#H-111

ns95
05/16/90

First Supplement to Memorandum 90-49

Subject: Study H-111 - Remedies for Breach of Assignment or Sublease Covenant (Comments on Tentative Recommendation)

We have received letters from Ronald P. Denitz of Tishman Companies (Exhibit 1) and from our consultant, Professor William G. Coskran (relevant portion of letter reproduced in Exhibit 2), commenting on the issues raised concerning remedies for breach of an assignment or sublease covenant.

General Comments

Mr. Denitz agrees with the Commission's tentative recommendation as it stands, and would not make any changes in it with one exception noted below. "The statement of remedies in the Tentative Recommendation are fair, reasonable and bilateral. Please do not alter them other than for a validation of the already recognized proposition of law that the parties may be contract negotiate such remedies."

Professor Coskran refutes the allegation that the tentative recommendation is biased in favor of landlords, pointing out the ways in which it improves the position of tenants. In general, Professor Coskran's reaction to the comments in Memorandum 90-49 is similar to that of Mr. Denitz, but Professor Coskran gives additional reasons for not changing the Commission's recommendation.

§ 1995.300. Remedies subject to express provision in lease

In Memorandum 90-49 the staff proposes the addition of a provision that codifies the general rule that the parties to a contract may negotiate the remedies to be applied in case of a breach. Mr. Denitz agrees with this addition. Professor Coskran likewise believes it is important to make clear that the statutory remedies for breach may be altered by the parties.

§ 1995.310. Tenant's remedies for landlord's breach

In Memorandum 90-49 the staff suggests a statement in the Comment that where the landlord's wrongful conduct involves a tort, tort damages (including punitive damages where appropriate) may be available:

> The landlord's wrongful conduct may, in addition to a breach of contract, involve a tort (e.g., interference with contract or prospective economic advantage, or trespass) and warrant tort damages, including punitive or exemplary damages where appropriate. Other remedies for breach of a lease may include statutory remedies. The tenant may also transfer without the landlord's wrongfully withheld consent.

Mr. Denitz disagrees with this addition. He believes the added language could be used to support arguments that wrongful refusal to consent to an assignment or subletting is in and of itself a tort. "The fact of a possible tort of interference with the sale of tenant's business (which is at best doubtful as a tort) does not need nor desire commentary as to what kinds of tort damages may or may not be available to wounded parties: the Commission's Study is of lease (contract) remedies and should not gratuitously stray into the tort area."

Professor Coskran does not address the issue of expansion of the Comment, but believes the statute should not deal with this matter. The intrusion of tort remedies in the contract area is fraught with danger; it is "an issue which deserves thorough study and deliberation in the broad context of contracts generally. I think piecemeal tinkering with it would not be prudent."

§ 1995.330. Application of remedies to assignee or subtenant

The issue is raised in Memorandum 90-49 whether the landlord should be able to terminate a wrongful assignment or sublease without terminating the lease itself. Section 1995.330(c) would allow the landlord to do this.

Mr. Denitz states that the ability to do this is essential for a landlord, and Tishman's leasing practice and forms so provide. "It would be manifestly unfair to force Landlord to choose between (i) an onerous subtenant or assignee and (ii) an empty space."

Professor Coskran notes that this remedy is important because the parties may have written a clause precluding assignment or sublease in order to avoid litigation over whether the proposed assignee or

subtenant is suitable. In addition, tenants may benefit from this remedy as well as landlords. "Are defaulting tenants generally going to be better off by eliminating the subsection (c) remedy and thus forcing the lessor to a termination & damages remedy?"

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

EXHIBIT 1

Tishman West Companies

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May 11, 1990

California Law Revision Commission
4000 Middlefield Rd., Suite D-2
Palo Alto, CA 94303-4739

Re: Study H-111 - Remedies for Breach of Assignment or Sublease Covenant (Memorandum 90-49)

Gentlemen:

Having continuously followed and having had the privilege of working with you on commercial leasing matters since 1969 and having closely followed your deliberations concerning the subject matter of Professor Coskran's Study and the three Tentative Recommendations resulting therefrom, I respectfully urge that the Commission submit the captioned Tentative Recommendation to the Legislature unchanged as to substance. We have, however, no objection to the addition of Section 1995.300 (which would make the statutory remedies subject to express lease-drafted provisions) inasmuch as the Staff correctly Comments the general California rule that the parties to a contract may negotiate remedies.

