

Memorandum 89-6

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--
application to residential tenancies)

The attached report from Professor Coskran discusses issues involved in whether the commercial assignment and sublease provisions developed by the Commission should be extended to residential leases.

Professor Coskran concludes that the basic Kendall rule should apply--if a residential lease requires the landlord's consent for a transfer but is silent as to the applicable standard, a reasonableness standard should be implied.

Professor Coskran believes it is not so clear whether residential tenancies should be also subject to the right of the parties to contract for absolute restrictions on transfer; he sees conflicting policies on this issue, including the inferior bargaining position of the tenant, the special nature of residential units, and the small bonus value ordinarily associated with residential tenancies. He suggests it may be useful for this purpose to distinguish between long and short term tenancies, between small rental units and large complexes, and between rent-controlled and open market properties.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary



LAW REV. COMM'N

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California Law Revision Commission
4000 Middlefield Road, Suite D-2
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FM BILL COSKRAN
DT 11/17/88

RE APPLICATION OF CONCLUSIONS TO RESIDENTIAL TENANCIES.
Study H-111. RESTRICTIONS ON LEASE TRANSFERS: VALIDITY AND
RELATED REMEDIES ISSUES.

Dear Nat:

Since some Commission members indicated the possibility that they might want to consider the application of the proposed legislation to residential tenancies, I have tried to get some response from practitioners, and I have expanded the short section of the study dealing with residential tenancies.

I have solicited opinions from about fifty real property lawyers (members of the State Bar Association Real Property Section Executive Committee, members of the Los Angeles County Bar Association Real Property Section Executive Committee, the Northern and Southern California Chairs of the Landlord/Tenant Subsection and the Commercial and Industrial Development Subsection of the State Bar Real Property Law Section, and a few others.) In addition, Tony White, chair of the Landlord/Tenant Subsection, has actively pressed for comments from his Subsection members. The Subsection does not at this point have an official "consensus" position, but the individual comments of its members can help identify the issues.

I have received comments from Kenneth Brans, Brian Back, Thomas Perkins and Richard Snyder. They are enclosed.

I have modified and expanded the study Section XVI ("Residential Leases") to raise the factors that I think should be taken into consideration. The revised section is attached.

Best regards,



WM. G. COSKRAN

Revision of Sec. XVI of Restrictions on Lease Transfers: Validity and Related Remedies Issues.

Replaces pages 103-106.

XVI. RESIDENTIAL LEASES.

This study is limited to non-residential leases. However, certain general observations can be made concerning residential tenancies.

A. Uncertainty

The rules applicable to assignment and sublease restrictions in residential tenancies in California are even less certain than those applicable to non-residential leases. The Kendall decision implied a requirement of reasonableness into a "silent consent standard" type clause in a commercial lease. Thus, a reasonableness standard will be imposed when a clause requires the lessor's consent but does not expressly state a governing standard. The court expressly refrained from deciding whether its opinion should be extended to residential tenancies.¹ It is interesting to note that of the four statutes referred to by the court as imposing a reasonableness standard on lessors, three apply to residential tenancies only and the fourth applies to residential and other types of leases.² The Kendall court relied heavily on the Wellenkamp loan security case in reaching its conclusion, and that case involved residential property. However,

the characteristics of a residential loan and a residential tenancy are typically quite different. For example, a loan generally involves a long term relationship and a residential tenancy a short one. Thus, there is a considerable difference in the duration and impact of a transfer restriction.

There is dictum in the Schweiso case, an earlier court of appeal decision, that the court saw no significant difference between a residential and a commercial lease when dealing with obligations of good faith and commercial reasonableness. However, the court limited its adoption of a reasonableness standard to commercial leases.³ So far, no reported California decision has dealt specifically with a residential lease. There is no clearcut pattern in out of state cases since most of them involve commercial leases.

