

Memorandum 90-4

Subject: Study H-112 - Commercial Lease Law (Use Restrictions--draft of tentative recommendation)

At the December meeting the Commission made initial policy decisions toward a tentative recommendation for legislation governing use restrictions in commercial real property leases. Attached to this memorandum is a staff draft of a tentative recommendation to implement the Commission's decisions. The draft parallels the statute on assignment and sublease restrictions.

The staff has only three items it wishes to bring to the Commission's attention:

(1) The draft is limited to use restrictions in commercial leases. Although it appears that residential leases could also be covered without harm, we have not done so, consistent with the Commission's decision on assignment and sublease restrictions.

(2) The matter of interrelation of use restrictions with remedies for breach we have treated in new Section 1997.040, rather than amending the individual remedies statutes. Although this arrangement is slightly awkward, we deem it preferable to tampering with the rather intricate and self-contained remedies statutes.

(3) The Commission decided that in determining possible mitigation of damages after the tenant's breach, the landlord is entitled to damages based on the use of the premises as restricted by the lease. The Commission did not consider the situation where the tenant has breached and abandoned and the landlord has relet the premises for a purpose that would have been restricted under the old lease. In this situation, the staff thinks the particular use restriction should no longer be relevant in computing the landlord's damages, the landlord having in effect waived the restriction, and we have added a Comment to this effect in Section 1997.040.

Respectfully submitted,

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#H-112

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12/15/89

Tentative Recommendation
relating to
COMMERCIAL REAL PROPERTY LEASES:
Use Restrictions

The California Supreme Court case of *Kendall v. Ernest Pestana, Inc.*¹ held that if a clause in a lease of commercial real property requires the landlord's consent for an assignment or sublease but fails to express a standard for giving or withholding consent, the clause must be construed to include an implied standard that the landlord's consent will not unreasonably be withheld. This holding has now been codified on recommendation of the Law Revision Commission² for leases executed on or after September 23, 1983, and overruled for leases executed before that date.³

The reasoning in the Supreme Court's opinion raises the question whether other lease clauses that require the landlord's consent but that fail to express a standard for giving or withholding consent will also be held to require reasonableness. Of the other consent clauses typically found in commercial leases, those restricting use of the leased property without the landlord's consent are the most closely related to assignment and sublease clauses and are probably the most common. An assignment or sublease restriction may be used as a means to control a change in use; a use restriction may be used to void an undesired assignment or sublease.

The dual bases of the Supreme Court's *Kendall* ruling--the rule against unreasonable restraints on alienation and the implied covenant

1. 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P. 2d 837 (1985).

2. *Recommendation Relating to Commercial Real Property Leases: Assignment and Sublease*, 20 Cal. L. Revision Comm'n Reports 251 (1989).

3. Civil Code §§ 1995.260-.270.

of good faith and fair dealing--apply somewhat differently to use restrictions than they do to assignment and sublease restrictions.⁴ A use restriction is not a direct restraint on alienation, although it clearly affects the ability of the tenant to make a transfer of the tenant's interest. A use restriction requiring the landlord's consent directly involves the implied covenant of good faith and fair dealing. Whether these varying considerations would yield the same result in the courts for use restrictions as for assignment and sublease restrictions is not clear.

The Law Revision Commission believes that the uncertainty in the law governing use restrictions caused by the *Kendall* decision, together with the high frequency of use restrictions and their interrelation with assignment and sublease restrictions, makes further codification of this area of the law important. The Commission believes public policy mandates that use restrictions be treated statutorily the same as assignment and sublease restrictions.⁵ Specifically, the Commission makes the following recommendations with respect to use restrictions in commercial real property leases:

(1) Absent a use restriction in the lease, the tenant should have unrestricted use of the leased property.⁶

(2) The parties to a lease should be able to include an enforceable use restriction, subject to the overriding public policies that the use restriction not be discriminatory or otherwise illegal and that the contract not be unconscionable or a contract of adhesion.⁷

4. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 532-548 (1989).

5. Civil Code §§ 1995.010-.270.

6. This would codify the common law. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 535-536 (1989).

7. See, e.g., Civil Code § 53(a) ("every restriction or prohibition as to the use or occupation of real property because of the user's or occupier's sex, race, color, religion, ancestry, national origin, or blindness or other physical disability is void").

(3) A use restriction should be strictly construed in favor of unrestricted use.⁸

(4) The parties to a lease should be able to absolutely prohibit a change in use, or to require that there be no change in use without the landlord's consent, with or without express standards for giving or withholding consent.

