#H-111

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12/16/88

Memorandum 89-5

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--comments on tentative recommendation)

The tentative recommendation relating to assignments and subleases of commercial real property leases was distributed for comment in October 1988. The general thrust of the tentative recommendation is (1) to validate lease clauses that restrict assignment and sublease and (2) to codify the California Supreme Court case of Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P. 2d 837 (1985) (imposing a reasonableness requirement where a lease requires the landlord's consent without providing a standard) as to leases executed after the Kendall case and overrule Kendall as to leases executed before the case.

We have received the comments attached to this memorandum as Exhibits. Two letters support the tentative recommendation, with specific suggestions for improvement. See Exhibits 1 (Robert J. Berton of San Diego) and 3 (James L. Stiepan of Irvine Office Company). Four other letters oppose the tentative recommendation. See Exhibits 2 (William E. Fox of Paso Robles), 4 (Paul J. Geiger and Dianne Humphrey of Denny's Inc.), 5 (Joel R. Hall of The Gap, Inc.), and 6 (Gordon W. Jones of Safeway Stores, Inc.). The specific problems raised are addressed in Notes following the sections to which they relate in the attached draft of the tentative recommendation.

We need to make decisions to finalize the assignment and sublease recommendation so that it can be submitted to the 1989 legislative session.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

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November 7, 1988

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Mr. John Demoulley
Executive Director
California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

Dear John:

I support the October 1988 Tentative Recommendation of the California Law Revision Commission relating to Assignment and Sublease of Commercial Real Property Leases. Please consider the following.

We now often include in commercial leases that the landlord shall not unreasonably withhold "or delay" its consent to assignment or sublease. We are now finding that a ploy sometimes used by landlords to thwart an assignment or sublease is to unreasonably delay a review of same against otherwise reasonable standards and conditions. Perhaps, the new statute needs to define "unreasonable delay" as part of "unreasonable withholding of consent."

Although what is "unreasonable" needs to be viewed in the light of the circumstances of each case, I feel differently with respect to the matter of the consideration received by the tenant in excess of the rent it owes the landlord. I think that issue should be faced, bargained for and settled at the time of the making of the lease. Therefore, proposed Civil Code Section 1995.260 should provide that, absent an express provision awarding the excess in whole or in part to the landlord, the tenant keeps the excess.

Finally, it would be most helpful to know by statute or comment thereto that wording in a lease stating

essentially as follows satisfies the requirements of Civil Code Section 1951.4(a), to wit:

> "Landlord has all of the remedies contained in California Civil Code Section 1951.4(a), to which section reference is made for further particulars."

Sincerely,

ROBERT J. BERTON

RJB:jb

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November 7, 1988

California Law Revision Commission
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Re: Commercial Real Property Leases

Gentlemen:

I am not in favor of a law that prohibits the absolute assignment of a lease. There are many unforeseen circumstances that can arise in the due course of business that makes the assignment of a lease practically mandatory.

If the proposed assignee has the same credit rating and business experience as the present lessee, I would recommend that the lessee be able to make an assignment of the lease.

Very truly yours,

WILLIAM E. FOX

WEF/kat

IRVINE OFFICE COMPANY

NOV 14 1988

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November 7, 1988

California Law Revision Commission
4000 Middleford Road, Suite D-2
Palo Alto, CA 94303-4739

Re: Commercial Real Property Leases

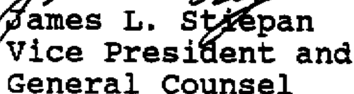
To Whom It May Concern:

I have reviewed with interest the Commission's tentative recommendation regarding proposed statutory revisions dealing with assignments/sublettings of commercial real property leases.

I strongly support the recommendation, both in form and substance. The only minor comment I would make concerns the final sentence of proposed Section 1995.250, the last portion of which I find very confusing. Unless there is a significant purpose that eludes me for the clause "or has not acted reasonably in stating in writing a reasonable objection to the transfer", I would suggest that it be deleted entirely.

Please keep me advised, if possible and appropriate, of any further modifications.

Sincerely,



James L. Stepan
Vice President and
General Counsel

JLS/kc

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A Division of The Irvine Company

Denny's Inc.
A Subsidiary of TW Services, Inc.

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December 7, 1988 FEDERAL EXPRESS

California Law Revision Commission
4000 Middlefield Road Suite #D2
Palo Alto, CA 94303-4739

Re: **TENTATIVE RECOMMENDATION RELATING TO COMMERCIAL REAL PROPERTY LEASES DATED OCTOBER, 1988**

Please be advised that Denny's Inc. which is a tenant in over 1,000 Denny's Restaurants, El Pollo Loco and Winchell's Donut Houses leases across the United States, approximately 400 of which are in the state of California, is opposed to the proposed revision which would, in effect, abrogate the California Supreme Court's rule set forth in Kendall vs. Ernest Pestana Inc. requiring the landlord to act reasonably when granting or withholding its consent to a proposed assignment or sublease as to leases executed on or before December 5, 1985.

Although Denny's Inc. agrees that it would be helpful to codify the different standards for consent for assignment and subleasing in commercial leases, we do not believe that it is a necessary part of that codification process that pre- Kendall decision leases should still allow the landlord to arbitrarily or unreasonably withhold its consent, when the lease does not specify that the landlord's consent may not be unreasonably withheld.

Very Truly Yours,

Paul J. Geiger
Associate General Counsel

PJG/clo
CLRC

cc: Ken Clark
Dianne Humphrey

Denny's Inc.

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December 7, 1988

California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

RE: TENTATIVE RECOMMENDATION RELATING TO COMMERCIAL REAL PROPERTY LEASES/ ASSIGNMENT AND SUBLEASE

Dear Commission Members:

It is our understanding that your tentative recommendations will reverse the implied duty of reasonableness rule established in Kendall v. Pestana for all leases executed before December 5, 1985. Please note that as a major tenant under hundreds of commercial leases in California, we object strongly to any such revision of the law.

Very truly yours,

Dianne Humphrey

Dianne Humphrey
Corporate Counsel

/cjs

The Gap, Inc.

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Phone 415 952-4400
Telex 470224 GAP UI

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Law Department December 13, 1988

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

Attn: Nathaniel Sterling, Esq.
Assistant Executive Secretary

Re: Study H-111 - Tentative Recommendation
Commercial Real Property Leases
Assignment and Sublease

Gentlemen:

I am a Senior Attorney - Real Estate for The Gap, Inc. of San Bruno, CA. The Gap operates approximately 900 stores in the United States through its various divisions. All of its retail locations are held under commercial leases.

I have only just received a copy of the Commission's proposed draft as well as Professor Coskran's treatise. I have also read some of Ronald P. Denitz's correspondence to the Commission and assume that much of their recommendations, speaking from the landlord's viewpoint, have been adopted into the Commission's present proposal. Thus, I respectfully offer my comments to the proposal from the background of my everyday practical experience in the marketplace having personally dealt with this subject in over 400 commercial leases for The Gap with sophisticated landlords. These include developers of enclosed regional shopping malls as well as the owners of significant downtown properties in San Francisco, Los Angeles and Manhattan where constantly rising rental values create a particular sensitivity in all parties to these issues.

The Commission seeks to accomplish a number of goals, including the following:

1. To limit the rule of Kendall v. Pestana ("Kendall") to prospective application, i.e. on and after December 5, 1985;

2. To preserve the landlord's remedy under Civil Code Sec. 1951.4 despite the presence of (a) a right of termination on the landlord's part in lieu of consenting to an assignment or sublease (collectively a "transfer"), or (b) a clause which appropriates part or all of the consideration in excess of the rent under the lease received by the tenant from an assignee or sublessee (collectively the "transferee");

3. To codify as substantive law various conditions or restrictions on transferability of a lease.

My conclusions, as discussed more fully below, are as follows:

1. That the rule of Kendall should be applied retroactively;

2. A. That in Section 1951.4, the proposed addition in subparagraph (b)(2), last sentence, which expressly imposes the burden of proof of unreasonableness on the tenant, be deleted. If anything be added, the rule should be reversed and the burden placed upon the landlord;

B. That the proposed subsection (3) and subparagraph (d) of 1951.4 be deleted as unnecessary and as potential sources of confusion;

3. A. That the doctrine of the implied duty of good faith and fair dealing be reaffirmed by statute.

B. That the reference to the meaning of reasonable consent as stated in the Tentative Recommendation, p. 12, comment to Section 1995.240 be clarified or deleted.

C. That the proposed Section 1995.260, which expressly recognizes the appropriation of profits clause in a lease, be deleted.

D. That certain ambiguous language in proposed Section 1995.250 be corrected.

DISCUSSION

1. Applicability of Kendall - Retroactive or Prospective? The limitation of Kendall to prospective application would result in an unfairness to a tenant, considering the risks undertaken by him in the lease. Tenants under commercial leases, particularly smaller commercial businesses, assume a great deal of downside risk and achieve very little downside protection. They customarily look to the assignment clause for relief from the burdens of a lease which has ceased to be profitable for them. It cannot be presumed, as the Commission does, that the tenant "relied" upon the unchangeable state of the pre-Kendall law when he signed his lease. It can only be said that he acquiesced in it.

The reality is that the landlord generally has superior bargaining position sufficient to resist any attempt by the tenant to insert a reasonable consent clause in the lease contract. Although the Commission often refers to the "principles of adhesion contracts" as the tenant's protection, a typical commercial landlord rarely occupies such a disproportionate position or is involved in such egregious circumstances as would meet the tests of adhesion contracts or unconscionability.

