

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

RECOMMENDATIONS

relating to

Commercial Real Property Leases

**Remedies for Breach of Assignment or Sublease Covenant
Use Restrictions**

May 1990

**CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739**

THE CALIFORNIA LAW REVISION COMMISSION

COMMISSION MEMBERS

EDWIN K. MARZEC
Chairperson

ROGER ARNEBERGH
Vice Chairperson

BION M. GREGORY
Member

ELIHU M. HARRIS
Member of Assembly

BRAD R. HILL
Member

BILL LOCKYER
Member of Senate

ARTHUR K. MARSHALL
Member

FORREST A. PLANT
Member

SANFORD M. SKAGGS
Member

ANN E. STODDEN
Member

COMMISSION STAFF

Legal

JOHN H. DEMOULLY
Executive Secretary

NATHANIEL STERLING
Assistant Executive Secretary

ROBERT J. MURPHY III
Staff Counsel

STAN ULRICH
Staff Counsel

Administrative-Secretarial

STEPHEN F. ZIMMERMAN
Administrative Assistant

EUGENIA AYALA
Word Processing Technician

VICTORIA MATIAS
Word Processing Technician

NOTE

The Commission's annual reports and its recommendations and studies are published in separate pamphlets which are later bound in permanent volumes. The page numbers in each pamphlet are the same as in the volume in which the pamphlet is bound. The purpose of this numbering system is to facilitate consecutive pagination of the bound volumes. This pamphlet will appear in Volume 20 of the Commission's *Reports, Recommendations, and Studies* which is scheduled to be published late in 1991.

Cite this pamphlet as *Recommendations Relating to Commercial Real Property Leases*, 20 Cal. L. Revision Comm'n Reports 2401 (1990).

STATE OF CALIFORNIA

**CALIFORNIA LAW
REVISION COMMISSION**

RECOMMENDATIONS

relating to

Commercial Real Property Leases

**Remedies for Breach of Assignment or Sublease Covenant
Use Restrictions**

May 1990

**CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739**

TABLE OF CONTENTS

	<i>Page</i>
TABLE OF CONTENTS	2403
RECOMMENDATIONS	
Remedies for Breach of Assignment or Sublease	
Covenant	2405
Use Restrictions	2421

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

RECOMMENDATION

relating to

Commercial Real Property Leases

Remedies for Breach of Assignment or Sublease Covenant

May 1990

CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

This recommendation includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were enacted since their primary purpose is to explain the law as it would exist (if enacted) to those who will have occasion to use it after it is in effect.

Cite this recommendation as *Recommendation Relating to Commercial Real Property Leases: Remedies for Breach of Assignment or Sublease Covenant*, 20 Cal. L. Revision Comm'n Reports 2405 (1990).

STATE OF CALIFORNIA

GEORGE DEUKMEJIAN, Governor

CALIFORNIA LAW REVISION COMMISSION

4000 MIDDLEFIELD ROAD, SUITE D-2
PALO ALTO, CA 94303-4739
(415) 494-1335

EDWIN K. MARZEC

CHAIRPERSON

ROGER ARNEBERGH

VICE CHAIRPERSON

BION M. GREGORY

ASSEMBLYMAN ELIHU M. HARRIS

BRAD R. HILL

SENATOR BILL LOCKYER

ARTHUR K. MARSHALL

FORREST A. PLANT

SANFORD M. SKAGGS

ANN E. STODDEN

May 31, 1990

To: The Honorable George Deukmejian
Governor of California, and
The Legislature of California

Legislation enacted at the 1989 session on recommendation of the Law Revision Commission clarifies the assignment and sublease rights of landlords and tenants of commercial real property leases. The enclosed Commission recommendation follows up the 1989 enactment with a clarification of remedies of landlords and tenants for violation of each other's assignment or sublease rights.

In brief, the recommendation would give the tenant the right to damages and termination of the lease if the tenant's assignment or sublease rights are violated by the landlord. It would give the landlord the right to damages and termination of the lease or of the assignment or sublease if the landlord's rights are violated by the tenant. And it would make clear that the notorious Rule in Dumpor's Case is not the law in California.

This recommendation is submitted pursuant to Resolution Chapter 35 of the Statutes of 1989. The Commission wishes to express its appreciation to Professor William G. Coskran of Loyola Law School of Los Angeles for his outstanding service as the Commission's consultant on this and other aspects of the commercial real property lease study.