(5) If the lease requires the landlord's consent without providing express standards for giving or withholding consent, the landlord should be subject to an implied requirement of reasonableness, consistent with the rule governing assignment and sublease restrictions.⁹ Because this would represent a change in the law on which parties to leases have relied, the new rule should apply only to leases executed after the operative date of the new law.

(6) If the lease requires the landlord's consent and provides express standards for giving or withholding consent, the express standards should be enforceable by their terms, including a provision that the landlord has sole and absolute discretion to give or withhold consent. Such a provision should be exempt from any implied standard of commercial reasonableness since it does not create an implication that the landlord will not be arbitrary. The parties might negotiate such a provision because the landlord needs to be able to exercise the landlord's best business judgment without being subject to second-guessing by the tenant and the courts.

(7) In case of termination of a lease for the tenant's breach, the tenant should be able to require mitigation of the landlord's damages¹⁰ based on any reasonable use of the premises if the lease contains no use restriction, and based on restricted use of the premises if the lease contains a use restriction.

8. This would codify the common law. See Coskran, Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers, 22 Loy. L.A.L. Rev. 405, 535-536 (1989).

9. Civil Code § 1995.260.

10. See Civil Code § 1951.2.

(8) In case the landlord continues a lease in effect notwithstanding the tenant's breach,¹⁰ the tenant should have the right to assign or sublet for any reasonable use of the premises if the lease contains no use restriction, and to assign or sublet for restricted use of the premises if the lease contains a use restriction.

The Commission's recommendations would be implemented by enactment of the following measure.

10. See Civil Code § 1951.4.

Civil Code §§ 1997.010-1997.270 (added). Use restrictions

Chapter 7 (commencing with Section 1997.010) is added to Title 5 of Part 4 of Division 3 of the Civil Code, to read:

CHAPTER 6. USE RESTRICTIONS

Article 1. General Provisions

§ 1997.010. Scope of chapter

1997.010. This chapter applies to a restriction on use of leased property by a tenant under a lease of real property for other than residential purposes.

Comment. Section 1997.010 limits the scope of this chapter to commercial real property leases. Use restriction issues concerning personal property leases and residential real property leases may involve different public policies than commercial real property leases, and therefore are governed by the common law and not by this chapter.

§ 1997.020. Definitions

1997.020. As used in this chapter:

(a) "Landlord" includes a tenant who is a sublandlord under a sublease.

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

(c) "Restriction on use" means a provision in a lease that restricts the use of leased property by a tenant, whether by limiting use to a specified purpose, mandating use for a specified purpose, prohibiting use for a specified purpose, limiting or prohibiting a change in use, or otherwise.

(d) "Tenant" includes a subtenant or assignee.

Comment. Section 1997.020 provides definitions for drafting convenience.

Subdivision (b) is consistent with Section 1997.010 (scope of chapter). A restriction separately agreed to by the parties that affects a lease is part of the lease for purposes of this 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.

Under subdivision (c), this chapter does not apply to a restriction on use unless the restriction is expressly provided in the lease (as defined in this section).

§ 1997.030. Use restriction for illegal purpose not authorized

1997.030. Nothing in this chapter authorizes a restriction on use that is otherwise prohibited by law.

Comment. Section 1997.030 makes clear that this chapter is not intended to validate a restriction on use that serves an illegal purpose. See, e.g., Civil Code § 53(a) ("every restriction or prohibition as to the use or occupation of real property because of the user's or occupier's sex, race, color, religion, ancestry, national origin, or blindness or other physical disability is void"). However, the chapter is intended to govern a restriction on use notwithstanding any contrary implication in the law governing unreasonable restraints on alienation or the implied covenant of good faith and fair dealing. See Section 1977.210 and its Comment.

§ 1997.040. Effect of use restriction on remedies for breach

1997.040. (a) For the purpose of subdivision (a) of Section 1951.2 (damages on termination for breach), the amount of rental loss that could be or could have been reasonably avoided is computed by taking into account any reasonable use of the leased property except to the extent the lease includes a restriction on use that is enforceable under this chapter.

(b) The remedy described in Section 1951.4 (continuation of lease after breach and abandonment) is available notwithstanding the presence in the lease of a restriction on use of the leased property, and the restriction on use applies under Section 1951.4 to the extent it is enforceable under this chapter.