The tenant in a commercial lease assumes a great deal of risk of changing circumstances both in the business climate as well as the legal climate from that which existed when he signed the lease. A prime example is the assumption by the tenant of the responsibility, often at a great expense, to remain in compliance with ever changing laws, regulations and building codes having jurisdiction over his premises. Any tenant who has had to face the expense of seismic upgrading or asbestos removal to keep current with present day safety requirements well knows the magnitude of this burden. Additionally, commercial tenants are often expected to assume the risk of a change in zoning which might outlaw or severely restrict his intended business. Further, leases universally contain a "severability clause" which attempts to preserve the remainder of a lease contract notwithstanding the fact that a particular provision of it subsequently becomes unlawful. Thus, for instance, if a tenant successfully negotiated for an exclusive provision in his lease which was subsequently declared void as against public policy, he is still bound by the remaining provisions of the lease even though he has lost one of his most important bargained-for protections (and without which he may have not proceeded with the deal) after having relied on its validity.

I'm not suggesting that any of the above examples have a different result. But I am stating that in light of the

foregoing it is unfair for a tenant to be denied the benefits of a change in the law which relaxes the older, harsh rule with respect to the "silent consent standard."[1]

With all due respect to the Commission's recommendation, I find it hard to believe that any landlord "relied" on pre-Kendall law with respect to the silent consent standard when all the landlord had to do - for the avoidance of doubt - was to add the few little words: **"which consent may be unreasonably withheld."** This is especially true in light of the fact that it is common knowledge in the leasing community that the rule of the Kendall case with respect to the silent consent standard was, prior to that decision, part of a growing trend in the jurisdictions throughout the United States.

2. **Amendments to Civil Code Section 1951.4**.

A. **Shifting the Burden of Proof**. Section 1951.4 functions, in my view, to relieve the landlord of a basic duty to mitigate damages by finding a replacement lessee for a tenant who has breached the lease and abandoned the premises. In return for this a tenant is guaranteed certain flexibility in his right to transfer the lease - in effect shifting the burden of mitigation to the tenant himself if he wishes to reduce his damages.

If one accepts the view that there is a certain "rough equivalency" in this scheme, then the Commission's proposal in (b)(2) that the tenant bear the burden of proof that the landlord was unreasonable unfairly swings the pendulum too far in the landlord's favor. If the tenant is to be given flexibility with respect to transfers in a default and abandonment context in return for the landlord's retention of his 1951.4 remedy without a duty on landlord's part to mitigate, then if a landlord potentially violates this concept by the imposition of alledgedly unreasonable conditions, it is manifestly unfair to put the tenant to the proof of this. Rather, the burden should be the other way - the landlord should bear the responsibility of proving that his actions justified his retention of the remedy afforded by 1951.4.

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[1] In this memorandum I shall use the convenient definitions developed by Professor Coskran in his Summary of Conclusions, p. 108, par. 5 ("silent consent standard") and p. 109, pars. 6 and 7 ("express reasonableness standard" and "express sole discretion consent standard").

Considering the quality of standards I often encounter in printed lease forms or actual negotiations[2], I think the Commissions's statement that: **"Any lease standards and conditions for transfer should be presumed reasonable..."** is overambitious, if not hasty, despite their further remark that the tenant should be able to show that a particular standard is unreasonable under the circumstances.[3] Regardless of whether the placement of this burden of proof is consistent with cases involving the reasonableness standard[4] I strongly object to the express inclusion of this sentence and further disagree with portions of the "underlying philosophy of this Chapter" which support it.[5]

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[2]Examples of recently proposed "standards of reasonableness" are as follows:

(i) the transfer shall not detrimentally affect the shopping center;

(ii) any such transfer shall continue to provide a fair balance of customer traffic;

(iii) the business of the transferee shall be consistent with the "first class" character of the building;

(iv) the transferee shall undertake and operate its business in the premises with similar merchandise and merchandising policies to that which existed prior to the transfer;

(v) the transferee shall have a net worth equal to $1 million per store location operated by such party. [Please note that The Gap, Inc. with its 900 stores as against a $270 million net worth would fail this test!]

To an experienced tenant negotiator such "standards" are either entirely subjective, completely ambiguous (e.g. clause (i), (ii) and (iii)) or simply commercially non-feasible (e.g. clause (iv and (v)).

[3]See Tentative Recommendation, p. 4, subparagraph 10(2); also see Professor Coskran's Summary of Conclusions, par. B. 3 on page 113.

[4]See Tentative Recommendation, page 8, Comment to proposed revisions to 1951.4.

[5]Ibid.

B. References to Termination and Profits Clauses. The addition of subdivision (3) to subparagraph (c) and the new subparagraph (d) seems unnecessary. Has there ever been a suggestion that a termination clause or an appropriation of profits clause in a lease would disqualify the landlord from entitlement to the remedy of 1951.4? Their inclusion here, even if no real substantive harm results, adds confusion rather than clarity to this section. Their appearance in statutory language accords them a dignity that is unwarranted and creates the false impression that they have any active function in this section. At best, they only provide psychological support to the landlord community. At worst, the presence, in particular, of the profits clause here may create the impression that such a provision in other contexts - in a reasonable consent clause for example - is presumably a reasonable condition (see my discussion below). It should not be the function of this remedies section to attempt to merely give further legitimacy to that clause in a substantive section elsewhere.

3. Restrictions on Transfer.

A. Abolition of the Good Faith Doctrine. While I have no specific objection to confirming that the parties may freely contract for (a) an absolute prohibition on transfer or (b) a limitation on transfers subject to the conditions set forth in Section 1995.240 (including the right to unreasonably withhold consent), I do strongly object to the Commission's avowed purpose (as stated in its comments to Section 1995.210 on page 10) to **"completely supercede the law governing... good faith and fair dealing..."**

Allowing a landlord to expressly contract for the right to be unreasonable should not mean that he is also contracting for the right to act in bad faith. To my mind the concept of "unreasonable" in the context of consent to transfers of a lease refers to subjective rather than objective criteria as these terms have been dealt with in the case law, not to bad faith as distinguished from good faith conduct. The concept of "bad faith" conduct seems to suggest something "beyond" unreasonable.

My point is that while all bad faith refusals of consent are also unreasonable, not all unreasonable objections constitute bad faith.

Example 1. Consider the following hypothetical: A lease expressly provides that the landlord's consent to a transfer may be unreasonably withheld. It also provides that if the landlord consents to a transaction the parties shall share equally in any profits received by the tenant from the transferee. The tenant then proposes a transferee to the landlord and the landlord now

insists that as a condition to his consent all profits must be paid over to him. Is this conduct unreasonable? It is. But is it even something worse than that. The tenant was not bargaining for this when he agreed to the express sole discretion consent standard. He had made his deal with the landlord with respect to the allocation of profit. What he thought he was agreeing to was the right of the landlord to apply subjective criteria in considering a transferee rather than objective ones. He was not bargaining for the right of the landlord to change the deal and in bad faith renege on what he had previously agreed to with the tenant. Therefore, in this way a landlord could agree to anything in the lease and use the occasion of a proposed transfer to arbitrarily and in bad faith change the lease in whatever manner he desired. The tenant's choice is to live with this risk or lose the proposed assignment or sublease, effectively eliminating any chance of transferring the lease. I would hope that the Commission agrees that this conduct is unacceptable. The adhesion of contracts doctrine would not apply here and I am far from certain that the doctrine of unconscionability is applicable here to afford the tenant relief.

Example 2. Assume once again that a lease provides that the landlord's consent may be unreasonably withheld. The tenant now submits a transferee to the landlord, who refuses to respond at all! The landlord maintains that under the unreasonableness standard he may give any reason for his refusal, no reason at all or be under no obligation to respond (which is tantamount to a refusal for no reason). Should this conduct be condoned in a commercial context? I hardly think that this conduct is "fundamental to the commerce and economic development of the state" simply because it was arrived at by the exercise of "freedom of contract by the parties to commercial real property leases."[6]

There are also situations where indulgence in an unreasonable (i.e. subjective) standard does not constitute an act of bad faith. For example, assume that a shopping center landlord is considering whether to lease premises to Retailer A or to Retailer B. Both proposed retailers may have a substantial financial net worth and carry fine merchandise but landlord prefers Retailer A because the level of fashion of his goods are slightly higher than that of Retailer B. Under the principle of freedom of contract the landlord may enter into a lease with Retailer A as distinguished from Retailer B even though Retailer

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[6]Tentative Recommendation, p. 11, Comment to Section 1995.240.

B would be considered acceptable by the hypothetical reasonable landlord. If the lease provided for reasonable consent to a transfer and if Retailer A wanted to assign to Retailer B, the case law would generally require landlord to accept Retailer B, all else being equal, since the subjective differences in the landlord's mind between Retailer A and Retailer B would not justify refusal on grounds considered reasonable under the decisions. Thus, Retailer B could come into the center by way of the assignment clause when the landlord would not have been required to deal with him in the first instance. However, if the lease permits the landlord to be unreasonable he can refuse Retailer B for the reasons cited. Under these circumstances, the landlord may have acted unreasonably (when measured against the case law) but he certainly is not guilty of bad faith.

Similarly, under the "express sole discretion consent standard" a landlord may condition his consent on the payment to him of all excess consideration or "profit" received by the tenant or raising the rent to fair market value. While these conditions are unreasonable under the case law construing a reasonableness standard, they are not necessarily grounded in bad faith or unfair dealing.

Those who hold the landlord's viewpoint may argue with me that to allow a landlord to provide for an express sole discretion clause in his lease on the one hand and then still subject him to attack from the tenant on the basis of bad faith on the other hand is to complicate the law rather than to simplify it. However, all parties would agree that the above described conduct should not be condoned and that this is no reason to shrink away from this subject. The Commission recognizes that a landlord with an express sole discretion standard is still subject to attack under the adhesion doctrine or the unconscionability principle. To the extent that those concepts do not fit the facts of an egregious case, the doctrine of good faith and fair dealing should apply.