Respectfully submitted,

Edwin K. Marzec
Chairperson

RECOMMENDATION

Remedies for Landlord's Breach

If a lease requires the landlord's consent for an assignment or sublease and the landlord improperly withholds consent in violation of the standards prescribed in the lease or implied by law, the tenant has an array of possible remedies, some more effective than others. These may include declaratory relief, specific performance or mandatory injunction, termination of the lease, contract damages, tort damages, statutory remedies, and self-help. Of these remedies, contract damages and lease termination may be most useful to a tenant; however, both are in need of statutory clarification and improvement. Whether it would be helpful to codify the tenant's right to other remedies is problematical and the Law Revision Commission does not recommend it.

Contract damages. The tenant may be able to obtain contract damages if the requirement for the landlord to be reasonable in withholding consent is construed to be a "covenant" by the landlord. If the reasonableness requirement is construed to be a "condition", the tenant may be allowed to make the transfer without the landlord's consent, but may not be allowed contract damages.¹

The tenant's remedies should not depend on whether the reasonableness requirement is construed to be a condition or covenant, depending on the happenstance of the particular phrasing used in the lease. A tenant who is precluded by the landlord's wrongful act from making a proper assignment or sublease may incur further expenses in attempting to assign or sublet and may lose the benefit of an advantageous business

1. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 505-08 (1989).

arrangement. Contract damages are appropriate in such a case.²

The covenant approach yields a more fair, practical, and consistent result, and should be codified. The tenant will thus be entitled to contract damages for the landlord's wrongful withholding of consent to an assignment or sublease.

Right to terminate lease. There is a conflict of opinion whether the tenant may terminate the lease if the landlord wrongfully withholds consent to the tenant's attempted assignment or sublease. As with contract damages, the right of a tenant to terminate depends on whether the provision violated by the landlord is construed to be a condition or a covenant. Contract law recognizes mutuality of covenants, so that substantial breach of a material covenant by the landlord excuses performance by the tenant and allows the tenant to terminate the lease.

There is no California case on point. However, California has adopted the contract doctrine of mutually dependent covenants for other aspects of real property tenancies, and there is no substantial reason to deny the tenant the right to terminate on establishing the landlord's breach of an assignment or sublease consent requirement. The right to assign or sublet is a key aspect of the lease and is an important protection for a tenant that may need to free itself from its obligations under the lease. If the tenant is wrongfully precluded from exercising its right to assign or sublet, termination of the lease is an appropriate remedy for the tenant.

The Commission recommends that the matter be clarified by codifying the tenant's right to terminate the lease as a

2. Civ. Code § 3300 ("For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this Code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.")

remedy for the landlord's wrongful refusal to consent to a proper assignment or sublease by the tenant. This would be consistent with the covenant treatment generally applied to lease clauses in California and with the modern trend of the law to treat a lease as a contract.³

Remedies for Tenant's Breach

If a provision in a lease restricts transfer by the tenant but the tenant makes a transfer in violation of the restriction, the landlord has only one major remedy:⁴ The landlord may terminate the lease and recover possession of the property, together with any damages caused by the tenant's breach of the lease.⁵

The landlord may waive the termination remedy and allow the transfer to remain in effect, but whether the landlord may also recover damages for the breach is not clear. Nor is it clear whether the landlord may, instead of terminating the entire lease, terminate only the wrongful transfer, leaving the underlying lease in effect. These and other unresolved issues should be clarified by statute.

Contract damages. Although the tenant's transfer in violation of a transfer restriction is a breach of contract, there is no case expressly dealing with the question of whether the landlord may waive the right to terminate the lease for breach and recover contract damages, and there is an implication in some cases that the landlord may not.⁶

It would be advantageous to both landlord and tenant for the law to state clearly that the landlord may waive the right to

3. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 510-12 (1989).

4. Other remedies available to the landlord include declaratory relief, injunctive relief, and (if needed) unlawful detainer.

5. The damages include any loss measured by the difference between the contract rent and what the landlord is able to get on reletting the property. Civ. Code § 1951.2.

6. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 495-98 (1989).

terminate for breach and recover damages caused by the breach. For the landlord, it might be perfectly satisfactory to allow the assignment or sublease to remain in effect, provided the landlord is made whole for any loss caused by the assignment or sublease, such as a loss of percentage rentals, a change in use causing increased insurance premiums, or hazardous substance liability. For the tenant, it may be advantageous to allow the assignment or sublease to stand and only to be liable for damages. If the damage remedy is not available, the landlord may be forced to terminate the entire lease in order to recover damages—possibly a worse outcome for the tenant.

