

Third Supplement to Memorandum 88-64

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--  
involuntary transfers)

Attached to this memorandum is a background study prepared by our consultant Professor Coskran on a subsidiary issue in the assignment and sublease study. The subsidiary study concerns the impact of a transfer restriction on an involuntary transfer of the tenant's interest in the lease. An involuntary transfer typically could occur at the tenant's death or as a result of action by the tenant's creditors to sell the tenant's interest in the lease.

Professor Coskran finds that lease transfer restrictions are generally construed not to cover involuntary transfers unless the restrictions are very specific in their application. The law on this matter is well-settled, and problems can be avoided by clear drafting in the lease. Professor Coskran recommends no curative or clarifying legislation in this area.

Respectfully submitted,

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INVOLUNTARY LEASEHOLD TRANSFERS: EFFECT OF RESTRICTIONS  
AGAINST ASSIGNMENT AND SUBLEASING

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EFFECT OF RESTRICTIONS AGAINST ASSIGNMENT & SUBLEASING

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TABLE OF CONTENTS

I.	SCOPE OF STUDY.	3
II.	TYPES OF INVOLUNTARY TRANSFERS.	5
III.	APPLICABLE RULES.	6
	A. General.	6
	B. Death Transfers.	7
	C. Financial Obligation Transfers.	11
IV.	CONCLUSIONS.	15

## I. SCOPE OF STUDY.

This study is related to, and supplements, the principal study of restrictions on commercial lease assignments and subleases entitled "Restrictions on Lease Transfers: Validity and Related Remedies Issues" (#H-111).<sup>1</sup> That study deals with the validity of, and consent standard applied to, various types of leasehold transfer restrictions. The principal study also deals with the relationship between transfer restrictions and the "lock-in" remedy<sup>2</sup> which allows the lessor to continue enforcement of the lease after the tenant's breach and abandonment.

This study deals with the application of a restriction against leasehold transfers, contained in a commercial lease of real property, to involuntary transfers. For convenience, the word "transfer" is used in this study to refer to either an assignment or a sublease.<sup>3</sup>

Certain transfers by operation of law originate in a voluntary act of the tenant, but end up with a transfer based on operation of the law rather than the specific intent of the tenant to transfer. The following are examples: a tenant makes a will and later dies; a tenant executes a mortgage and later defaults leading to foreclosure; or, a tenant files a voluntary petition in bankruptcy leading to a transfer to the trustee in bankruptcy. These transfers by operation of law are treated as involuntary transfers in this study.

Assume that a lessor and tenant enter into a commercial lease of real property. The lease contains a clause restricting transfers of the leasehold by the tenant. Later, an involuntary transfer occurs. Typically, the involuntary transfer will occur because of the death or financial obligations of the tenant. The lessor seeks a remedy, usually termination of the lease, for non-compliance with the transfer restriction. A dispute between the lessor and the transferee ensues.

Does the transfer restriction clause entitle the lessor to terminate the lease (or seek other remedies) based on an involuntary transfer?

## II. TYPES OF INVOLUNTARY TRANSFERS.

The death of a tenant does not ordinarily terminate the lease.<sup>4</sup> Thus, the leasehold, as part of the deceased tenant's estate, will be distributed to beneficiaries of a will or intestate heirs, or be sold during administration. The transfer by operation of law, pursuant to a will, the intestate succession statutes, or probate administration statutes is treated as an involuntary transfer. See the discussion in Section III below.

Financial obligations of the tenant can cause a variety of involuntary transfers of the tenant's leasehold, or temporary loss of control over the leasehold. For example, there may be an execution sale to satisfy judgment creditors, a foreclosure or trustee's sale under a delinquent mortgage or deed of trust on leasehold security, an appointment of a receiver to control the property (control without transfer) while litigation is pending, or a transfer to or by a trustee in bankruptcy in connection with bankruptcy proceeding. See the discussion in Section III below.