Thus I agree with the conclusion of Kendis v. Cohn [7], as recited in Professor Coskran's treatise [8] that:

> "a lessor is still bound by a requirement of good faith even though he does not have to be judged by an objective reasonableness standard. A person may be unreasonable but

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[7] 90 Cal. App. 41,66; 265 P. 844 (1928).

[8] Coskran pp. 39-40.

still acting in good faith. Reasonableness is an objective test based on common experience of the ordinary reasonable person. 'Good faith, in contrast, suggests a moral quality; its absence is equated with dishonesty, deceit or unfaithfulness to duty'."

In summary, it is appropriate for the parties to agree that the landlord may indulge in subjective standards in denying his consent so long as they are in some way connected to or protective of a rational business interest and free from bad faith. The "protection" of the "adhesion contract doctrine" [9] is of little value if the landlord, regardless of the relative bargaining positions of the parties, is not bound by basic principles of good faith and fair dealing. Thus, a clear statement of the preservation of the principles of good faith and fair dealing must be added to the Article.

B. **"Unreasonably Withheld" -Its Meaning**. The meaning of "unreasonably withheld" under subdivision (a) of proposed Section 1995.240 (i.e. under the "express reasonableness standard") is not really governed by the intention of the parties [10] - it is governed by the relatively objective standards developed from the whole body of judicial decisions on this subject throughout the United States. Those principles were best enunciated below:

"Can the reasonableness or unreasonableness of refusing consent vary with the identity and activities of the landlord? If so, we are relegated not to the objective standards by which any tenant can be measured, but to wholly subjective criteria which render effective judicial review difficult, if not impossible. To the extent that rejection of a proposed subtenancy is based upon the supposed needs or dislikes of the landlord, a policy of judicial disapproval of such subjective criteria is discernible." American Book Co. vs. Yeshiva University Development Foundation, Inc. (1969) 59 Misc. 2d 31, 297 NYS 2d 156 at pp. 160-161.

"Arbitrary considerations of personal taste, sensibility or convenience do not constitute the criteria of the landlord's duty under an agreement such as this. Personal satisfaction is not the sole determining factor. Mere whim or caprice,

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[9] Tentative Recommendation, p. 12, Section 1995.250(b) - statement of legislative intent.

[10] Tentative Recommendation, p. 12, Comment to Section 1995.240.

> however honest the judgment, will not suffice...the standard is the action of a reasonable man in the landlord's position. What would a reasonable man do in like circumstances? The term reasonable is relative and not readily discernible. As here used, it connotes action according to the dictates of reason--such as is just, fair and suitable in the circumstances." Broad & Branford Place Corp. vs. J.J. Hockenjos Co. (1944) 132 NJL 229 at p. 232, 39 A. 2d 80 at p. 82.

C. **Appropriation of Profits**. The Commission has devoted much attention to this subject as it curiously (but unnecessarily) appears in a new subparagraph (d) in Section 1951.4, the comment to subparagraph (b) of Section 1995.240 as well as codifying it in its own special section - 1995.260.

Under the universal case law on this subject, if the lease simply states (or if it is implied) that the landlord's consent will not be unreasonably withheld and nothing more, then increasing the rent, e.g. to fair market value or appropriating the profits paid by a transferee (which is another version of the same thing) as a condition of consent is per se unreasonable. However, if the lease expressly permits the landlord to be unreasonable, then such conditions would be allowed. It is my observation that experienced landlords and tenants understand these principles and resolve this most sensitive issue through the exercise of their freedom of contract - either they negotiate it or they don't.

The Commission's proposal would reverse the longstanding common law rule on this subject by legitimizing this concept as a pronouncement of public policy. Thus, if hereafter a lease merely provided for reasonable consent without more (or a silent consent standard of reasonableness applied), a landlord could now condition his consent on the appropriation of profit (or its alternate form - the raising of the rent) and point to Section 1995.260 as validation that his condition is reasonable. This is totally unacceptable and inappropriate.

Many landlords resent the fact that a tenant may transfer the lease and retain the appreciation in rental value ("bonus value" or "profit") that has occurred since the lease was first signed. They vehemently complain that the landlord is in the real estate business rather than the tenant. While this statement is true, it fails to take into account the magnitude of the risk assumed by the tenant in a commercial lease. It is the tenant who undertakes a great deal of "downside" risk with very little downside protection. He is thus entitled to the "upside" potential of a rise in rental value. The landlord has made his bargain and was content to accept the agreed-upon rent for the

term; he is only entitled to the reversion. It is neither inherently evil nor presumptuous of the tenant to enjoy this appreciation. The landlord really wants to have it both ways - to receive the agreed-upon rent while at the same time be guaranteed fair rental value despite his failure at the time of lease execution to negotiate a more favorable rent scheme to protect him in the future. He seizes upon the opportunity of an assignment to realize the increase in rental value.

It must be remembered that no one is taking money out of the landlord's pocket - at best, we are talking about a windfall caused by rising real estate values. In commercial leases this issue is almost always negotiated and resolved on the basis of a 50-50 split of the profit after the tenant has first recovered his major costs and expenses in the deal, such as (i) the remaining book value of his leasehold improvements, (ii) broker's commission in finding the new tenant, (iii) alterations performed for the new tenant, and (iv) attorneys' fees and other incidental costs.

If the Commission champions freedom of contract then it is incumbent upon the landlord to raise the issue in the lease negotiations and for the parties to freely contract for a distribution of such increased rental value; alternatively, its the landlord's burden to attempt to tie his consent power to an arbitrary standard. The result of that exchange would depend on the interaction of the negotiation process. This is what the Court in Kendall meant when it observed:

> "...whatever principle governs in the absence of express lease provisions, nothing bars the parties to commercial lease transactions from making their own arrangements respecting the allocation of appreciated rentals if there is a transfer of the leasehold." 40 Cal. 3d at 505, n. 17.

Hence, it is entirely inappropriate and severely disruptive of the universal common law rule to include Section 1995.260 in the Tentative Recommendation.

D. Section 1995.250 - Implied Standard. The first sentence appears to codify Kendall. In subparagraph (c), last sentence, concerning the satisfaction of the tenant's burden of proof, the sentence seems ambiguous:

(1) Clearly, if the landlord fails to respond at all, tenant has met the burden;

(2) If landlord responds with an objection, then presumably tenant must still show that the objection was unreasonable. Isn't this the whole premise of the

burden of proof? It seems circuitous to say that he can meet this burden by showing that landlord was unreasonable!

(3) The final phrase "**or has not acted reasonably in stating in writing a reasonable objection to the transfer**" is confusing to me - I don't know what it means. Is landlord acting unreasonably <u>because</u> he failed to state a reasonable objection? If so, then the statement would seem unnecessary because the section already provides that "**the landlord has not stated a reasonable objection**". Or is some other conduct intended by this phrase - please clarify.

I sincerely appreciate the opportunity to offer my comments to the Commission and hope that they will assist you in reaching an informed and equitable final proposal which is fair to the competing interests of landlords and tenants.

Respectfully submitted,

Joel R. Hall
Senior Attorney

JRH:cb

cc: Howard W. Lind, Esq.
M.J. Pritchett, Esq.
Gordon W. Jones, Esq.
Ronald P. Denitz, Esq.

CA LAW REV. COMM'N

DEC 14 1988

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Oakland, CA 94660 (4th and Jackson Streets)

December 13, 1988

FEDERAL EXPRESS

California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

Attention: Nathanial Sterling
Assistant Executive Secretary

RE: Tentative Recommendation Relating To Commercial Real Property Leases

Ladies and Gentlemen:

Safeway Stores Incorporated desires to enter the following comments in the public record regarding the proposed statute (the "Proposed Statute") recommended by the California Law Revision Commission (The "Commission") in its Tentative Recommendation relating to Commercial Real Property Leases: Assignment and Sublease (the "Recommendation"). Overall, we believe the Proposed Statute is unfairly and unnecessarily biased against tenants. We are thus opposed to the recommendation of the Proposed Statute to the Legislature in its present form.

The Commission's statutory mandate includes the duty to recommend changes in the law to "eliminate antiquated and inequitable rules of law, and to bring the law of this State into harmony with modern conditions." In the area of lease assignments, the California courts beat the Commission to the punch. In a series of decisions culminating in 1985 with Kendall v. Pestana, the courts reversed the antiquated and inequitable common law rule which permitted a landlord to arbitrarily withhold its consent to assignments unless explicitly required to be reasonable by the lease and adopted instead the modern rule of good faith and fair dealing. We understand that because the Commission had sponsored earlier legislation (Civil Code Section 1951.4) based in part on the pre-Kendall rule, it commissioned a study regarding lease assignments: "Restrictions on Lease Transfers: Validity and Related Remedies Issues (Must consenting Adults be Reasonable?)" (the "Study"). Unfortunately, as is

apparent even from the Study's subtitle, the Study adopted a very negative approach to the Kendall case. Both its tone and substance reflect a hostility towards the modern view adopted by Kendall and a naive, if not sentimental, longing for the antiquated common law rule. The Study describes these issues as "an important confrontation between freedom of contract and public policy." However, it turns out to be no contest. "Freedom of contract" wins every round.

There is, of course, nothing wrong with the Study's adoption of a very conservative viewpoint. The Study makes it quite clear that its views are those of its author and not of the Commission. What is, however, both surprising and disappointing is how completely the Proposed Statute incorporates the Study's most extreme views. The irony of the Commission's adoption of the Study's viewpoint is that it turns the Commission's mandate on its head. Rather than eliminating antiquated and inequitable rules in light of modern views, the Proposed Statute does as much as possible to preserve the antiquated and inequitable common law rule as long as possible and to limit any future expansion of the modern view. Though large tenants like Safeway will be hurt if the Proposed Statute is adopted, they will not be its primary victims. In a "freedom of contract" system large players like Safeway can use their bargaining power and sophisticated lawyers to protect themselves. Those most hurt will be the vast bulk of commercial tenants; small businessmen and businesswomen who compete in a world of non-negotiable standard lease forms. If the Proposed Statute is adopted, these standard lease forms will quickly be amended to exploit every ounce of "freedom of contract" granted to the landlord industry by the Proposed Statute.