B. Consumer Protection

Generally, there is stronger concern for "consumer" protection when dealing with a tenancy for housing than there is when dealing with a commercial lease for business operations.⁴ It has been argued that the common law and majority rule operates unfairly on residential tenants when there is a housing shortage, and that implication of a sole discretion standard into the "Silent Consent Standard" clause does not meet the reasonable expectations of a residential tenant.⁵ Residential tenants

generally do not hire a lawyer to advise and negotiate concerning the terms of the residential tenancy. The amount of rent is the major concern, and I think it is reasonable to assume that there is usually little bargaining over the other terms of the tenancy. A residential tenant is typically unconcerned about transfer restrictions at the time of entering into a lease, and thus does not actively bargain over them.⁶ If the residential rental occurs at a time and place of unit shortages, there is little practical bargaining power.

When a clause requires the lessor's consent but fails to express the standard governing that consent, there are two basic choices for a standard: reasonableness or sole discretion. In the absence of express language to the contrary, it seems likely that most residential tenants would expect a reasonableness standard. Since the lessor generally has drafting control, it is a minimal burden to require a lessor desiring a sole discretion consent standard to expressly state it. If a lessor is required to use express provisions to avoid a reasonableness standard, language of sole discretion or absolute prohibition will probably become commonplace. A tenant who reads the agreement will have notice of the broad restriction, but will likely have little incentive or power to insist on a reasonableness standard.

C. Short Term

Residential tenancies are typically short term or on a month to month basis. If the tenancy is for a fixed term, it is seldom for more than one year. When longer terms are involved, they are usually for a single family residence (free standing or condominium). A local rent control ordinance that prohibits the lessor from terminating a tenancy except for "just cause" can obviously convert a short term tenancy into a long one. The impact of a rent control ordinance is considered separately below.

Transferability of the leasehold is an important economic factor to most commercial tenants, and one that should be carefully considered at the time of entering into a commercial lease. However, in a short term residential tenancy, it is unlikely that a significant "bonus value" (difference between the agreed rent and the market rental value) will build up. Thus, it is unlikely that a short term residential tenant will be concerned about the ability to reap the benefit of this bonus value by receiving consideration from a third party assignee or subtenant. Also, a lessor in this situation is not likely to be concerned about getting the bonus value upon a transfer because the rent can be raised to the market in the short term whether there is a transfer or not. For example, a "Profit Sharing" or "Possession Recovery" type of a transfer clause would not likely be worth the time it takes to draft and enforce it.

The short term nature of a residential tenancy reduces the problems faced by a tenant who wants to move, and thus reduces the need to transfer. If a month-to-month tenant wishes to get out of the agreement, a short time notice (typically 30 days) will do the job. A residential tenant who enters into a fixed short term tenancy (e.g. a one year lease) and later decides to move will generally have a relatively short term remaining. If the tenant elects to get out by breaching the lease and abandoning the premises, the tenant will have a relatively short time left on the term for exposure to damages under Cal. Civ. Code Sec. 1951.2, and that section provides for an offset of "reasonably" avoidable rent losses. If the lessor keeps the lease in effect by using the "lock-in" remedy under Cal. Civ. Code Sec. 1951.4, the lessor is subject to a mandatory reasonableness standard.

Since the lessor is able to recover possession after a relatively a short time due to expiration of a fixed term or termination of a periodic tenancy (absent rent control limitations), there may be less need for absolute control over transfer in the interim. However, when an unlawful detainer action is involved to recover possession, a mandatory reasonableness standard could cause a lessor additional problems when faced with an unconsented "Arrieta" occupant.⁷

When a short term tenancy is involved, the duration of the transfer restraint is limited and has less practical impact than

in a long term lease. Also, it seems that resolving a dispute over reasonableness by litigation is generally impractical in a short term tenancy.