As further amplified in my letter to you of even date regarding Use Restrictions (Study H-112), my 22 years of experience of "in the field" negotiation and draftsmanship, as well as coping with real-world controversies between Landlord and tenant (before, during and after negotiation, occupancy and breach) validate in every way that:

(a) The free and successful flow of commerce requires that there be freedom of contract between Landlord and tenant with respect to the Remedies as well as with regard to substantive rights and obligations of the parties;

(b) The remedies favoring, equally, Landlord and tenant contained in the Tentative Recommendation very closely parallel the pattern of leasing which we propose to our prospective tenants, which tenants both large and small negotiate, and which expeditiously solve problems of breach, oftentimes (happily) without litigation;

(c) The "lock-in" remedy of Section 1951.4 which we uniformly include in our leasing and which (throughout the hundreds of leases, both large and small, with tenants of every kind and nature from the largest to the smallest and from the single individual upward to

the giant corporations, accept the lock-in remedy without (to my knowledge) any modifications or dispute; and

(d) We have always regarded California law as not following the "Rule in Dumpor's Case" and have uniformly (and, I might add, successfully) included in our Consents to Sublease letter agreements a provision forbidding further assignment or subletting or underletting by the subtenant: Throughout these many years of my practice at Tishman, only a very few proposed subtenants have sought to negotiate those restrictions (and those negotiations have been almost uniformly limited to requests by a large corporate proposed subtenant that a reasonable assignment of sublease be permitted in the event of merger, consolidation, corporate reorganization or a "parent/child" future transfer.

As the Commission will observe from my further correspondence regarding studies H-112 (Use Restrictions) and H-113 (Reconsideration of Kendall Legislation), the objections of Ernest E. Johnson, Esq. of Overton, Lyman & Prince, ignores the already-enacted statutes concerning the Kendall case and the legislative will that Landlord and tenant be free to contract against assignment or subletting or both.

The practical operation of the field of restrictions on assignment and subletting is, with due regard for Mr. Johnson's claimed length of experience, almost precisely the opposite of the Chamber of Horrors which he projects where the tenant dies or the tenant merges or an incorporation occurs or a partnership composition changes or an owner decides to retire and sell to his employees:

(a) the last thing that most Landlords want is an empty premises or a money judgement against judgement-proof widows or orphans;

(b) in most mergers and partnership incorporations and changes the resultant tenant-party is, as a matter of practicality, stronger than the prior tenant, but we need enforceable knowledge of precisely who is involved (and only restrictions can force the tenant to make full disclosure), and

(c) We are not the type of Landlord or Landlord's agent (despite the fact that me manage so many buildings [the same being in excess of 50 in California]) that would try to grind a widow or be interested in

> litigation both expensive and disruptive unless a proposed change in the identity of the real parties and interest (on the tenant's side) would result in a manifestly undesirable or dangerous or immoral or revolutionary type of party-tenant coming into possession through the use of the "back-door" type of approach.

Additionally, for the purposes of the Remedies of Landlord where a tenant attempts an unauthorized assignment or subletting it is essential that Landlord be able to (and our leasing practice and lease forms provide) Landlord need not terminate the entire lease but rather may declare the purported assignment or sublease void. It would be manifestly unfair to force Landlord to choose between (i) an onerous subtenant or assignee and (ii) an empty space.

Finally, Mr. Johnson proposes that punitive damages be made available as a tenant Section 1995.310 remedy " ... in the event of a wrongful withholding of consent ... [by Landlord to an assignment or subletting] ... " (Johnson, April 9, 1990, page 4, numbered paragraph 4). This approach is contrary to the recent California Supreme Court Foley decision (47 Cal. 3d 654 [1984]) that punitive damages are not available as a contract damage remedy in cases involving breach of a covenant of good faith and fair dealing. It also represents a "back door" way of undermining the entire already-enacted Kendall legislation by holding over Landlord's head the threat of punishment which would go beyond even the compensatory-damages of the Kendall, Cohen & Schwiso cases. The Staff should not have been persuaded to yield, even in the Comment, to Mr. Johnson's arguments; the insertion of punitive damage language into the Comment would only fuel the arguments of some future claimant that wrongful refusal to consent to an assignment or subletting is, in and of itself, a "tort". The fact of a possible tort of interference with the sale of tenant's business (which is at best doubtful as a tort) does not need nor desire commentary as to what kinds of tort damages may or may not be available to wounded parties: the Commission's Study is of lease (contract) remedies and should not gratuitously stray into the tort area.