In our view the most significant, and the most harmful, effect of the Proposed Statute would be the reversal of Kendall as to leases executed prior to the date of Kendall, as set forth in Section 1995.250(b). Since this reversal raises serious constitutional questions the Proposed Statute includes elaborate public policy recitals designed to insulate this portion of the Proposed Statute from constitutional challenge. The Legislature is asked to declare that, "The Kendall case reversed the law on which parties to commercial real property leases . . . could reasonably rely, thereby frustrating the expectations of the parties, with the result of imparing commerce and economic development." This flowery rhetoric quickly wilts under the glare of close scrutiny.

Was it in fact reasonable for a landlord to rely on the omission of a few words in a lease for the right to be unreasonable and arbitrary, especially in light of a rising flood of cases and articles implying a duty of reasonableness in various areas of the law? Which of the parties expectations were frustrated? Did tenants really expect that their landlords had the right to be unreasonable and arbitrary? Has commerce and economic development really been impaired by the Kendall decision? Even assuming these rhetorical recitals were true, the change in the law they seek to justify must be scrutinized. It is simply an attempt to preserve the right of landlords to be arbitrary and to prevent courts from assisting tenants who have been victims of landlord's arbitrariness. Is this "freedom" from the duty of good faith and fair dealing included in every other contract and every other provision of the lease so fundamental that the Commission (of all people) needs to draft a statute to protect it? We think not.

Most of the other provisions of the Proposed Statute are variations on the anti-tenant theme. New Chapter 6 starts off with Section 1995.010, and its corollary Section 1995.020(b), which state that the Proposed Statute does not apply to residential leases, This exclusion glaringly reveals the Proposed Statute's anti-tenant bias. If the Proposed Statute is in fact an equitable change the Commission should have not hesitation about including residential tenants within its scope. In fact, one would normally expect the Commission to draft legislation designed to help residential tenants and exclude commercial tenants from these special benefits. The Proposed Statute is exactly the opposite. It is specifically designed to hurt commercial tenants (both small and large) and thus the Commission must shield residential tenants from its effects.

The definitions in Section 1995.020 serve mostly to insure that the Proposed Statute sweeps as widely as possible in cutting down commercial tenants' protections against arbitrary behavior by landlords. For example, by broadly defining transfer, a wide variety of unexpected events, including death, dissolution of a partnership or an involuntary encumbrance could create a potentially incurable default under a tenant's lease.

Section 1995.210(a) is another harmless looking section that is in fact anti-tenant. According to the comment the simple sentence, "Subject to the limitations in this chapter, a lease may include a restriction on transfer of the tenant's interest in the Lease," means that matters related to tenant lease

assignments are completely insulated from the effects of the covenant of good faith and fair dealing implied in every contract as well as the law regarding unreasonable restraints on alienation. Why should assignments of tenant's rights be exempt from the rules that govern every other contract and every other conveyance of real property? Doesn't the same rationale (or lack thereof) apply to assignments of lessor's interests in leases? There is not reason why the statutory validation of a right to be unreasonable, i.e., to withhold consent on subjective grounds, should also include an approval of the right to act in bad faith.

Sections 1995.210(b) and 1995.220 appear to benefit tenants. However, they merely restate that existing common law. They appear to be included in the statute soley so these common law rules can be narrowed and circumscribed by the other provisions of the Proposed Statute.

Section 1995.250(a) narrowly restates the Kendall holding as to post-Kendall leases. Though this provision also appears to benefit tenants, it will be virtually irrelevant as soon as it is adopted. By its terms, it applies only to leases which do not include a standard of consent. Prior to Kendall, some landlords' leases did not specifically state that the landlord could arbitrarily withhold its consent on the theory that the best approach, especially with unsophisticated tenants, was to rely on the old case law arbitrariness rule and avoid raising the issue in the lease negotiations. Since Kindall, only the most ill-informed landlords fail to specify the standard for consent. With the adoption of the Proposed Statute such silent consent provisions would virtually disappear.

Section 1995.230 declares that an absolute prohibition on transfer is permitted. Section 1995.240 plays out a number of variations on this unfettered landlord discretion theme. What public policy requires that the transfer of a tenant's leasehold be exempt from the general principles of unreasonable restraints on alienation that apply to all other real property transfers? Why should this provision of a lease, and only this provision, be exempt from the duty of good faith and fair dealing implied in every other provision of a lease and every other contract? The adhesion contract doctrine referred to in the comments to these sections is a red herring. The strict adhesion contract rules would virtually never operate to protect a tenant in the commercial lease context. Obviously, if these protections had been sufficient to protect tenants, there would have been no need for the modern view adopted in Kendall to have been developed.

The revisions to Section 1951.4 which were the original inspiration for the Study, also have an anti-tenant bias. The burden of proving the landlord's unreasonableness is shifted to the tenant. Why, is this the case, especially in the context of amendments which allow the lessor to have its cake and eat it too? The landlord is now permitted to include a specific right to be arbitrary in the lease but to retain its rights under Section 1951.4 so long as it is not then being unreasonable (with the burden of proof on the tenant). This change eliminates any negotiating leverage a tenant would have otherwise derived from the landlord's need to either agree to be reasonable at the outset or to forfeit the Section 1951.4 remedy.

In sum, the adoption of the Proposed Statute would be a travesty of the Commission's role. Rather than replacing outdated and unfair rules with equitable, modern counterparts, the Proposed Statute effectively eliminates the modern rule adopted by Kendall and attempts to push back the clock in the area of lease assignments. It replaces reasonableness with arbitrariness and fairness with bias. The Proposed Statute reads like a landlord industry wish list rather than the product of the Commission's considered deliberations. We must therefore respectfully urge that the recommendation of the Proposed Statute to the Legislature be carefully reconsidered.

Sincerely,

SAFEWAY STORES, INCORPORATED
Real Estate Law Division

Gordon W. Jones
Vice President and Manager

GWJ/pi

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10/24/88

TENTATIVE RECOMMENDATION

relating to

COMMERCIAL REAL PROPERTY LEASES:

ASSIGNMENT AND SUBLEASE

Background

Traditionally, if a lease required the landlord's consent to an assignment or sublease, the landlord had absolute discretion whether or not to consent. But in 1985, the California Supreme Court reversed this rule in *Kendall v. Ernest Pestana, Inc.*[1] Under *Kendall*, if a commercial real property lease provides no standard governing the landlord's consent, the landlord may not withhold consent to the tenant's assignment or sublease unless the landlord has a commercially reasonable objection.

The *Kendall* decision leaves unresolved a number of related issues. Among these issues are (1) whether the new rule should be applied to leases executed before the decision,[2] (2) whether the rule should be applied to residential leases,[3] and (3) whether a lease may absolutely prohibit assignment or grant absolute discretion over assignment to the landlord.[4] The uncertainty that now exists in the law relating to assignment and sublease will continue to cause problems in practice and disrupt normal commerce. The California Law Revision

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

2. *Cf.* Coskran, *Restrictions on Lease Transfers: Validity and Related Remedies Issues*, 82-90 (1988).

3. "We are presented only with a commercial lease and therefore do not address the question whether residential leases are controlled by the principles articulated in this opinion." *Kendall*, 40 Cal. 3d at 492 n. 1.

4. *Kendall*, 40 Cal. 3d at 499 n. 14.

Commission has concluded that the law in this area should be codified and clarified.

Codification of Kendall

If a lease precludes the tenant from assigning or subletting without the landlord's consent, but is silent as to the standards governing the landlord's consent, should the landlord have absolute discretion or should the law imply a standard of reasonableness? Since December 5, 1985, the date of the *Kendall* decision, California law has implied a standard of reasonableness. Before that date, absolute discretion was the generally accepted rule.[5]

Both of these rules promote identifiable public policies. The *Kendall* rule is supported by the policy against unreasonable restraints on alienation[6] and the implied contractual duty of good faith and fair dealing[7]. Considerations that support the previous rule of landlord discretion include the landlord's overriding interest in protecting the reversion and the uncertainty and litigation caused by a reasonableness standard.

In deciding between the competing policies, the decisive factor should be the reasonable expectations of the parties who negotiate a provision in a lease requiring the landlord's consent without further guidance. Certainty in the law and the ability to rely on a negotiated agreement are of primary importance in the commercial world. The parties need assurance that the rights and obligations under their tenancy agreement will be honored.

By now, parties who negotiate a lease understand the *Kendall* rule that if the lease is silent on standards for the landlord's consent, the law implies a reasonableness requirement. The parties' reliance on

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5. See Coskran, *Restrictions on Lease Transfers: Validity and Related Remedies Issues*, 37-45 (1988); *Kendall*, 40 Cal. 3d at 507-11 (dissent); Kreisher v. Mobil Oil Corporation, 198 Cal. App. 3d 389, 243 Cal. Rptr. 662 (1988), review den. May 5, 1988.

6. *Kendall*, 40 Cal. 3d at 498-500.

7. *Kendall*, 40 Cal. 3d at 500.

the *Kendall* rule should be protected. The Commission recommends that the *Kendall* rule be codified to confirm this reliance and protect parties from future changes in the currents and tides of judicial philosophy.