D. Type of Property

The degree of tolerable control may depend upon the type of residential property subject to the tenancy. One's attitude toward transfer restrictions in a residential lease can shift dramatically depending on the nature of the transaction. Suppose you have a nice single family residence which has served as your family nest since you personally designed and built it. It is filled with unique furnishings collected over the years. You have been temporarily transferred or you are planning an extended trip and need to rent your home, furnished, to provide income for loan payments, taxes, insurance and maintenance. You select your tenant according to your own personal standards, preferences and instincts. Should you be required to have a "commercially reasonable objection" to prevent a transfer by this tenant? In some situations, the lessor, as well as the tenant, may be considered to be in need of consumer protection.

On the other hand, suppose that a major apartment development and management company owns hundreds of virtually identical apartment units throughout the state, with professional on-site management and security. Do you mind imposing a reasonableness standard on that lessor?

The Restatement recognizes the distinction between these two situations when applying a reasonableness standard. It points out that "(a) reason may be reasonable in relation to residential property that is the personal home of the landlord that would not be reasonable as to other residential property."⁸

If the validity and scope of a transfer restriction depends upon the type of residential property involved, it is difficult to make clear distinctions that can be easily applied. There are a variety of situations where legislation has made a distinction between one to four unit residential transactions and other residential transactions.⁹ This would cover the hypotheticals posed above, and it might be a reasonable, although less than perfect, compromise distinction.

E. Mobilehomes

The expense and difficulty of moving a mobilehome put mobilehome site tenancies in a distinct category. The lessor's ability to restrict transfer of the tenancy is strictly limited when title to the mobilehome is transferred. The limitations are contained in a separate article of the comprehensive "Mobilehome Residency Law", particularly in Cal. Civ. Code Sections 798.73-798.74 (sale of mobilehome), 798.78 (death transfer and later sale), and 798.79 (foreclosure transfer and later sale). It seems that these limitations should be preserved due to the unique nature of the mobilehome tenancies.

F. Continuing Liability

A tenant who assigns or sublets to a third party remains liable to the lessor for breaches of the tenancy obligations in the absence of a release, and a lessor's consent to the transfer is not a release. If the tenant can terminate the tenancy without breach, the typical residential tenant is better off terminating the tenancy rather than risking continuing exposure to liability related to premises no longer controlled by the tenant. Thus, a "freedom to transfer" may be an illusory benefit for most tenants, and a trap for some who transfer to a person who turns out to be irresponsible.

The degree of protection provided to the lessor by this continuing liability depends on the continued availability and solvency of the original tenant.

G. Rent Control

A rent control ordinance which strictly limits the lessor's ability to terminate a tenancy, or ability to decline to renew it, dramatically changes the potential term of a residential lease. When a local jurisdiction adopts rent control, it is likely to include some form of "just cause" limitations on the lessor's power to end the tenancy (e.g. rent default, extensive

rehabilitations, move-in by lessor or family, etc.). These limitations restrict the lessor's power to terminate the tenancy, but typically leave the tenant free to terminate it.

If a lessor were to be subjected simultaneously to a "just cause" limit on termination, and a mandatory reasonableness standard on tenant transfers, the result would be a rather unique tenancy. A typical monthly periodic tenancy would become an indefinitely long term tenancy (theoretically perpetual), with occupants chosen by successive tenants. The tenant would have the unilateral right to terminate on thirty days notice without cause.

A tenant enjoys the benefits of a bonus value (here, the difference between the controlled rental and a free market rental) while occupying the premises. This serves the basic purpose of the controlled rentals, and it does not seem necessary to go further and limit the lessor's ability to restrict transfers by the tenant.

One type of ordinance allows the lessor to raise the rent to the market rent when the tenancy terminates and the unit is relet. Suppose that a lessor could not prevent transfer, and a tenant could transfer the unterminated tenancy at the same controlled rental. The original tenant, who no longer occupies the unit, could receive profit in the amount of the bonus value from the third party. The new transferee occupant, by paying an

"assignment fee" or sublease rent to the original tenant, would pay more than the controlled rental. The lessor would lose the ability to catch the rent up to the free market rental.