The added flexibility in the law that results from the landlord's ability to waive the termination remedy and recover damages for breach is desirable; the remedy should be codified so that the law is clear that it is available. This is a specific application of the general rule that a landlord may leave a lease in effect and recover damages for breach of a covenant.

Right to terminate assignment or sublease. Existing law precludes the landlord from invalidating a wrongful assignment or sublease while leaving the underlying lease in effect.⁷ The landlord's only option is to terminate the entire lease or to let the wrongful assignment or sublease stand.

This choice of remedies may be inadequate in some situations. It may be important for the landlord to preserve favorable terms in the lease while preventing the wrongful assignment or sublease. This is particularly true where the parties have negotiated the right of the landlord to maintain the lease in effect under Civil Code Section 1951.4 in the event of the tenant's breach and abandonment. In this situation the landlord needs to be able to terminate a wrongful

7. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 499-501 (1989).

assignment or sublease in order to maintain the Section 1951.4 remedy.

For these reasons the Commission recommends that the remedies available to the landlord for the tenant's breach be expanded to provide that the landlord may terminate a wrongful assignment or sublease without terminating the underlying lease.⁸

Liability of assignee or subtenant. If the tenant makes an assignment or sublease, an assignee is liable to the landlord for subsequent breaches of the lease, but a subtenant is not. This rule is founded on the privity between landlord and assignee and lack of privity between landlord and subtenant.⁹

Although the law is clear that an assignee is liable for subsequent breaches, it is not clear that the assignee is liable for damages caused by the wrongful assignment itself. Liability of the assignee for damages could benefit both the landlord and the assignee. For the landlord, the tenant may be insolvent and the assignee may be the only solvent party able to respond for the harm caused by the wrongful assignment. For the assignee, it may be more desirable to have the assignment stand and respond in damages, if there are any, than to force the landlord to a termination of the assignment. This option could also help avoid precipitous litigation by ensuring the landlord an adequate remedy short of termination if the assignment proves ultimately to harm the landlord's interest.

The Commission recommends that the law make clear that an assignee, but not a subtenant, is jointly and severally liable with the tenant for damages caused by a wrongful assignment.

8. The right to terminate the wrongful assignment or sublease requires adaptation of the unlawful detainer procedures in order to regain possession from the assignee or subtenant.

9. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 *Loy. L.A.L. Rev.* 405, 498-99 (1989).

This principle would apply to the parties to a wrongful reassignment as well.

Effect of Landlord's Consent or Waiver (Rule in Dumpor's Case)

The Rule in Dumpor's Case is a common law principle dating from 16th century England. The rule states that notwithstanding a lease provision requiring the landlord's consent to an assignment of the tenant's interest, if the landlord consents to an assignment (as opposed to a sublease), the initial consent effectively operates as a waiver of all future right the landlord may have to object to subsequent assignments by subsequent tenants.

The Rule in Dumpor's Case has been judicially criticized, and has been statutorily overruled in many jurisdictions. The situation in California has been summarized as follows:

[T]here is language in early cases indicating, but not directly holding, that California follows *Dumpor's Case* with respect to successive assignments. There is language in later California cases criticizing, and at least one holding by a court of appeal rejecting, the rule. There is no California Supreme Court decision expressly involving the issue and either adopting or rejecting the rule. The decisions distinguish between a restriction that is expressly made binding on assignees, and one that is not express. The former has been treated as a continuing covenant that binds successors. The latter has been treated as a single and personal covenant that binds only the original tenant. California appears to follow the consensus that *Dumpor's Case* does not apply to subleases.¹⁰

The rule is illogical and serves no useful purpose. It is a trap for the unwary. And for the wary, it may cause a refusal to consent to an otherwise reasonable transfer for fear that a single waiver will be converted into a permanent waiver. Efforts to draft around the rule in leases are generally

10. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 564 (1989).

ineffective since the rule has been held to apply notwithstanding the most clear and precise lease clauses to the contrary. Statutory modification of the rule is necessary.

It is probable that most lease transfer restrictions are intended to apply continuously to any transfer and are not personal to the original tenant. The Rule in Dumpor's Case should be reversed by statute, which should create a presumption that a restriction on assignment applies not only to the original tenant but also to subsequent assignees. This rule should be subject to an express provision in the lease to the contrary.