Application to Pre-*Kendall* Leases

The *Kendall* rule should be codified only as to leases executed on or after December 5, 1985, the date of the *Kendall* decision. The interest of parties who relied on the pre-*Kendall* rule of absolute landlord discretion is also entitled to protection. This recommendation is consistent with narrow judicial construction of pre-*Kendall* leases by post-*Kendall* cases,[8] and with case law expressly limiting retroactivity of *Kendall*.[9]

Impact of *Kendall* on Landlord Remedies

Under Civil Code Section 1951.4, the landlord may keep the lease in force and require continued payment of rent notwithstanding abandonment by the tenant. This remedy is available only if the lease expressly incorporates the remedy and only if the lease allows the tenant to assign or sublet. If the landlord's consent is required to assign or sublet, the lease must also provide that the landlord's consent may not unreasonably be withheld. This statute was based on the assumption of prior law that the landlord's consent is not subject to a reasonableness requirement unless the lease imposes it.

With the change in California law to imply a reasonableness requirement in the absence of an express standard for consent in the lease, Section 1951.4 should also be revised. The landlord's right to keep the lease in force should be available if a reasonableness standard is implied, as well as if the lease expressly imposes a

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8. See, e.g., John Hogan Enterprises, Inc. v. Kellogg, 187 Cal. App. 3d 589, 231 Cal. Rptr. 818 (1985); Airport Plaza, Inc. v. Blanchard, 188 Cal. App. 3d 1594, 234 Cal. Rptr. 198 (1987).

9. Kreisher v. Mobil Oil Corporation, 198 Cal. App. 3d 389, 243 Cal. Rptr. 662 (1988), review den. May 5, 1988.

reasonableness standard. Other technical and clarifying amendments should also be made in Section 1951.4.[10]

Other Lease Restrictions on Transfer

Kendall dealt only with a lease clause that requires the landlord's consent but that fails to state a standard for giving or withholding consent. However, the reasoning of the decision raises issues concerning the validity of other types of lease restrictions on transfer. The court's concern over unreasonable restraints on alienation and the court's importation of the good faith and fair dealing doctrine into lease law could easily affect other types of restrictions on lease transfer.[11] The Commission believes a systematic statutory exposition of the governing law in this area is necessary to avoid many years of litigation and uncertainty.

The statute should reaffirm the governing principle of freedom of contract between the parties to a lease and honor the reasonable expectations of the parties based on their agreement. The parties

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10. Changes in Section 1951.4 recommended by the Commission include:

(1) The remedy should be available to the landlord if the lease does not prohibit, rather than "if the lease permits," assignment or sublease.

(2) Any lease standards and conditions for transfer should be presumed reasonable, although the tenant should be able to show that a particular standard or condition is unreasonable under the circumstances when it is applied.

(3) The statute should state clearly that, if a condition on transfer has become unreasonable due to a change in circumstances, the landlord may waive the condition and still take advantage of the Section 1951.4 remedy.

(4) The statute should state clearly that the remedy is not denied to a landlord because of the presence in a lease of a provision giving the landlord the right to recover the premises in case of a transfer. Exercise of such an election, however, terminates the lease and precludes the landlord's use of the Section 1951.4 remedy.

(5) The existence or exercise of a provision in a lease that gives the landlord the right to recapture any benefits realized by the tenant as a result of a transfer should not preclude the landlord's use of the Section 1951.4 remedy.

11. See, e.g., Coskran, *Restrictions on Lease Transfers: Validity and Related Remedies Issues*, 59-63 (1988).

should be able to negotiate any restrictions on transfer that are appropriate for the particular transaction with the assurance that the restrictions will be enforced. While this fundamental principle assumes some bargaining ability by both parties to the lease, it does not necessarily assume equality of bargaining position. Either the landlord or the tenant may have superior bargaining power depending on its financial condition, its representation by legal counsel, the economics of the commercial lease market, and other factors. Where the situation is such that the lease is a contract of adhesion or the particular clause is unconscionable, for example, general principles limiting freedom of contract will govern.[12]

The statute should codify the common law rules that the tenant may assign or sublet freely unless the parties agree to a limitation on the right of the tenant to assign or sublease,[13] and that any ambiguities in a limitation are to be construed in favor of transferability.[14] The statute should make clear that the right to agree to limitations on transferability includes the right to agree that the tenant's interest will be absolutely nontransferable, or that the tenant's interest may not be transferred without the landlord's consent, which may be given or withheld in the landlord's sole and absolute discretion.

The parties should also be able to agree on standards and conditions for transfer, and those standards and conditions should be enforceable. The conditions might include, for example, that the landlord is entitled to recapture any consideration realized by the tenant as a result of a transfer, or that the landlord may elect either to consent to a transfer or to terminate the lease. So long as these limitations satisfy the general restrictions on freedom of contract, they should be recognized as valid.

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12. See, e.g., 1 B. Witkin, Summary of California Law *Contracts* §§ 23-36 (9th ed. 1987) (adhesion and unconscionable contract doctrines).

13. See, e.g., Kassan v. Stout, 9 Cal. 3d 39, 507 P. 2d 87, 106 Cal. Rptr. 783 (1973).

14. See, e.g., Chapman v. Great Western Gypsum Co., 216 Cal. 420, 14 P. 2d 758 (1932).

Application to Commercial and Not Residential Leases

The recommendations made in this report relate only to commercial real property leases, not to residential leases. While it might be beneficial to clarify the law relating to residential leases and to maintain some degree of uniformity between the residential and commercial lease law of the state, different policy considerations (particularly relating to bargaining position of the parties) affect commercial and residential lease law. Moreover, transfer issues arise less frequently in connection with residential leases because they are generally short in duration and rarely develop a large transfer value. A residential tenant may not expect to receive consideration on assignment or sublease of the tenancy to the same extent a commercial tenant may be seeking consideration as part of the lease transaction.

For these reasons, the Commission believes the recommendations made in this report should be limited to commercial leases at this time. The Commission plans to give further study, in a later report, to the issue of whether some or all of the recommendations should be made applicable to residential leases.

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

An act to amend Section 1951.4 of, and to add Chapter 6 (commencing with Section 1995.010) to Title 5 of Part 4 of Division 3 of, the Civil Code, relating to commercial real property leases.

The people of the State of California do enact as follows:

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

SECTION 1. Section 1951.4 of the Civil Code is amended to read:

1951.4. (a) The remedy described in this section is available only if the lease provides for this remedy.

(b) Even though a lessee of real property has breached ~~his~~ 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 ~~his~~ the lessor's rights and remedies under the lease, including the right to recover the rent as it becomes due under the lease, if the lease permits the lessee, or the lessee otherwise has the right, to do any of the following:

(1) Sublet the property, assign ~~his~~ the lessee's interest in the lease, or both.

(2) Sublet the property, assign ~~his~~ the lessee's interest in the lease, or both, subject to standards or conditions, and the lessor does not, at the time the lessee seeks to sublet or assign, require compliance with any unreasonable standard for, nor any unreasonable condition on, such subletting or assignment. The lessee has the burden of proof that the lessor requires compliance with a standard or condition that is unreasonable.

(3) Sublet the property, assign ~~his~~ the lessee's interest in the lease, or both, with the consent of the lessor, and ~~the lease provides that~~ such consent ~~shall~~ may not unreasonably be withheld while the lessor enforces the remedy described in this section.

(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.

<u>(3) A provision in the lease that the lessor may elect either to consent to a subletting or assignment or to terminate the lessee's right to possession, so long as the lessor does not make the election to terminate the lessee's right to possession.</u>

<u>(d) Neither the presence nor the exercise of a provision in a lease that, if the lessee receives from a sublessee or assignee consideration in excess of the rent under the lease, the lessor is entitled to some or all of the consideration, precludes the lessor's use of the remedy described in this section.</u>

<u>Comment.</u> The introductory portion of subdivision (b) of Section 1951.4 is amended to recognize that a lessee may sublet the property or assign the lessee's interest in the lease whether or not the lease permits it, so long as the lease does not prohibit it. Cf. Section 1995.210 (right to transfer commercial lease absent a restriction).

Subdivision (b)(2) is amended to impose on the lessee the burden of proof of unreasonableness of a standard or condition at the time and in the manner it is applied. The parties may agree to standards and conditions for assignment and sublease. Section 1995.260 (transfer restriction subject to standards and conditions). Imposing the burden of proof on the lessee is consistent with cases involving the reasonableness standard generally and with the underlying philosophy of this chapter. See Coskran, *Restrictions on Lease Transfers: Validity and Related Remedies Issues*, 100 (1988). See also subdivision (d).

Subdivision (b)(2) also is amended to clarify existing law that the lessor may waive a standard or condition on subletting or assignment that is or has become unreasonable and still take advantage of the remedy provided in Section 1951.4. See *Recommendation Relating to Real Property Leases,* 9 Cal. L. Revision Comm'n Reports 153, 168 (1969) ("Occasionally, a standard or condition, although reasonable at the time it was included in the lease, is unreasonable under circumstances existing at the time of the subletting or assignment. In such a situation, the lessor may resort to the remedy provided by Section 1951.4 if he does not require compliance with the now unreasonable standard or condition."). Under subdivision (b)(2) a standard or condition may be reasonable or unreasonable, so long as the lessor does not require compliance with a condition that is unreasonable at the time of the proposed subletting or assignment.

Subdivision (b)(3) is amended to recognize that the lessor's consent to an assignment or subletting may not unreasonably be withheld, even though the lease does not require reasonableness, if the lease provides no standard for giving or withholding consent. Section 1995.250 (implied standard for landlord's consent in commercial lease). A lease may provide that the lessor may unreasonably withhold consent if the remedy provided in this section is not being exercised, but that the landlord may not unreasonably withhold consent if the remedy provided in this section is being exercised.

Subdivision (c)(3) is added to recognize that the existence of an unexercised right of the lessor to terminate the lessee's right to possession does not prejudice the lessor's right to the remedy under this section. Cf. Section 1995.240 (express standards and conditions for landlord's consent).

Subdivision (d) is new. See Section 1995.260 and Comment thereto (transfer restriction subject to standards and conditions).