### III. APPLICABLE RULES.

#### A. General.

Restrictions against leasehold transfers, although permissible, are strictly construed in favor of transferability. Strict construction is a product of the policy against restraints on alienation.<sup>5</sup> Since the lessor may terminate the lease if a prohibited transfer occurs,<sup>6</sup> the policy against forfeitures also leads to strict construction against the restriction.<sup>7</sup> For example, a statute provides: "A condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created."<sup>8</sup>

Restrictions against involuntary transfers are permissible, but the rule of strict construction requires that the restriction expressly cover the involuntary transfer involved. As a result, a general restriction against assignments or subleases will be interpreted to cover only voluntary transfers.<sup>9</sup> The involuntary transfer restriction must be specific.<sup>10</sup> This is an old rule which was followed in England at an early date.<sup>11</sup> However, a tenant cannot take advantage of this rule by attempting to disguise a voluntary transfer as an involuntary one in order to evade the clause.<sup>12</sup>



### B. Death Transfers.

Transfers caused by the death of the tenant are not covered by a general transfer restriction.<sup>13</sup> There is some authority for a difference in treatment for a death transfer by intestate succession and one by will.<sup>14</sup> It is generally agreed that an intestate transfer upon the death of the tenant is not covered by a general restriction against leasehold transfers. Some cases have held that a death transfer by will is covered by the general restriction because the will reflects the tenant's intent. It seems that the approach taken by the cases which do not distinguish between the two types of death transfers is more consistent, and in keeping with probable expectations. California appears to treat a will transfer as beyond the scope of a general transfer restriction.<sup>15</sup>

Language making lease, which includes a general transfer restriction, binding upon the heirs, successors, executors and administrators of the tenant are usually insufficient to restrict a transfer upon death.<sup>16</sup>

Although a death transfer is a transfer by operation of law, it is risky for the lessor to rely just on a clause restricting transfer "by operation of law." The Stratford case is a good example of the strictness of construction.<sup>17</sup> The clause gave the lessor the option to terminate if "any person, other than the

lessee named herein, shall secure possession of the interest of the lessee hereunder, under execution, or by reason of any receivership or proceeding in bankruptcy, or other operation of law, or otherwise..."<sup>18</sup> The tenant died intestate and the administratrix sold and assigned the leasehold. The lessor attempted to terminate the lease through an unlawful detainer action. Although someone other than the tenant secured possession, and there was a transfer by operation of law, the court found that the language was limited to solvency events and did not apply to an involuntary death transfer.

The Burns case is another example of the risks of relying on the general phrase "by operation of law."<sup>19</sup> One clause prohibited assignment without the lessor's consent, and specifically provided that the lease was not assignable "by operation of law." Another clause provided that certain solvency events such as appointment of a receiver, assignment for benefit of creditors and bankruptcy would constitute a breach of the lease. The tenant died leaving the leasehold to a beneficiary. The court determined that the beneficiary could take the leasehold without the lessor's consent. The court pointed out that "the lessor desiring...protection against the intrusion of strangers, has only to insert in the lease 'very special' language reserving the right to terminate the lease upon a tenant's death, or requiring consent to a bequest of the lease."<sup>20</sup>

In the more recent Miller case, newspaper dealership agreements simply provided that they were "not assignable nor transferable in whole or part by Dealer, voluntarily, by operation of law or otherwise."<sup>21</sup> The court held that the phrase "by operation of law" was sufficient to prevent transfer by will to a beneficiary. The court distinguished the situation where the phrase is contained in a context of language referring to the tenant's "potential financial demise," and thus is limited to solvency events. Even though this case involved dealership agreements rather than leases, the court did not treat them as personal service contracts, so the more liberal construction of the restriction cannot be explained on that basis.<sup>22</sup> The Horning case also involved a simple clause which did not refer to solvency events, but the court reached the opposite result.<sup>23</sup> An installment sale contract provided that the contract could not be assigned by the buyer "or by operation of law." The court held that the clause did not prevent the buyer's interest from passing upon death.

The issue of clause coverage arose in an unusual manner in the Joost case.<sup>24</sup> The tenant died and the representatives of his estate claimed that lease clauses caused the termination of the lease in the event of death. A clause entitled "Assignment and Subletting" restricted assignment or sublease without the lessor's consent, and specifically prohibited assignment or sublease by "operation of law or otherwise." The court held that

this clause "clearly applied to voluntary acts" and not the death of the tenant. Another clause entitled "Nontransferable Involuntarily" provided that in the event of bankruptcy, or certain other solvency events, the lessor had the option to terminate the lease. Since this clause only applied to solvency type events, not death, and since it was optional whether the lessor terminated or not, the court held that this clause did not result in termination.