PROPOSED LEGISLATION

Civil Code § 1951.4 (amended). Continuation of lease after breach and abandonment

1951.4. (a) The remedy described in this section is available only if the lease provides for this remedy. In addition to any other type of provision used in a lease to provide for the remedy described in this section, a provision in a lease in substantially the following form satisfies this subdivision:

“The lessor has the remedy described in California Civil Code Section 1951.4 (lessor may continue lease in effect after lessee's breach and abandonment and recover rent as it becomes due, if lessee has right to sublet or assign subject only to reasonable limitations).”

(b) Even though a lessee of real property has breached the lease and abandoned the property, the lease continues in effect for so long as the lessor does not terminate the lessee's right to possession, and the lessor may enforce all the lessor's rights and remedies under the lease, including the right to recover the rent as it becomes due under the lease, if any of the following conditions is satisfied:

(1) The lease permits the lessee, or does not prohibit or otherwise restrict the right of the lessee, to sublet the property, assign the lessee's interest in the lease, or both.

(2) The lease permits the lessee to sublet the property, assign the lessee's interest in the lease, or both, subject to express standards or conditions, provided the standards and conditions are reasonable at the time the lease is executed and the lessor does not require compliance with any standard or condition that has become unreasonable at the time the lessee seeks to sublet or assign. For purposes of this paragraph, an express standard or condition is presumed to be reasonable; this presumption is a presumption affecting the burden of proof.

(3) The lease permits the lessee to sublet the property, assign the lessee's interest in the lease, or both, with the consent of the lessor, and the lease provides that such consent shall not be unreasonably withheld or the lease includes a standard implied by law that consent shall not be unreasonably withheld.

(c) For the purposes of subdivision (b), the following do not constitute a termination of the lessee's right to possession:

(1) Acts of maintenance or preservation or efforts to relet the property.

(2) The appointment of a receiver upon initiative of the lessor to protect the lessor's interest under the lease.

(3) *Withholding consent to a subletting or assignment, or terminating a subletting or assignment, if the withholding or termination does not violate the rights of the lessee under subdivision (b).*

Comment. Paragraph (3) is added to Section 1951.4(c) to make clear that the landlord's efforts to preclude or terminate an assignment or sublease that is neither reasonable nor otherwise permitted by the lease are not held to impair the landlord's rights under this section. This clarifies a matter that was unclear under prior law.

Civil Code §§ 1995.300-1995.340 (added). Breach and remedies**Article 3. Breach and Remedies****§ 1995.300. Remedies subject to express provision in lease**

1995.300. A remedy provided by law for violation of the rights of the tenant or of the landlord concerning transfer of a tenant's interest in a lease, including a remedy provided in this article, is subject to an express provision in the lease that affects the remedy.

Comment. This section codifies the general rule that the parties to a contract may negotiate the remedies to be applied in case of a breach of the contract. This rule is of course 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).

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

1995.310. If a restriction on transfer of a tenant's interest in a lease requires the landlord's consent for transfer subject to an express or implied standard that the landlord's consent may not be unreasonably withheld, and the landlord unreasonably withholds consent to a transfer in violation of the tenant's rights under the lease, in addition to any other remedies provided by law for breach of a lease, the tenant has all the remedies provided for breach of contract, including but not limited to either or both of the following:

(a) The right to contract damages caused by the landlord's breach.

(b) The right to terminate the lease.

Comment. Section 1995.310 treats a requirement that the landlord be reasonable in withholding consent as a covenant rather than a condition, violation of which is a breach of the lease. This clarifies California law and is consistent with the majority view in the United States. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 505-07 (1989). Section 1995.310 does not distinguish between breach of an express reasonable consent requirement under Section 1995.250 and an implied reasonable consent requirement under Section 1995.260; a breach of either an

express or implied covenant entitles the tenant to the normal remedies for breach of contract.

The remedies available for breach of contract include declaratory relief, specific performance or mandatory injunction, termination of the lease, and contract damages. Under Section 1995.310, the tenant may seek contract damages or exercise the right to terminate the lease or both. See Section 3300 (measure of contract damages).

The landlord's wrongful conduct, such as wrongful withholding of consent, may, in addition to a breach of contract, involve a tort (e.g., interference with contract or prospective economic advantage, or trespass). Other remedies for breach of a lease may include statutory remedies. The tenant may also transfer without the landlord's wrongfully withheld consent.

§ 1995.320. Landlord's remedies for tenant's breach

1995.320. If a tenant transfers the tenant's interest in a lease in violation of a restriction on transfer of the tenant's interest in the lease, in addition to any other remedies provided by law for breach of a lease, the landlord has all the remedies provided for breach of contract, including but not limited to either or both of the following:

(a) The right to contract damages caused by the tenant's breach.