The other changes in Section 1951.4 are technical, intended to render the provision gender-neutral.

NOTE. Code of Civil Procedure Section 1951.4 permits the landlord to keep the lease in effect and collect rent even though the tenant has breached and abandoned, provided the tenant has the right to assign or sublet. In effect, it shifts the duty to mitigate from the landlord to the tenant.

Subdivision (a)

Subdivision (a) limits the Section 1951.4 remedy to leases that provide for the remedy. Robert J. Berton of San Diego (Exhibit 1) suggests that it would be helpful to make clear in the statute or Comment that the limitation would be satisfied by a general statement in a lease to the following effect:

> *Landlord has all of the remedies contained in California Civil Code Section 1951.4(a), to which section reference is made for further particulars.*

The staff agrees it is not clear whether a general reference, as opposed to a recitation of the specific remedy, satisfies the statutory requirement. A general reference in the lease to Section 1951.4 does put the tenant on notice, of sorts. A recitation of the specific remedy retained by the landlord is better notice to the tenant. A middle ground would be a short-form reference that gives the tenant some information, thus:

> *(a) The remedy described in this section is available only if the lease provides for this remedy. In addition to any other provision in the lease for the remedy described in this section, a provision in the lease in substantially the following form satisfies this subdivision:*
>
> > *The landlord has the remedy described in California Civil Code Section 1951.4 (landlord's right to continue lease in effect after tenant's breach and abandonment subject to tenant's right to sublet or assign).*
>
> *Comment. Subdivision (a) is amended to provide a "safe harbor" of specific language that satisfies the requirement that the lease provide for the remedy in this section. The amendment should not be construed to imply that no other form of language will satisfy the requirement. Whether any other language will satisfy the requirement depends on the language used and the understanding of the parties.*

Subdivision (b)

Subdivision (b)(2) allows the landlord to exercise the Section 1951.4 remedy if the landlord does not require the tenant to comply with any unreasonable standard or condition for subletting or assigning. The Commission's tentative recommendation would impose on the tenant the burden of proof that a standard or condition is unreasonable. Joel R. Hall of The Gap (Exhibit 5) and Gordon W. Jones of Safeway (Exhibit 6) object to imposing this burden on the tenant. Mr. Hall states that restrictions imposed by a landlord should not be presumed reasonable; he gives examples of standards and conditions on transfer sought to be imposed by landlords that are either subjective, ambiguous, or not commercially feasible. He argues that Section 1951.4 gives the landlord a remedy on condition that the tenant be allowed to sublet or assign; if the landlord refuses to allow the subletting or assignment and still wants to take advantage of the Section 1951.4 remedy, the landlord should be put to the proof of the reasonableness of the refusal. The staff believes Mr. Hall makes a good case for imposing the burden of proof on the landlord rather than on the tenant for the purpose of this section.

The proposed revision of subdivision (b)(3) would allow the landlord to include in the lease a provision that the landlord may not unreasonably withhold consent if the landlord elects to use the Section 1951.4 remedy, but otherwise the landlord may unreasonably withhold consent. Mr. Jones objects that this allows the landlord to have its cake and eat it too. The change eliminates any negotiating leverage a tenant would have otherwise derived from the landlord's need to either agree to be reasonable at the outset or to forfeit the Section 1951.4 remedy. This problem is also noted in Professor Coskran's study, which states that "allowing such a provision eliminates any benefit the section would give a tenant in bargaining for a reasonableness standard governing all transfers."

Subdivision (c)

The landlord may exercise the Section 1951.4 remedy only if the landlord does not terminate the tenant's right to possession. Subdivision (c) enumerates acts that do not amount to a termination of possession for this purpose. The Commission has proposed to add to the listing a new paragraph (3)--if a lease clause allows the landlord to terminate instead of consenting to an assignment or sublease, the landlord may elect not to terminate under the clause, and the existence of the clause itself is not considered a termination. Mr. Hall objects to the inclusion of this provision: the provision is unnecessary, addresses a matter that is not a problem, serves to further complicate the section, bestows an unwarranted dignity on the type of clause described by giving it statutory status, adds nothing to the law, and simply provides psychological support to the landlord community. The staff tends to agree that putting this provision in the statute will encourage its use; we would demote the provision from the statute to the Comment.

Subdivision (d)

Mr. Hall has the same problems with proposed new subdivision (d) as with subdivision (c). Subdivision (d) states that neither the existence nor the exercise of a lease clause giving the landlord some

or all of the profit of an assignment or sublease precludes the landlord from exercising the Section 1951.4 remedy. He is also concerned that subdivision (d) may give the misleading impression that a profit shift clause is reasonable in other contexts as well, whereas the reasonableness of such a clause depends on the rule applicable to it in the context to which it relates.

The staff feels differently about subdivision (d) than about subdivision (c). Negotiation and a clear statement in the lease of rights on the central issue of profit shifting is desirable. We would retain subdivision (d), but make clear in the Comment that whether or not such a clause is reasonable here does not affect its reasonableness for other purposes.

Civil Code §§ 1995.010-1995.260 (added). Assignment and sublease

SEC. 2. Chapter 6 (commencing with Section 1995.010) is added to Title 5 of Part 4 of Division 3 of the Civil Code, to read:

CHAPTER 6. ASSIGNMENT AND SUBLEASE

Article 1. General Provisions

§ 1995.010. Scope of chapter

1995.010. This chapter applies to transfer of a tenant's interest in a lease of real property for other than residential purposes.

Comment. Section 1995.010 limits the scope of this chapter to commercial real property leases. Assignment and sublease issues concerning personal property leases and residential real property leases involve different public policies than commercial real property leases, and therefore are governed by the common law and not by this chapter.

NOTE. Gordon W. Jones of Safeway (Exhibit 6) states that if the proposed statute were equitable it should be extended to residential tenancies as well as commercial tenancies; the fact that it is not reveals the proposal's anti-tenant bias.

Mr. Jones has apparently overlooked the portion of the tentative recommendation that addresses the matter of residential tenancies. The tentative recommendation notes the different policies involved, and states that "The Commission plans to give further study, in a later report, to the issue of whether some or all of the recommendations should be made applicable to residential leases." In fact, the Commission has scheduled this matter for consideration at the same meeting at which the present comment of Mr. Jones will be considered. See Memorandum 89-6 (residential tenancies).

§ 1995.020. Definitions

1995.020. 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 transfer" means a provision in a lease that restricts the right of transfer of the tenant's interest in the lease.

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

(e) "Transfer" of a tenant's interest in a lease means an assignment, sublease, or other voluntary or involuntary transfer or encumbrance of all or part of a tenant's interest in the lease.

Comment. Section 1995.020 provides definitions for drafting convenience.

Subdivision (b) is consistent with Section 1995.010 (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.

Subdivision (e) makes clear that the statute applies not only to assignments and subleases but also to encumbrances of the tenant's interest, by way of mortgage, trust deed, assignment for security purposes, or other creation of a security interest, and to involuntary transfers of the tenant's interest, including transfer pursuant to execution sale or tax sale.

NOTE. Gordon W. Jones of Safeway (Exhibit 6) remarks that the definitions serve mostly to insure that the Proposed Statute sweeps as widely as possible in cutting down commercial tenants' protections against arbitrary behavior by landlords. As a specific example, he states that under the broad definition of "transfer" a variety of unexpected events, including death, dissolution of a partnership, and involuntary encumbrance could create a potentially incurable default by the tenant.

It is not the definition of "transfer" that creates a default, but the agreement of the parties to the lease that characterizes such events as a default. The definition merely ensures that if the parties to the lease agree to restrictions on involuntary transfer by the tenant, those restrictions will be treated by the law the same way lease restrictions on voluntary transfer are treated. The staff notes that, as a general rule, a restriction on involuntary transfer must be quite clear and specific before it will be enforced. See Memorandum 89-10 (involuntary transfers), also scheduled for consideration at the meeting at which the present comment of Mr. Jones will be considered.

The Comment to the section may have given Mr. Jones the misimpression that the definition itself restricts involuntary transfers by the tenant. We would remedy this by revising the Comment to read:

> *Subdivision (e) makes clear that the statute applies not only to lease restrictions on assignments and subleases but also to lease restrictions on encumbrances of the tenant's interest, by way of mortgage, trust deed, assignment for security purposes, or other creation of a security interest, and to lease restrictions on involuntary transfers of the tenant's interest, including transfer pursuant to execution sale or tax sale.*

Article 2. Restrictions on Transfer

§ 1995.210. Right to transfer absent a restriction

1995.210. (a) Subject to the limitations in this chapter, a lease may include a restriction on transfer of the tenant's interest in the lease.

(b) Unless a lease includes a restriction on transfer, a tenant's rights under the lease include unrestricted transfer of the tenant's interest in the lease.

Comment. Subdivision (a) of Section 1995.210 is a specific application of general principles of freedom of contract. Subdivision (a) is limited by the provisions of this chapter governing restrictions on transfer. See, e.g., Section 1995.250 (implied standard for landlord's consent). The provisions of this chapter are intended to completely supersede the law governing unreasonable restraints on alienation (see, e.g., Civil Code § 711) and the law governing good faith and fair dealing (see, e.g., California Lettuce Growers v. Union Sugar Co., 45 Cal. 2d 474, 289 P. 2d 785 (1955)) as they relate to restrictions on transfer of a tenant's interest in a lease. See Comment to Section 1995.250. 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 freely assign or sublease unless the right is expressly restricted by the parties. See, e.g., Kassan v. Stout, 9 Cal. 3d 39, 507 P. 2d 87, 106 Cal. Rptr. 783 (1973).