### C. Financial Obligation Transfers.

An execution sale is not covered by a general restriction against leasehold transfers.<sup>25</sup> In the Farnum case, the clause provided that the tenant would not "underlet any portion of said premises nor assign this lease without the written permission" of the lessor.<sup>26</sup> The court referred to the clause as the "ordinary kind" and held that it applied to voluntary, not involuntary, assignments. The court pointed out that the lessor can subject involuntary transfers to the restriction by express language. There are, however, recent specific statutory provision dealing with execution sales of leaseholds to enforce money judgments.

Cal. Code of Civ. Proc. Sec. 695.035 is divided into two major parts. Part (a) provides in substance that the leasehold can be transferred to satisfy a money judgment if the tenant has the right to voluntarily sublet or assign either without restriction, or subject to conditions or standards that are met by the transferee. If the lease requires the lessor's consent to an assignment or sublease, the lessor's consent is necessary and the lessor is subject to the same consent standard that would apply to a voluntary transfer. For example, if there is an express or implied reasonable consent standard, the lessor would have to show a commercially reasonable objection to the transfer. If, however, the clause expressly gives the lessor the right to use sole discretion, he would not have to show a reasonable

objection to the involuntary transfer.<sup>27</sup> Part (b) nullifies a provision restricting involuntary transfers to the extent that it would prevent the application of part (a). This statute does not change the rule that holds an involuntary transfer is not subject to a general transfer restriction. It merely prevents a clause that would restrict executions sales more severely than it restricts voluntary transfers.

The appointment of a receiver to take control of the premises is not covered by a general restriction against leasehold transfers. This result can be justified either on the basis that it is involuntary, or on the additional basis that a receivership does not typically involve a transfer of any interest in the leasehold.<sup>28</sup> However, a specific restriction against receiverships should generally be enforced.<sup>29</sup> The recent Superior Motels case involved the issue of whether an express anti-receivership provision in a lease was an invalid restraint on alienation.<sup>30</sup> The disputed lease clause provided that the appointment of a receiver to take possession of the tenant's assets would constitute a breach of the lease.

The clause was attacked as an unreasonable restraint on alienation in violation of Cal. Civ. Code Section 711. That section provides: "Conditions restraining alienation, when repugnant to the interest created, are void."<sup>31</sup> The court said that the section only prohibits restraints that are unreasonable, those not necessary to protect, or prevent impairment of, a

security. The court cited Kendall and two secured loan transaction cases<sup>32</sup> as authority for this proposition. The court went on to say that it cannot resolve the validity of the clause in the abstract and there was no evidence regarding the necessity of the provision to protect security interests. The question of whether there is a need to comply with a reasonableness standard is the subject of the principal study.<sup>33</sup>

A foreclosure or trustee's sale under a mortgage or deed of trust on leasehold security is not covered by a general restriction, even though the security instrument originated in the voluntary act of the tenant.<sup>34</sup> There is some question whether the tenant's execution of the deed of trust violates a general transfer restriction in California. In the 1932 Chapman case, the decision by the Supreme Court states that "we do not believe that a covenant against assignment contained in a lease is violated by the giving of a mortgage on the lease."<sup>35</sup> This result can be explained either by strict construction or by the fact that execution of a deed of trust creates a lien and does not transfer the leasehold. The recent Airport Plaza decision by a court of appeal mentions Chapman, but states that a clause which restricts "assignment or 'transfer' of the lease, 'in whole or part, or (lessee's) interest'...is broad enough to cover transfers to secure a loan."<sup>36</sup> The court in Airport Plaza found that the lessor's objection to hypothecation of the leasehold was reasonable.

A voluntary assignment for the benefit of creditors has been held to be covered by a general restriction against transfer.<sup>37</sup> Although it is usually the result of financial difficulties, it is a voluntary act without operation of law. However, Cal Civ. Code Sec. 1954.1 temporarily limits the lessor's right to terminate when there is a general assignment for the benefit of creditors.<sup>38</sup> That section allows the assignee to occupy and to operate the business on the premises for up to 90 days after the assignment, notwithstanding any lease provision. The assignee is required to pay rent provided for in the lease.