The statement of remedies in the Tentative Recommendation are fair, reasonable and bilateral. Please do not alter them other

than for a validation of the already recognized proposition of law that the parties may by contract negotiate such remedies.

Very truly yours,

RONALD P. DENITZ
Vice President and
General Counsel
Tishman West Companies

RPD:hm

cc: W. Coskran, Esq.

EXHIBIT 2

MAY 16 1990

RECEIVED

LOYOLA LAW SCHOOL

TO Nathaniel Sterling
California Law Revision Commission

FM Bill Coskran
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(714) 846-5920

DT 5/14/90

RE RECONSIDERATION OF ASSIGNMENT/SUBLEASE RESTRICTION LEGIS.; REMEDIES FOR BREACH OF ASSIGNMENT/SUBLEASE CLAUSE; USE RESTRICTIONS.

Thank you for copies of the correspondence concerning the above matters.

If the Commission is going to address reconsideration of the Assignment/Sublease Restriction legislation that went into effect January 1st, I think that issue should be resolved before going into the proposals on Remedies and Use Restrictions. The existing legislation is the product of a considerable amount of review, discussion and compromise. If there are going to be proposals to change the it, it seems the process begins anew. The issues of Remedies and Use Restrictions are closely related to the existing legislation. If the Commission reopens the existing legislation and makes changes, the changes will most likely have an effect on the recommendations regarding Remedies and Use Restrictions.

A summary of my comments is attached.
(Note: Citations to principal cases and treatises referred to in this memo are in the background study and not repeated here; page references to the study refer to the published version.)

Respectfully submitted,

Bill COSKRAN

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REMEDIES FOR BREACH OF ASSIGNMENT/SUBLEASE CLAUSE

1. CHARGE OF LANDLORD BIAS.

Mr. Johnson charges that the recommendations concerning remedies are heavily biased in favor of lessors. The proposals, and the discussions leading to them, were an honest and objective effort to clarify and evaluate remedies of both the lessor and tenant. It would be incorrect to believe that attorneys for tenants have not been exposed to the proposals or have not had an opportunity to comment.

The proposal gives the tenant the benefit of contractual expectations when the lessor is subject to an express or implied reasonableness standard. The tenant is given important protection in the proposal by treating an express or implied reasonableness standard as a lessor's covenant rather than a condition. The tenant is given further protection by treating the lessor's covenant as dependent rather than independent. The result of these two factors is to give the tenant the normal remedies for breach of contract if the lessor unreasonably withholds consent. Without this legislation, it is certainly not clear in California that the tenant would have this protection. The proposal expands or solidifies the tenant's remedies; it does not reduce the tenant's remedies in any way. A lessor advocate could look at the

remedies provisions selectively, and conclude that there was a tenant bias.

2. TENANT RIGHT TO SPECIFIC PERFORMANCE OR MANDATORY INJUNCTION; C.C. 1995.310.

The tenant is given important protection in the proposal by treating an express or implied reasonableness standard as a lessor's covenant rather than a condition. The purpose for this treatment is to provide the tenant with breach of contract remedies upon lessor's breach. This is made clear in section 1995.310. It provides for all the remedies. The specification of damages and termination remedies is clearly not exclusive. I believe the statute is clear on its face. In addition, the comment gives more of the background, including reference to other possible remedies. I do not think specific mention of specific performance or mandatory injunction in the statute is necessary

Statutes and case decisions contain detailed requirements for the discretionary remedies of specific performance and mandatory injunction. A specific statutory reference to those remedies here might create an inference that they were to be treated differently in the assignment/sublease context.

3. TENANT RIGHT TO PUNITIVE DAMAGES; C.C. 1995.310.

The purpose of sec. 1995.310 is to give the tenant the benefit of contractual expectations when the lessor is subject to an express or implied reasonableness standard. The tenant is

given important protection in the proposal by treating an express or implied reasonableness standard as a lessor's covenant rather than a condition. The tenant is given further protection by treating the lessor's covenant as dependent rather than independent. The result of these two factors is to give the tenant the normal remedies for breach of contract.

Mr. Johnson appears to be proposing a statutory provision for an award of punitive damages for breach of contract. I believe this would be a mistake for two reasons.