(b) The right to terminate the lease.

Comment. Section 1995.320 treats a restriction on transfer as a covenant, violation of which is a breach of the lease. A transfer in violation of the restriction is voidable, not void, and the landlord may waive the landlord's remedies for breach either expressly or by conduct. This principle applies to a sublease as well as an assignment. Section 1995.020(e) ("transfer" defined).

Section 1995.320 makes clear the landlord may seek contract damages caused by the wrongful transfer in addition to termination of the lease. This is a specific application of Section 1951.2 (damages in connection with lease termination).

Section 1995.320 also permits the landlord to waive the termination remedy and still collect contract damages for wrongful transfer. This resolves a matter that was unclear under prior law, consistent with the general principle that a landlord may leave a lease in effect and recover damages for breach of a covenant. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 495-98 (1989).

Other remedies available to the landlord for the tenant's breach include unlawful detainer, declaratory relief, and injunctive relief. For remedies against the assignee or subtenant under a wrongful transfer, see Section 1995.330 (application of remedies to assignee or subtenant).

§ 1995.330. Application of remedies to assignee or subtenant

1995.330. (a) An assignee who receives or makes a transfer in violation of a restriction on transfer of a tenant's interest in a lease is jointly and severally liable with the tenant for contract damages under Section 1995.320. For this purpose the provisions of Section 1951.2 applicable to a lessee apply to an assignee.

(b) The landlord's right to terminate a lease under Section 1995.320 includes the right to terminate a transfer without terminating the lease. If the landlord terminates a transfer without terminating the lease, the assignee or subtenant in possession is guilty of unlawful detainer and the landlord may obtain possession from the assignee or subtenant without terminating the right to possession of the tenant. For this purpose the landlord may use the procedure provided in Chapter 4 (commencing with Section 1159) of Title 3 of Part 3 of the Code of Civil Procedure, with the changes necessary to make the procedure applicable to this subdivision.

Comment. Subdivision (a) of Section 1995.330 is an application of the general rule that the landlord and assignee are in privity of estate. On the basis of privity of estate an assignee is liable to the landlord for breaches occurring after transfer. Subdivision (a) makes clear that these principles apply to the wrongful transfer itself. An assignee that receives a transfer or makes a subsequent transfer in violation of a transfer restriction is liable to the same extent as a tenant would be.

Subdivision (b) makes clear that the landlord's remedies for breach of a transfer restriction include the right to terminate the transfer without terminating the underlying lease. This right is new in California. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 487-93 (1989).

§ 1995.340. Rule in Dumpor's Case abolished

1995.340. (a) Subject to subdivision (b), a restriction on transfer of a tenant's interest in a lease applies to a subsequent

transfer by a tenant, an assignee, or a subtenant notwithstanding the landlord's consent to a prior transfer or the landlord's waiver of a standard or condition for a prior transfer.

(b) Subdivision (a) does not apply if either of the following conditions is satisfied:

(1) The lease provides expressly that the restriction on transfer is limited to the original tenant.

(2) The landlord states expressly in writing that the consent or waiver applies to a subsequent transfer.

Comment. Section 1995.340 makes clear that the Rule in *Dumpor's Case*, 76 Eng. Rep. 1110, 4 Coke 119(b) (K.B. 1578), is not the law in California. This probably codifies existing law. *Cf.* Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 560-64 (1989).

STATE OF CALIFORNIA

**CALIFORNIA LAW
REVISION COMMISSION**

RECOMMENDATION

relating to

Commercial Real Property Leases

Use Restrictions

May 1990

**CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739**

This recommendation includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were enacted since their primary purpose is to explain the law as it would exist (if enacted) to those who will have occasion to use it after it is in effect.

Cite this recommendation as *Recommendation Relating to Commercial Real Property Leases: Use Restrictions*, 20 Cal. L. Revision Comm'n Reports 2421 (1990).