A bankruptcy proceeding is not covered by a general restriction against leasehold transfers, and this construction is generally followed whether the bankruptcy petition is involuntary or voluntary.<sup>39</sup> The transfer results from operation of law rather than the tenant's specific intent to transfer. Even if the lease contains a transfer restriction specifically aimed at bankruptcy proceedings, the Federal Bankruptcy Act has detailed limitations on and procedures for enforcement of leasehold transfer restrictions.<sup>40</sup>



#### IV. CONCLUSIONS.

1. Restrictions on involuntary transfers of a leasehold are, with some limitations, permitted.

2. The policies of dislike of restraints on alienation and dislike of forfeitures lead to a strict construction against restrictions on involuntary transfers.

3. A general restriction on transfer will be construed to apply to voluntary, not involuntary transfers.

4. A restriction on involuntary transfers must be express and specific.

5. The rules in this area of the law are old and well established.

6. There is some question in the cases concerning the degree of specificity required, however the questions can be avoided by careful drafting to express the intent and expectations of the parties with respect to particular types of transfers.

7. There are existing statutory limitations on the enforceability of solvency type transfer restrictions, For Example: (a) It is not permissible to impose a stricter restriction on involuntary transfers by execution sales than is imposed on voluntary transfers. (b) When a general assignment for the benefit of creditors occurs, there is a temporary grace period during which the lessor cannot terminate a lease. (c) The Federal Bankruptcy Act limits enforcement of transfer restrictions when actions under the Act are involved.

- 1 This study is also related to separate studies on assignment and sublease topics  
entitled: *Tenant Remedies For Wrongful Enforcement of Assignment & Sublease  
Restrictions*; *Lessor Remedies For Breach Of Assignment & Sublease Restrictions*;  
*Enforcement of Leasehold Transfer Restriction Against Tenant's Successor: Should  
Dumpor's Be Dumped*; and, *Use Restrictions In Leases: Relationship To Restrictions  
Against Assignment & Sublease*.
- 2 Cal. Civ. Code Sec. 1951.4 (West 1985).
- 3 An assignment is a transfer of the entire leasehold, whereas a sublease is a transfer  
of only an interest in the leasehold. The distinctions between an assignment and a  
sublease, although significant, are not important for the purposes of this study. For a  
discussion of the distinctions, see Sec. III of the principal study. Coskran, *Restrictions  
on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 4 Cal. Civ. Code Sec. 1934 (West 1985).
- 5 See Section XIIA of the principal study. Coskran, *Restrictions on Lease Transfers:  
Validity & Related Remedies Issues*, Study H-111.
- 6 See Section III of the related study *Lessor's Remedies For Breach of Assignment &  
Sublease Restrictions*.
- 7 *Stratford Co. v. Continental Mortgage Co.*, 74 Cal. App. 551, 555, 241 P. 429 (1925).
- 8 Cal. Civ. Code Sec. 1442 (West 1982).
- 9 *Farnum v. Hefner*, 79 Cal. 575, 21 P. 955 (1889); Restatement Second Property  
(*Landlord and Tenant*) Sec. 15.2, comment e. (1977); 2 *Powell on Real Property*, Sec.  
246[1], p. 372.100-372.103 (Patrick J. Rohan rev'n. ed. 1986); 49 Am. Jur. 2d,  
*Landlord and Tenant*, Sec. 414 (1970); 46 A.L.R. 847, 847 (*Transfer in Bankruptcy, or  
Otherwise in Interest of Creditors or Lien Holders, as Violating Covenant in Lease  
Against Assignment*.)
- 10 For an example of an express specific clause, see *Commercial Real Property Lease  
Practice*, § 3.114, (Cal CEB, 1975).
- 11 See note (A) to *Dumpor's Case*, 4 Coke 119B, 76 Eng. Rep. 1110, 1111 (K.B. 1578).
- 12 *Farnum v. Hefner*, 79 Cal. 575, 581, 21 P. 955 (1889); 49 Am. Jur. 2d, *Landlord and  
Tenant*, Sec. 415 (1970).
- 13 *California Packing Corp. v. Lopez*, 207 Cal. 600, 279 P. 664 (1929); 2 *Powell on Real  
Property*, Sec. 246[1], p. 372.102-372.103 (Patrick J. Rohan rev'n. ed. 1986); 4 Witkin,  
*Summary of California Law, Property*, Sec. 644 (9th ed., 1987)..
- 14 49 Am. Jur. 2d, *Landlord and Tenant*, Sec. 420 (1970).
- 15 *Burns v. McGraw*, 75 Cal. App. 2d 481, 171 P.2d 148 (1946).