First, punitive damages are available to the tenant if the lessor commits a tort (e.g. interference with contract or prospective economic advantage). The proposal does not detract from a tort cause of action or remedy. The comment points this out.

Second, I believe in the admonition given by the California Supreme Court in the Seaman's case. The court viewed the extension of tort remedies into contract breaches as "largely uncharted and potentially dangerous waters" and cautioned that "it is wise to proceed with caution."
This is an issue which deserves thorough study and deliberation in the broad context of contracts generally. I think piecemeal tinkering with it would not be prudent.

4. TENANT RIGHT TO TERMINATION FOR LESSOR BREACH. C.C. 1995.310.

The tenant is given important protection in the proposal by treating an express or implied reasonableness standard as a lessor's covenant rather than a condition. The tenant is given fur-

ther protection by treating the lessor's covenant as dependent rather than independent. The result of these two factors is to give the tenant the normal remedies for breach of contract, including the right to terminate the lease for substantial breach of a material covenant. The issue here is different from the question of whether to mention specific performance and mandatory injunction in the statute. Here it is important to specifically mention termination as a remedy for breach of covenant in order to clarify that California is rejecting the independent covenant doctrine traditionally applied to lessor covenants.

Mr. Kent states that the tenant should not have the right to terminate a lease if a landlord unreasonably withholds consent. He argues that lessors have a variety of considerations in deciding the type of tenant to occupy their property. If the lessor wants to reserve the right to exercise discretion without potential litigation over the issue of reasonableness, the existing Assignment/Sublease legislation makes it possible to do so by express provisions. However, when the lessor has made an express or implied covenant to be reasonable in withholding consent, contract remedies for breach seem appropriate.

Mr. Kent makes an additional point. He believes the right to termination should not be specified in the legislation. Rather, it should be subject to negotiation. The reason for mentioning termination specifically in the legislation is to clarify that California applies the contract rule of mutually dependent covenants to this lease clause, rather than the common-law con-

veyance rule of independent covenants. However, he does raise an important point with regard to the ability to negotiate concerning the termination remedy. He apparently wants the statute to avoid mention of termination, but allow the parties to specifically negotiate it into the lease. It seems preferable to mention termination specifically in the legislation to resolve the independent/dependent covenant issue, but allow the parties to negotiate this remedy away. It should be made clear that the specific mention of termination in the statute does not mean that you are creating a non-negotiable remedy.

Creating a non-negotiable remedy of termination would be a significant change in existing law and would create serious problems in many lease transactions. For example, the ability to negotiate a waiver of the right to terminate is an important factor when the lessor is considering financing on the property. When the lessor seeks a loan, and income from the lease is a factor in granting the loan, the lender usually will insist that the lease comply with certain requirements. Typically, one of these requirements is that, in the event of a lessor default, the tenant must look to the lessor for damages and not terminate the lease. (For example, see Sec. 2.34 of the CEB book on Commercial Real Property Lease Practice which states at p.35: "Lenders usually will not approve a lease in which the tenant has the right to terminate the lease in case of the landlord's default." and Sec. 5.34 of the CEB book on California Real Property Financ-

ing which states at p.250: "The tenant should not have the right to terminate the lease in the event of landlord's default.")

5. APPLICATION TO REMEDIES TO ASSIGNEE OR SUBTENANT; C.C. 1995.330 (a) & (b).

Sec. 1995.330 reflects a continued observance of the traditional relationships between lessor, tenant, assignee, and subtenant. In summary, the relationships are as follows.

Assignment:

Lessor and tenant continue in privity of contract.

Lessor and assignee are in privity of estate.

Tenant and assignee are in privity of contract.

Sublease:

Lessor and tenant continue in privity of contract & estate.

Lessor and subtenant have no privity relationship.

Tenant and subtenant are in privity of contract & estate.

The significance of the privity relationships in this context is the relationship or lack of relationship between the lessor and the third party, and the enforceability of obligations contained in the (prime) lease. Mr. Williams argues that, instead of focusing on privity, "the landlord should be considered in law to be an intended beneficiary of both the contract of assignment and the contract of sub-tenancy." Substituting a theory of third party beneficiary contract for privity based theories would have ramifications far beyond the scope of the specific remedies issues involved in this legislation.

