that the Kendall rule most likely applies, so many original landlords have already lost the benefit of their bargains. The staff views this as somewhat analogous to the status of property taxes after Proposition 13--if the owner holds onto the property, lower taxes are locked in, but if the property is transferred, the transferee gets socked with a substantial tax increase. The same type of situation would exist where the original landlord under a pre-Kendall lease transfers the property.

There is a constitutional risk here in overruling the retrospective aspect of Kendall, both from a contract clause and a due process clause perspective. However, the Supreme Court has made clear that legislation may constitutionally have retroactive effect even though it may impair "vested" property rights. In determining whether

retroactivity would be constitutional, the court looks to "the significance of the state interest served by the law, the importance of the retroactive application of the law to the effectuation of that interest, the extent of reliance upon the former law, the legitimacy of that reliance, the extent of actions taken on the basis of that reliance, and the extent to which the retroactive application of the new law would disrupt those actions." *In re Marriage of Bouquet*, 16 Cal.3d 583, 592, 128 Cal. Rptr. 427, 546 P. 2d 1371 (1976). Since the issue of constitutionality is determined by a balancing test, we have attempted to make strong legislative findings in the statute that support our approach.

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.