- 17 *Stratford Co. v. Continental Mortgage Co.*, 74 Cal. App. 551, 241 P. 429 (1925).
- 18 *Stratford Co. v. Continental Mortgage Co.*, 74 Cal. App. 551, 553, 241 P. 429 (1925).
- 19 *Burns v. McGraw*, 75 Cal. App. 2d 481, 171 P.2d 148 (1946).
- 20 *Burns v. McGraw*, 75 Cal. App. 2d 481, 488, 171 P.2d 148 (1946).
- 21 *Miller v. San Francisco Newspaper Agency*, 164 Cal. App. 3d 315, 317, 210 Cal. Rptr. 159 (1985).
- 22 A Maryland court has held that a clause which prohibited transfers by operation of law was broad enough to cover a merger by which the tenant corporation was extinguished and the leasehold transferred to the surviving corporation by force of statute. *Citizens Bank & Trust Co. v. Barlow Corp.*, 456 A.2d 1283 (Md. 1983).
- 23 *Horning v. Ladd*, 157 Cal. App. 2d 806, 321 P.2d 795 (1958).
- 24 *Joost v. Castel*, 33 Cal. App. 2d 138, 91 P.2d 172 (1939).
- 25 *Farnum v. Hefner*, 79 Cal. 575, 21 P. 955 (1889). See also: 46 A.L.R. 847, Sec. III (*Transfer in Bankruptcy, or Otherwise in Interest of Creditors or Lien Holders, as Violating Covenant in Lease Against Assignment.*); 2 *Powell on Real Property*, Sec. 246[1], p. 372.01 (Patrick J. Rohan rev'n. ed. 1986).
- 26 *Farnum v. Hefner*, 79 Cal. 575, 577, 21 P. 955 (1889).
- 27 The principal study discusses the appropriate consent standard to apply. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 28 49 Am. Jur. 2d, *Landlord and Tenant*, Sec. 417 (1970).
- 29 *Urban Properties Corp. v. Benson*, 116 F. 2d 321 (9th Cir. 1940).
- 30 *Superior Motels v. Rinn Motor Hotels*, 195 Cal. App. 3d 1032, 241 Cal. Rptr. 487 (1987).
- 31 (West 1982).
- 32 *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 148 Cal. Rptr. 379, 582 P.2d 970 (1978); *Tucker v. Lassen Sav. & Loan Ass'n.*, 12 Cal. 3d 629, 116 Cal. Rptr. 633 (1974).
- 33 Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 34 46 A.L.R. 847, Sec. IV (*Transfer in Bankruptcy, or Otherwise in Interest of Creditors or Lien Holders, as Violating Covenant in Lease Against Assignment.*); Restatement Second Property (*Landlord and Tenant*) Sec. 15.2, comment e. (1977).
- 35 *Chapman v. Great Western Gypsum Co.*, 216 Cal. 420, 426, 14 P.2d 758 (1932). See also Restatement Second Property (*Landlord and Tenant*) Sec. 15.2, comment e. & Reporter's note 5 (1977).

Reporter's note 5 (1977).

- 36     *Airport Plaza, Inc. v. Blanchard*, 188 Cal. App. 3d 1594, fn. 2, 1599-1600, 234 Cal. Rptr. 198 (1987).
- 37     49 Am. Jur. 2d, *Landlord and Tenant*, Sec. 418 (1970).
- 38     Cal. Civ. Code Sec. 1954.1 (West 1985).
- 39     49 Am. Jur. 2d, *Landlord and Tenant*, Sec. 416 (1970); 46 A.L.R. 847, Sec. II (*Transfer in Bankruptcy, or Otherwise in Interest of Creditors or Lien Holders, as Violating Covenant in Lease Against Assignment.*); Restatement Second Property (*Landlord and Tenant*) Sec. 15.2, illus. 1 to comment e. (1977)..
- 40     See particularly 11 U.S.Code Sec. 365. There is a good summary in the Oct. 1987 Supp. to Sec. 27:100 of Miller & Starr, 4 *Current Law of California Real Estate*, and in the May 1988 Supp. to Sec. 3.114 of *Commercial Real Property Lease Practice*, p. 57-58 (Cal CEB, 1975).