Under another type of ordinance, the rent remains controlled even when the tenancy terminates and the unit is relet. The lessor cannot require a higher rent from the new occupant whether the former tenancy is terminated or transferred. In theory, the new occupant does not have to "buy" the bonus value from the present tenant because the new occupant will be protected by the rent ceiling under a new tenancy. In practice, if there is a shortage of rent controlled units available, an existing tenant may be able to "sell" his position if the lessor cannot restrict transfers.

Obviously, there are ways a rent control ordinance can be designed to deter a windfall profit to the vacating tenant at the expense of the new occupant and the owner. However, the point is that free transferability by the tenant is not necessary to accomplish the public purpose of rent control, and in some instances it might be counterproductive.

H. Basic Issues

This study contains several conclusions, summarized in Section XVII, concerning the validity and interpretation of transfer restrictions in non-residential leases. Underlying the conclusions are two basic issues that will need to be resolved with respect to residential tenancies.

First, absent express language in the agreement to the contrary, should a lessor who objects to a transfer be held to a reasonableness consent standard? In other words, if the lessor wishes to have a sole discretion standard apply, should that be required to be express in the agreement? If there is no language expressing a different standard, it seems that a reasonableness standard conforms to the likely expectations of a residential tenant. A requirement to expressly disclose a sole discretion standard to a residential tenant is a minimal and reasonable burden.

Second, should the lessor be able to contract away the reasonableness standard in a residential tenancy? In other words, should there be a mandatory reasonableness standard or should the express language of the transfer restriction govern? Here there is a more difficult balancing of policies.

The general approach of the conclusions regarding restrictions in non-residential leases is to require disclosure by express agreement, and to allow enforcement of expressly agreed strict restrictions on transfer according to their terms. The following policy issues will have to be resolved:

(1) Is there a compelling policy reason to depart from this approach when a residential tenancy is involved?

(2) If a different approach is adopted (for example, a mandatory reasonableness standard):

(a) Should there be a distinction based on the duration of the tenancy?

(b) Should there be a distinction based on the type of residential property involved?

(c) Should there be special provisions for tenancies subject to rent control?

- 1 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, fn. 1 at p. 492, 220 Cal. Rptr. 818, fn. 1 at p. 820.
- 2 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, fn. 13, at p. 499, 220 Cal. Rptr. 818, fn. 13, at p. 825 (1985).
- 3 *Schweiso v. Williams*, 150 Cal. App. 3d 883, fn. 3, at p. 886, 198 Cal. Rptr. 238, fn. 3, at p. 840 (1984), modified at 151 Cal. App. 3d 776c.
- 4 For example, see Cal. Civ. Code Sec. 1671 (West 1985), concerning liquidated damages, and Secs. 1941-1942.5 (West 1985 & West Supp. 1988) concerning habitability and retaliation.
- 5 Note, *Effect of Leasehold Provisions Requiring The Lessor's Consent to Assignment*, 21 Hastings L.J. 516 (1970).
- 6 Rohan, 7 *Current Leasing Law & Techniques*, Sec. 5.01 at p. 5-10.1 (1987).
- 7 *Arrieta v. Mahon*, 31 Cal.3d 381, 182 Cal.Rptr. 770 (1982). Cal. Code of Civ. Proc. Secs. 715.020(d) and 1174.3.
- 8 Restatement Second Property (*Landlord and Tenant*) Sec. 15.2, comment g. & illus. 8 at p. 105-106 (1977).
- 9 For example: Cal Code of Civ. Proc. Sec. 580(b) (West 1976) (anti-deficiency protection on third party loan); Cal. Civ. Code Sec. 1102 (West Supp. 1988) (sale and other transfer disclosures); Cal. Civ. Code Sec. 1675 (West 1985) (strict limitations on liquidated damages); Cal. Civ. Code Sec. 2373(j) (West Supp. 1988) (broker agency disclosures); Cal. Civ. Code Sec. 2924(i) (West Supp. 1988); Cal. Civ. Code Sec. 2956 (West Supp. 1988) (disclosures in residential real property credit sales).