NOTE. Joel R. Hall of the Gap (Exhibit 5) and Gordon W. Jones of Safeway (Exhibit 6) object to the policy expressed in the Comment to subdivision (a) that this chapter is intended to completely supersede the law governing unreasonable restraints on alienation and good faith and fair dealing, as they relate to restrictions on transfer of a

tenant's interest in a lease. They believe that the statutory validation of the right to enforce a lease provision allowing the landlord to act unreasonably should not affect general contract principles affecting bad faith actions by the parties. "Allowing a landlord to expressly contract for the right to be unreasonable should not mean that he is also contracting for the right to act in bad faith." (Exhibit 5) "Why should this provision of a lease, and only this provision, be exempt from the duty of good faith and fair dealing implied in every other provision of a lease and every other contract?" (Exhibit 6)

Mr. Hall gives two examples of cases where he believes the landlord's action would not only be unreasonable but would also amount to bad faith that should not be condoned. The first case is a lease the permits the landlord to unreasonably withhold consent, but if the landlord does consent, any profits of the transfer are to be shared between landlord and tenant. In this situation, according to Mr. Hall, if the landlord insists on all profits as a condition of consenting to the tenant's transfer, the landlord has gone beyond unreasonable withholding of consent and is acting in bad faith by trying to change the nature of the agreement. The landlord is trying to convert the right to exercise absolute control over the identity of the tenant into a right to all profits from a lease transfer contrary to the express agreement of the parties, which is a bad faith violation of the tenancy agreement, according to Mr. Hall. In his second example, the landlord refuses to respond at all to the tenant's request for consent, on the basis that the right to unreasonably withhold consent means the landlord may give any reason for refusal, no reason at all, or be under no obligation to respond. Mr. Hall does not believe this conduct should be condoned in a commercial context; bad faith is the only remedy of the tenant in an egregious case.

> *In summary, it is appropriate for the parties to agree that the landlord may indulge in subjective standards in denying his consent so long as they are in some way connected to or protective of a rational business interest and free from bad faith. The "protection" of the "adhesion contract doctrine" is of little value if the landlord, regardless of the relative bargaining positions of the parties, is not bound by basic principles of good faith and fair dealing. Thus a clear statement of the preservation of the principles of good faith and fair dealing must be added to the Article.*
> *--Exhibit 5*

§ 1995.220. Transfer restriction strictly construed

1995.220. An ambiguity in a restriction on transfer of a tenant's interest in a lease shall be construed in favor of transferability.

Comment. Section 1995.220 codifies the common law. See, e.g., Chapman v. Great Western Gypsum Co., 216 Cal. 420, 14 P. 2d 758 (1932).

§ 1995.230. Transfer prohibition

1995.230. A restriction on transfer of a tenant's interest in a lease may absolutely prohibit transfer.

Comment. Section 1995.230 settles the question raised in *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P.2d 837 (1985), of the validity of a clause absolutely prohibiting assignment or sublease. 40 Cal. 3d at 499, n. 14. A lease term absolutely prohibiting transfer of the tenant's interest 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 1995.210 and Comment thereto (right to transfer absent a restriction). It should be noted that an absolute prohibition on transfer precludes the landlord's use of the remedy provided in Section 1951.4 (continuance of lease after breach and abandonment). See Section 1951.4 and Comment thereto.

NOTE. William E. Fox of Paso Robles (Exhibit 2) is not in favor of "a law that prohibits absolute assignment of a lease." We take this to mean that he is not in favor of a law that validates a lease clause absolutely prohibiting assignment, as Section 1995.230 does. He states "There are many unforeseen circumstances that can arise in the due course of business that makes the assignment of a lease practically mandatory. If the proposed assignee has the same credit rating and business experience as the present lessee, I would recommend that the lessee be able to make an assignment of the lease." Gordon W. Jones of Safeway (Exhibit 6) asks, "What public policy requires that the transfer of a tenant's leasehold be exempt from the general principles of unreasonable restraints on alienation that apply to all other real property transfers?"

The answer to these points, of course, is that the parties to a lease are the persons best able to decide whether a particular limitation on transfer is reasonable under the circumstances. If the tenant is concerned about potential problems, the tenant should not agree to an absolute prohibition on assignment. The response from the tenants, however, would be that there is not generally equality of bargaining power in these situations:

> *In a "freedom of contract" system large players like Safeway can use their bargaining power and sophisticated lawyers to protect themselves. Those most hurt will be the vast bulk of commercial tenants; small businessmen and businesswomen who compete in a world of non-negotiable standard lease forms. If the Proposed Statute is adopted, these standard lease forms will quickly be amended to exploit every ounce of "freedom of contract" granted to the landlord industry by the Proposed Statute.*
> *--Exhibit 6*

§ 1995.240. Express standards and conditions for landlord's consent

1995.240. A restriction on transfer of a tenant's interest in a lease may require the landlord's consent for transfer 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 absolute discretion to give or withhold consent, including the right to unreasonably withhold consent.

(d) The landlord may elect either to consent or to terminate the tenant's right to possession.

Comment. Section 1995.240 is a specific application of the broad latitude provided in this chapter for the parties to a lease to contract for express restrictions on transfer of the tenant's interest in the lease. Such restrictions are valid subject to general principles governing freedom of contract, including the adhesion contract doctrine, where applicable. See Section 1995.210 and Comment thereto (right to transfer absent a restriction). It should be noted that the landlord's requirement of compliance with an unreasonable restriction on transfer precludes the landlord's use of the remedy provided in Section 1951.4 (continuance of lease after breach and abandonment). See Section 1951.4 and Comment thereto.

The meaning of "unreasonably withheld" under subdivision (a) is governed by the intent of the parties.

Subdivision (b) makes clear that the lease may condition the landlord's consent in any manner. Standards and conditions for the landlord's consent may include, for example, a provision that, if the lessee receives consideration for the transfer in excess of the rent under the lease, the landlord may recover some or all of the consideration. *Cf.* Section 1995.260 (transfer restriction subject to standards and conditions).

Subdivision (c) settles the question raised in *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P.2d 837 (1985), of the validity of a clause granting absolute discretion over assignment or sublease to the landlord. 40 Cal. 3d at 499 n. 14. 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.

The inclusion in the lease of a provision described in subdivision (d), which gives the landlord an election to consent to a transfer or to terminate the tenant's right to possession, does not preclude the landlord's use of the remedy provided in Section 1951.4, so long as the landlord does not exercise the election to terminate the right to possession. See Section 1951.4 and Comment thereto.

NOTE. Gordon W. Jones of Safeway (Exhibit 6) is opposed to this provision for the same reason he opposes the preceding section validating a lease provision that absolutely precludes transfer.

Joel R. Hall of The Gap (Exhibit 5) questions the Comment to subdivision (a), which states that the meaning of "unreasonably withheld" under the subdivision is governed by the intent of the parties. He believes the meaning is governed by the relatively objective standards developed from the whole body of judicial decisions on this subject throughout the United States. The staff disagrees. Under subdivision (a) we are not dealing with a reasonableness standard implied by law, but a reasonableness standard negotiated by the parties. In this situation it is the understanding of the parties and their circumstances that must control the meaning. "Unreasonably withheld" under subdivision (a) may have a different meaning from the commercial reasonableness concept of Section 1995.250, where the law implies a reasonableness standard.

§ 1995.250. Implied standard for landlord's consent

1995.250. (a) If a restriction on transfer of the tenant's interest in a lease requires the landlord's consent for transfer but provides no standard for giving or withholding consent, the restriction on transfer 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 not stated in writing a reasonable objection to the transfer or has not acted reasonably in stating in writing a reasonable objection to the transfer.

(b) The Legislature finds and declares:

(1) It is the public policy of the state and fundamental to the commerce and economic development of the state to enable and facilitate freedom of contract by the parties to commercial real property leases.

(2) The parties to commercial real property leases must be able to negotiate and conduct their affairs in reasonable reliance on the rights and protections given them under the laws of the state.

(3) Until the case of *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P.2d 837 (1985), the parties to commercial real property leases could reasonably rely on the law of the state to provide that if a lease restriction requires the landlord's consent for

transfer of the tenant's interest in the lease but provides no standard for giving or withholding consent, the landlord's consent may be unreasonably withheld.

(4) The *Kendall* case reversed the law on which parties to commercial real property leases executed before December 5, 1985, the date of the *Kendall* case, could reasonably rely, thereby frustrating the expectations of the parties, with the result of impairing commerce and economic development.

(5) For these reasons, the Legislature declares the law as follows. Subdivision (a) of this section applies to a restriction on transfer executed on or after December 5, 1985. If a restriction on transfer executed before December 5, 1985, requires the landlord's consent for the tenant's transfer but provides no standard for giving or withholding consent, the landlord's consent may be unreasonably withheld, except that in an action concerning the restriction commenced before the operative date of this section, the law applicable at the time of trial of the action governs. For purposes of this paragraph, if the terms of a restriction on transfer are fixed by an option or other agreement, the restriction on transfer is deemed to be executed on the date of execution of the option or other agreement.

Comment. Section 1995.250 codifies the rule of *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 709 P. 2d 837, 220 Cal. Rptr. 818 (1985), and limits its retroactive application.

Under subdivision (a), 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 or failing to respond to a request of the tenant for consent to a transfer, or the landlord may not have a reasonable objection to the transfer. Either of these circumstances may give rise to a determination that the landlord has not acted reasonably in stating a reasonable objection to the transfer within the meaning of subdivision (a). Subdivision (a) 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.

Although *Kendall* states as a matter of law that denial of consent solely on the basis of personal taste, convenience, or sensibility, and denial of consent in order that the landlord may charge a higher rent than originally contracted for, are not commercially reasonable (40 Cal. 3d at 501), Section 1995.250 rejects this absolute rule. Whether a particular objection is reasonable within the meaning of subdivision (a) is a question of fact that must be determined under the circumstances of the particular case.