Comment. Subdivision (a) of Section 1997.040 makes clear that absent an enforceable use restriction the tenant is entitled to the benefit of mitigation under Section 1951.2 that would be achieved by devoting the leased property to any reasonable use. A reasonable use, for this purpose, must be lawful and not materially different from that for which the premises are ordinarily used or for which they were constructed or adapted. See Coskran, Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers, 22 Loy. L.A.L. Rev. 405, 535-536 (1989). Thus if the tenant could have changed the use without the landlord's consent, or is limited only by a requirement for the landlord's reasonable consent, the tenant is entitled to have a possible reasonable change in use considered as one of the factors in determining the reasonably avoidable rental loss.

Subdivision (a) also makes clear that an enforceable use restriction may not be ignored in determining the extent of the landlord's obligation to mitigate following termination of the lease for the tenant's breach. Thus, if the tenant could not have changed the use because the terminated lease contained a restriction on use that was absolute or subject to the landlord's consent in the landlord's sole and absolute discretion, the landlord is not required to give up the bargained-for benefit in order to reduce the damages to the breaching tenant. However, if the landlord in fact relets for a purpose that would have violated the use restriction, the reletting is in effect a waiver of the use restriction for that purpose and the tenant is entitled to have that purpose taken into account in the computation of damages.

Subdivision (b) makes clear that the landlord's use of the remedy provided in Section 1951.4 does not limit enforceability of a use restriction that is otherwise enforceable. Thus if the lease allows the tenant to change the use without restriction or with the landlord's reasonable consent, the transferee would have the same freedom and limitations. If a use restriction absolutely prohibits change, or gives the landlord sole and absolute discretion to prevent change, both the tenant and transferee have to conform to those restraints.

§ 1997.050. Transitional provision

1997.050. Except as provided in Section 1997.270, this chapter applies to a lease executed before, on, or after January 1, 1992.

Comment. Section 1997.050 makes clear that this chapter is intended to be applied to existing leases as well as to leases executed after its operative date. An exception is made in the case of the rule of Section 1997.260 (implied standard for landlord's consent), which only applies to leases executed on or after January 1, 1992. See Section 1997.270 (limitation on retroactivity of Section 1997.260).

Article 2. Use Restrictions

§ 1997.210. Right of unrestricted use absent a restriction

1997.210. (a) Subject to the limitations in this chapter, a lease may include a restriction on use of leased property by a tenant.

(b) Unless the lease includes a restriction on use, a tenant's rights under a lease include unrestricted use of leased property.

Comment. Subdivision (a) of Section 1997.210 is a specific application of general principles of freedom of contract. Subdivision (a) is limited by the other provisions of this chapter. See, e.g., Sections 1997.030 (use restriction for illegal purpose not authorized) and 1997.260 (implied standard for landlord's consent). Neither the law governing unreasonable restraints on alienation nor the law governing the implied covenant of good faith and fair dealing prevents

the enforcement of a restriction on use in accordance with the express terms of the restriction. It should be noted, however, that subdivision (a) remains subject to general principles limiting freedom of contract. See, e.g., 1 B. Witkin, Summary of California Law Contracts §§23-36 (9th ed. 1987) (adhesion and unconscionable contract doctrines).

Subdivision (b) codifies the common law rule that a tenant has unrestricted use of the leased property unless the right is expressly restricted by the parties.

§ 1997.220. Use restriction strictly construed

1997.220. An ambiguity in a restriction on use of leased property by a tenant shall be construed in favor of unrestricted use.

Comment. Section 1997.220 codifies the common law.

§ 1997.230. Prohibition of change in use

1997.230. A restriction on use of leased property by a tenant may absolutely prohibit a change in use.

Comment. Section 1997.230 settles the question of the validity of a clause absolutely prohibiting change in use of the leased property by the tenant. A lease term absolutely prohibiting change in use is not invalid as a restraint on alienation. Such a term is valid subject to general principles governing freedom of contract, including the adhesion contract doctrine, where applicable. See Section 1997.210 and its Comment (right of unrestricted use absent a restriction).

§ 1997.240. Use restriction subject to standards and conditions

1997.240. A restriction on use of leased property by a tenant may provide that a change in use is subject to any express standard or condition.

Comment. Section 1997.240 is a specific application of subdivision (a) of Section 1997.210 (lease may include use restriction). This section does not apply, and Section 1997.250 does apply, to a restriction on use of the leased property by a tenant that requires the landlord's consent for a change in use. Section 1997.240 is subject to general principles limiting freedom of contract. See Section 1997.210 and its Comment.