After an assignment, privity of estate creates reciprocal obligations of lessor to assignee and assignee to lessor, and a personal liability to one another for breach of obligations (real covenants) in the lease. A third party beneficiary theory, making the lessor the beneficiary of the contract between the tenant and assignee, would create a unilateral contractual liability of the tenant to the lessor, but no reciprocal liability of the lessor to the assignee.

After a sublease, there is no privity of estate or contract between the lessor and the subtenant. As a result, there is generally no personal liability of either one to the other. If there is a violation of the terms of the lease, the lessor can terminate the lease and recover possession from the sublessee through an unlawful detainer action. The subtenant takes "subject to" the terms of the lease with respect to the lessor's termination remedy. But the subtenant is not personally liable to the lessor on the lease terms. A third party beneficiary theory, making the lessor the beneficiary of the contract of sublease between the tenant and sub-tenant, would create a unilateral contractual liability of the tenant to the lessor.

Parties can choose the practical effects of the privity relationships by the way in which they structure their transactions. In addition, they can intentionally vary those relationships by additional agreements such as releases and assumptions. Also, there are various other ramifications of privity relationships which would have to be reconsidered if privity doc-

trines are changed to a third party beneficiary theory imposed by law. For example, there would have to be a reconsideration of the right of the tenant to bring an unlawful detainer action against the third party, and of the rights between tenant and third party to exercise valuable options contained in the (prime) lease.

If Mr. Williams concern is limited to the right of the lessor to have some remedy in the event of an assignment or sublease by a sub-tenant, I believe that is already available to the lessor by express drafting. Existing law clearly provides that the subtenant takes "subject to" the terms of the prime lease. This is simply a ramification of the concept that the tenant cannot transfer to a third party greater rights than the tenant has. An express clause in the prime lease could restrict transfer by the subtenant, and the lessor could terminate the lease and recover possession upon violation. However, the subtenant would not be liable to the lessor for damages. If the lessor wants to create personal liability of the subtenant to the lessor, the lessor can negotiate for an express lease clause requiring a written assumption agreement by a future sub-tenant and then get an express assumption agreement at the time of the sublease.

In short, it does not seem that there are compelling policies to abandon "privity" in this context, and substitute a third party beneficiary theory imposed by law.

6. LESSOR'S RIGHT TO RECOVER POSSESSION WITHOUT TERMINATING THE LEASE; C.C. 1995.330(c).

Mr. Johnson criticizes sec. 1995.330(c) as "giving the landlord too much power to demand tribute when his rights would not be adversely or materially affected."

If the tenant violates an express transfer restriction in the absence of subsection (c), the lessor can terminate the lease and sue for damages, or leave the lease in effect and sue for damages.

Subsection (c) gives the lessor a third choice. If the tenant violates an express transfer restriction, the lessor can recover possession from the third party who is wrongfully in possession, without terminating the lease. If the lessor wants to remove the third party wrongfully in possession, this remedy gives the lessor a choice that is less drastic than lease termination and damages. In some situations, the tenant may prefer to avoid forfeiture of the leasehold. When the tenant has violated the lease terms, the subsection (c) remedy allows the lessor to retain the benefits of the existing lease while avoiding an unconsented transfer.

The lessor would only be able to use this remedy when the tenant makes a wrongful transfer in violation of an express restriction. This would cover three basic situations:

1st. An express or implied general reasonableness standard governs and the tenant makes a transfer in violation of a reasonable objection.

2nd. Express specific requirements are negotiated into the lease and the tenant makes a transfer in violation of the specific requirements.

3rd. An express absolute prohibition against transfer is contained in the lease and the tenant makes a transfer in violation.

Mr. Johnson makes a strong argument for blocking this remedy when the lessor's rights are "not adversely or materially" affected." I assume he is referring to the 3rd situation, an absolute prohibition clause. However, the matters that were discussed before adopting this remedy go beyond a simple "no harm, no foul" approach.

It begs an important question just to ask whether the subsection (c) remedy should be available where the lessor's rights are not adversely or materially affected. Whether the effects of a transfer are "adverse" and "material" is a factual question, subject to litigation. The very reason for the clause may have been the desire to avoid the delays, expense and uncertainties of litigation. By the way, I do not accept without qualification Mr. Johnson's examples of corporate restructuring or sale of a business as events that will never have an adverse or material affect on the lessor.

Are defaulting tenants generally going to be better off by eliminating the subsection (c) remedy and thus forcing the lessor to a termination & damages remedy?