The date of applicability of subdivision (a) is December 5, 1985, the date of the *Kendall* opinion. If there is a sublease on or after December 5, 1985, under a lease executed before that date, the rights as between the parties to the sublease are governed by subdivision (a). See Section 1995.020(b) ("lease" means lease or sublease).

Limitation of retroactive operation of *Kendall* is supported by the public policy stated in subdivision (b), including the need for foreseeability, reliance, and fairness. See Coskran, *Restrictions on Lease Transfers: Validity and Related Remedies Issues*, 37-45, 82-90 (1988); Kendall, *supra*, 40 Cal. 3d at 507-11 (dissent); Kreisher v. Mobil Oil Corporation, 198 Cal. App. 3d 389, 243 Cal. Rptr. 662 (1988).

NOTE.

Subdivision (a)

Subdivision (a) of this section codifies the rule of Kendall that if a lease requires the landlord's consent for a transfer but gives no standard for exercise, a reasonableness requirement is implied. Gordon W. Jones of Safeway (Exhibit 6) believes this provision is useless since, in light of Kendall, "only the most ill-informed landlords fail to specify the standard for consent. With the adoption of the Proposed Statute such silent consent provisions would virtually disappear." Which is of course exactly what we want--the agreement of the parties should be clearly stated and not implied by law.

Subdivision (a) also sets standards of proof for determining whether a landlord has acted reasonably in denying a request to assign or sublet, including that the landlord "has not acted reasonably in stating in writing a reasonable objection to the transfer." James L. Stiepan of Irvine Office Company (Exhibit 3) finds this provision very confusing and, unless it serves a significant purpose, would delete it. Joel R. Hall of The Gap (Exhibit 5) would also like to see some clarification.

The purpose of the provision is to preclude the landlord from unduly delaying acting on the tenant's request or from imposing unwarranted requirements such as excessive investigation fees in order to avoid consenting to an appropriate transfer. In fact, Robert J. Berton of San Diego (Exhibit 1) puts his finger directly on this issue--"We are now finding that a ploy sometimes used by landlords to thwart an assignment or sublease is to unreasonably delay a review of same against otherwise reasonable standards and conditions. Perhaps, the new statute needs to define 'unreasonable delay' as part of 'unreasonable withholding of consent'."

In light of these comments, we may wish to elaborate the landlord "has not acted reasonably" concept. To begin with, we think the statute would be more clear if it provided that the landlord has not stated a reasonable objection, "or has not acted reasonably in response to the tenant's written request, whether or not the landlord has stated a reasonable objection to the transfer." Secondly, we would expand the Comment to state, "For example, the landlord may have acted unreasonably in response to the tenant's request for consent by unduly delaying a review of the request or by demanding an excessive fee for investigation of the request."

Subdivision (b)

Subdivision (b) would overrule the Kendall case for a lease executed before Kendall that is silent as to the standard for denying consent by providing that the landlord is not subject to a reasonableness requirement. Paul J. Geiger and Dianne Humphrey of Denny's Inc. (Exhibit 4), Mr. Hall, and Mr. Jones all oppose this aspect of the recommendation. They note that the Commission bases its recommendation on the reasonable expectations of the parties at the time the lease was executed, but the reasonable expectations of the parties are not so clear:

> *With all due respect to the Commission's recommendation, I find it hard to believe that any landlord "relied" on pre-Kendall law with respect to the silent consent standard when all the landlord had to do--for the avoidance of doubt--was to add the few little words: **"which consent may be unreasonably withheld."** This is especially true in light of the fact that it is common knowledge in the leasing community that the rule of the Kendall case with respect to the silent consent standard was, prior to that decision, part of a growing trend in the jurisdictions throughout the United States.*
> *--Exhibit 5*

> *Which of the parties expectations were frustrated? Did tenants really expect that their landlords had the right to be unreasonable and arbitrary?*
> *--Exhibit 6*

They also argue that as a matter of policy, the better rule is that a reasonableness requirement should be implied for pre-Kendall cases. The landlord is generally in a superior bargaining position and can resist efforts to insert a reasonableness requirement. The tenant is not protected by adhesion contract or unconscionability principles in the usual case. The tenant assumes a great deal of commercial risk under the lease, and it is a fair tradeoff to require the landlord to act reasonably with respect to a tenant looking to the assignment clause for relief from the burdens of a lease that has ceased to be profitable to it. The proposal to overrule Kendall in its retroactive application "is simply an attempt to preserve the right of landlords to be arbitrary and to prevent courts from assisting tenants who have been victims of landlord's arbitrariness. Is this 'freedom' from the duty of good faith and fair dealing included in every other contract and every other provision of the lease so fundamental that the Commission (of all people) needs to draft a statute to protect it?" Gordon W. Jones (Exhibit 6).

The staff thinks it is important in this discussion not to lose sight of the real issue behind all the arguments. Who is to benefit from an increase in the value of the leasehold interest on transfer--the landlord or the tenant? The issue is highlighted from the tenant's perspective thus:

> *Many landlords resent the fact that a tenant may transfer the lease and retain the appreciation in rental value ("bonus value" or "profit") that has occurred since the*

> *lease was first signed. They vehemently complain that the* <u>*landlord*</u> *is in the real estate business rather than the tenant. While this statement is true, it fails to take into account the magnitude of the risk assumed by the tenant in a commercial lease. It is the tenant who undertakes a great deal of "downside" risk with very little downside protection. He is thus entitled to the "upside" potential of a rise in rental value. The landlord has made his bargain and was content to accept the agreed-upon rent for the term; he is only entitled to the reversion. It is neither inherently evil nor presumptuous of the tenant to enjoy this appreciation. The landlord really wants to have it both ways--to receive the agreed-upon rent while at the same time be guaranteed fair rental value despite his failure at the time of lease execution to negotiate a more favorable rent scheme to protect him in the future. He seizes upon the opportunity of an assignment to realize the increase in rental value.*
> *--Joel R. Hall (Exhibit 5)*

The staff believes this statement accurately reflects the dynamics at work here, and this is one reason Mr. Hall suggests that any right of the landlord to share in profits should be expressly stated in the lease agreement. But what about the pre-<u>*Kendall*</u> *leases which are silent as to these issues? One possible middle ground the Commission has not considered before is to impose a reasonableness requirement on the landlord, but also to allow the landlord a share of the profit.* <u>*This could be an attractive resolution of the competing policies here.*</u>

<u>§ 1995.260. Transfer restriction subject to standards and conditions</u>

1995.260. A restriction on transfer of a tenant's interest in a lease may provide that transfer is subject to any standard or condition, including but not limited to a provision that the landlord is entitled to some or all of any consideration the tenant receives from a transferee in excess of the rent under the lease.

<u>Comment.</u> Section 1995.260 codifies the rule stated in *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P.2d 837 (1985), that "nothing bars the parties to commercial lease transactions from making their own arrangements respecting the allocation of appreciated rentals if there is a transfer of the leasehold." 40 Cal. 3d at 505 n. 17.

The authority provided in this section for the parties to agree to an express lease provision governing allocation of consideration for transfer of the tenant's interest in a lease is not intended to create an implication that absent an express provision the landlord is not entitled to demand all or part of the consideration as a condition for consenting to the transfer in a case where the lease requires the landlord's consent. Whether such a demand would be "unreasonable" within the meaning of Section 1995.240(a) (express standards and conditions for landlord's consent) or 1995.250 (implied standard for

landlord's consent) is a question of fact that must be determined under the circumstances of the particular case. See Comments to Sections 1995.240 and 1995.250.

Section 1995.260 is a specific application of subdivision (a) of Section 1995.210 (lease may include transfer restriction). It should be noted, however, that Section 1995.260 remains subject to general principles limiting freedom of contract. See Section 1995.210 and Comment thereto.

<u>NOTE.</u> Robert J. Berton of San Diego (Exhibit 1) states this section should provide that any excess belongs to the tenant absent an express provision awarding the excess in whole or in part to the landlord. This is certainly the implication of the statute, and it could be made express, thus:

> *<u>(b) Unless the lease includes a provision that the landlord is entitled to some or all of any consideration the tenant receives from a transferee in excess of the rent under the lease, the tenant is entitled to all of the consideration.</u>*
> *<u>Comment.</u> Subdivision (b) is a specific application of subdivision (b) of Section 1995.210 (tenant's right of transfer unrestricted unless lease includes restriction).*

Joel R. Hall of The Gap (Exhibit 5) believes this section is unnecessary and could have the effect of implying that a landlord's demand for a share of the profits, even though not negotiated in the lease, is sanctioned by law and therefor "reasonable." The staff agrees that the section is technically unnecessary, since the common law does validate an agreement to share profits. However, part of the reason for the present project is to clearly state the law in an accessible form and to insulate the parties to a lease from shifts in judicial philosophy such as occurred in the <u>Kendall</u> case.

The staff also agrees that a landlord might argue that a demand for a share of profits is not unreasonable, although the existence of this section would not necessarily be the basis for such an argument. The Comment to Section 1995.260 refers to this possibility expressly, and it is the Commission's policy to permit this. See the second paragraph of the Comment.

Mr. Hall would question this policy. He feels the matter of the landlord's right to share in the profits generated by a transfer should be covered expressly by the lease:

> *It is my observation that experienced landlords and tenants understand these principles and resolve this most sensitive issue through the exercise of their freedom of contract--either they negotiate it or they don't....The landlord really wants to have it both ways--to receive the agreed-upon rent while at the same time be guaranteed fair rental value despite his failure at the time of lease execution to negotiate a more favorable rent scheme to protect him in the future. He seizes upon the opportunity of an assignment to realize the increase in rental value....If the Commission champions freedom of contract then it is incumbent upon the landlord to raise the issue in the lease negotiations and for the parties to freely contract for a*

distribution of such increased rental value; alternatively, it's the landlord's burden to attempt to tie his consent power to an arbitrary standard. The result of that exchange would depend on the interaction of the negotiation process.