STATE OF CALIFORNIA

GEORGE DEUKMEJIAN, Governor

CALIFORNIA LAW REVISION COMMISSION

4000 MIDDLEFIELD ROAD, SUITE D-2
PALO ALTO, CA 94303-4739
(415) 494-1335

EDWIN K. MARZEC
CHAIRPERSON
ROGER ARNEBERGH
VICE CHAIRPERSON
BION M. GREGORY
ASSEMBLYMAN ELIHU M. HARRIS
BRAD R. HILL
SENATOR BILL LOCKYER
ARTHUR K. MARSHALL
FORREST A. PLANT
SANFORD M. SKAGGS
ANN E. STODDEN

July 27, 1990

To: **The Honorable George Deukmejian**
Governor of California, and
The Legislature of California

This recommendation would clarify the law governing use restrictions in commercial real property leases. Under the recommendation, the parties to a lease may restrict or prohibit changes in use, and their agreement is enforceable. If the lease prohibits change in use without the landlord's consent, but is silent as to the standard for exercise of the landlord's consent, the recommendation would imply a reasonableness standard. The implied reasonableness standard would apply to a lease executed on or after the operative date of the proposed new law.

This recommendation is submitted pursuant to Resolution Chapter 53 of the Statutes of 1990. The Commission wishes to express its appreciation to Professor William G. Coskran of Loyola Law School of Los Angeles for his outstanding service as the Commission's consultant on this and other aspects of the commercial real property lease study.

Respectfully submitted,

Edwin K. Marzec
Chairperson

RECOMMENDATION

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 change of 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 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

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 (1990).

3. Civil Code §§ 1995.260-1995.270.

4. *Coskran, Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loy. L.A.L. Rev. 405, 532-48 (1989).

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 be able to make any reasonable 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

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

5. Civil Code §§ 1995.010-1995.270.

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, 535-36 (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").

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, 535-36 (1989).

(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.

(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. If the lease contains a use restriction, mitigation should be based on restricted use of the premises except to the extent the tenant proves enforcement of the restriction would be unreasonable.

(8) In case the landlord continues a lease in effect notwithstanding the tenant's breach,¹¹ the tenant should have the right to assign or sublet for any reasonable use of the premises if the lease contains no use restriction. If the lease contains a use restriction, the tenant should have the right to assign or sublet only for the restricted use of the premises except to the extent the tenant proves enforcement of the restriction would be unreasonable.

9. Civil Code § 1995.260.

10. See Civil Code § 1951.2.

11. See Civil Code § 1951.4.

PROPOSED LEGISLATION

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 7. 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 1997.210 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. However, if the lease contains a restriction on use that is enforceable under this chapter, the computation shall take into account the restricted use of the property except to the extent the tenant proves that under all the circumstances enforcement of the restriction would be unreasonable. The circumstances include, but are not limited to, those involving both the leased property and any building or complex in which it is located.

(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. The restriction on use applies under Section 1951.4 if it is enforceable under this chapter except to the extent the tenant proves that under all the circumstances enforcement of the restriction would be unreasonable. The circumstances include, but are not limited

to, those involving both the leased property and any building or complex in which it is located.

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. 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, the landlord is not required to give up the bargained-for benefit in order to reduce the damages to the breaching tenant. However, the use restriction is not taken into account in computing mitigation damages to the extent the tenant satisfies the burden of showing that enforcement of the use restriction would be unreasonable. And, 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 regardless of whether enforcement of the use restriction would have been reasonable.

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, both the tenant and transferee have to conform to that restraint. However, the landlord's use of the Section 1951.4 remedy precludes the landlord's enforcement of a use restriction to the extent the tenant satisfies the burden of showing that enforcement of the use restriction would be unreasonable.

The circumstances that may be considered in determining the reasonableness of enforcement of a use restriction for purposes of this section include the following and all other relevant circumstances whether of a similar or dissimilar character:

(1) The landlord's desire to preserve or encourage a so-called "tenant mix" in a shopping center.

(2) The landlord's intent to preclude residential uses in a commercial building or complex.

(3) The landlord's intent to preclude medical arts uses in an almost exclusively business-use office building (or vice versa).

(4) The fact that a proposed use by a prospective new tenant would require the landlord to grant the right to engage in that use in the building or complex to the exclusion of other parties or would contravene a pre-existing right of exclusive use already possessed by, or promised to, another party.

(5) The fact that a proposed use is already prohibited by an outside party (e.g. a mortgagee or ground lessor or landlord) to whom the landlord is obligated.

§ 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 any reasonable 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 any reasonable 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), 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 may make any reasonable 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. 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 that absolutely prohibits a change in use in accordance with the express terms of the restriction. Such a lease clause 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 any reasonable 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, either 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.

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 any reasonable 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.

§ 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. Under subdivision

(b), if a lease is made on or after January 1, 1992, under an option signed before that date, the rights between the parties to the lease are governed by the second sentence of subdivision (a). If a sublease is made on or after January 1, 1992, under a lease executed before that date, the rights 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 withheld in the landlord's sole and absolute discretion, 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.