§ 1997.250. Express standards and conditions for landlord's consent

1997.250. A restriction on use of leased property by a tenant may require the landlord's consent for a change in use subject to any express standard or condition for giving or withholding consent, including, but not limited to, any of the following:

(a) The landlord's consent may not be unreasonably withheld.

(b) The landlord's consent may be withheld subject to express standards or conditions.

(c) The landlord has sole and absolute discretion to give or withhold consent.

Comment. Section 1997.250 is a specific application of the broad latitude provided in this chapter for the parties to a lease to contract for express restrictions on use of the leased property by the tenant. Such restrictions on change in use are valid subject to general principles governing freedom of contract, including the adhesion contract doctrine, where applicable. See Section 1997.210 and its Comment (right of unrestricted use absent a restriction).

The meaning of "unreasonably withheld" under subdivision (a) is a question of fact that must be determined under the circumstances of the particular case, applying an objective standard of commercial reasonableness as developed by case law.

Subdivision (b) makes clear that the lease may condition the landlord's consent in any manner.

Subdivision (c) settles the question of the validity of a clause granting sole and absolute discretion over change in use to the landlord. A lease clause of the type described in subdivision (c) is not invalid as a restraint on alienation, and its exercise by the landlord is not a violation of the law governing good faith and fair dealing.

§ 1997.260. Implied standard for landlord's consent

1997.260. If a restriction on use of leased property by a tenant requires the landlord's consent for a change in use but provides no standard for giving or withholding consent, the restriction 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, in response to the tenant's written request for a statement of reasons for withholding consent, the landlord has failed, within a reasonable time, to state in writing a reasonable objection to the change in use.

Comment. Section 1997.260 is new. For an analogous provision, see Section 1995.260 (assignment and sublease). The retroactive application of Section 1997.260 is limited by Section 1997.270.

Under Section 1997.260, whether a landlord's consent has been unreasonably withheld may be a question of procedure or substance or both. A landlord may act unreasonably in responding to a request of the tenant for consent to a change in use (for example by delaying or

failing to respond or by requiring excessive investigation charges), or the landlord may not have a reasonable objection to the change in use. Either of these circumstances may give rise to a determination that the landlord has unreasonably withheld consent to the change in use within the meaning of this section.

This section provides the tenant a means of satisfying the burden of proof on this matter by making a written request for a statement of reasons. However, this is not the exclusive means of satisfying the burden of proof that the landlord's consent has been unreasonably withheld in a particular case, and proof of unreasonableness may be made by other means.

Section 1997.260 rejects an absolute approach to the question of commercial reasonableness. Whether a particular objection is reasonable within the meaning of this section is a question of fact that must be determined under the circumstances of the particular case, applying an objective standard of commercial reasonableness as developed by case law.

§ 1997.270. Limitation on retroactivity of Section 1997.260

1997.270. (a) Section 1997.260 applies to a restriction on use executed on or after January 1, 1992. If a restriction on use executed before January 1, 1992, requires the landlord's consent for a change in use of leased premises by a tenant but provides no standard for giving or withholding consent, the landlord has sole and absolute discretion to give or withhold consent.

(b) For purposes of this section, if the terms of a restriction on change in use are fixed by an option or other agreement, the restriction on change in use is deemed to be executed on the date of execution of the option or other agreement.

Comment. Section 1997.270 limits the retroactive application of Section 1997.260 (implied standard for landlord's consent). The date of applicability of Section 1997.260 is January 1, 1992. If there is a sublease on or after January 1, 1992, under a lease executed before that date, the rights as between the parties to the sublease are governed by Section 1997.260. See Section 1997.020(b) ("lease" means lease or sublease).

Limitation of retroactive operation of Section 1997.260 is supported by the public policies of foreseeability, reliance, and fairness.

Nothing in this section is intended to limit the law governing modification or waiver of a lease provision by subsequent conduct or agreement of the parties, including modification or waiver of a restriction on use that expressly or impliedly permits the landlord's consent to be unreasonably withheld, whether the lease was executed before or after January 1, 1992. See also Section 1995.020(b) ("lease" includes modifications and other agreements affecting lease). Thus, a tenant may show that the landlord's sole and absolute discretion to

give or withhold consent pursuant to an express or implied lease restriction executed before January 1, 1992, has been modified or waived.