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07/02/86

Memorandum 86-71

Subject: Study H-111 - Commercial Lease Law (Progress on Consultant's Study)

Professor William G. Coskran of Loyola Law School is the Commission's consultant on commercial (and where appropriate residential) landlord and tenant law. Professor Coskran's study is due by March 1, 1988.

Attached to this memorandum is a letter from Professor Coskran indicating his progress in organizing the study and requesting input as to specific topics appropriately included or excluded. We have asked Professor Coskran to attend the Commission's July meeting in San Diego to meet with the Commission to review his progress and outline his tentative thoughts on what topics to include and exclude. If Commissioners are concerned about particular problems in the commercial lease law area, this would be an appropriate time to give the consultant the benefit of the concerns.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

LOYOLA LAW SCHOOL

June 20, 1986

Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, CA 94303-4739

Re: Commercial Leasing Study

Dear Nat:

Thanks for suggesting the contact with the California Association of Realtors and Tishman in your April 16 letter. I have solicited their ideas. Also, I have added to my prior list of contacts all the instructors for the recent C.E.B. program on commercial Real Property Leases.

Attached is a preliminary list of topic suggestions so far. I plan to add more potential topics to the list. Once the list is complete, I will evaluate the topics and place them in one of the following three categories:

1. Definitely should be included.

2. Include if time permits.

3. Exclude because beyond the scope of the Study, or not a sufficient problem to warrant a legislative effort, or inappropriate for some other reason.

Before I get locked into my personal opinions, I am asking the members of the State Bar Real Property Section Executive Committee for their comments on the appropriate categories for the topics on the preliminary list. Also, since you are best aware of what the Commission is looking for, I would appreciate any comments you have on the topics.

1441 West Olympic Blvd., Los Angeles, California 90015 - Telephone: (213) 736-1000

One of the topics seems they sure bet for inclusion, so I started preliminary work on it. The general topic concerns the Lessor's rights to restrict or condition an assignment or sublease. There are several significant issues that have been opened up but not resolved by recent decisions, and it could take several years of litigation to resolve them all. I wrote an analysis of the Kendall case as a first step to generate some comments from leasing practitioners. It was published in the spring issue of the California Real Property Journal. A copy is enclosed.

Best regards,

William G. Coskran

WGC:m

Encl.

COMMERCIAL LEASING STUDY
Coskran
6/15/86

Scope of Study: Substantive law relating to commercial lease transactions. "Commercial" is used in the broad sense to include all but residential transactions. Residential lease transactions will not be specifically studied. However, a particular problems are identified, it may become appropriate to determine whether the law does or should distinguish between residential and commercial transactions in resolving the problems.

Purpose of Study: Identify, research and report defects, anachronisms and inconsistencies in the law that may be suitable for legislative reform.

TOPIC SUGGESTIONS RECEIVED

Note: This is a preliminary list of topic suggestions received so far. This is not the final list of topics that will be included in the Study. The topic suggestions will be evaluated to determine which ones are most appropriate for inclusion in the Study and the sequence in which they will be studied. Some topics on the list will not be included in the Study. Additional topics may be added to the list for inclusion in the Study.

ASSIGNMENT & SUBLEASE.

What rules govern the Lessor's ability to restrict or condition an assignment or sublease by the Tenant? A limited issue was involved in Kendall v Ernest Pestana, Inc. (1985) 40 Cal.3d 488, 200 Cal.Rptr. 818, and there are several unresolved issues.

ASSIGNMENT & SUBLEASE; BREACH REMEDIES.

Civil Code Section 1951.4 requires an express reasonableness standard to be set forth in the lease for the Lessor to use the "Lock-In" remedy provided in that section. Under certain circumstances, the Kendall case imposes a mandatory standard of reasonableness on the Lessor even if it is not set forth in the lease. Suppose a lease does not contain an express reasonableness standard and one is implied. Is the Lessor prevented from using the "Lock-In" remedy in 1951.4 even though he is now subject to the implied reasonableness standard?

ASSIGNMENT & SUBLEASE; BREACH REMEDIES.

Tenant assigns to Assignee (but remains liable to Lessor). Assignee defaults in rent payments. Lessor delays terminating the lease and thus allows a considerable amount of delinquent rent to accumulate before bringing action for rent against the original Tenant. Is the Lessor under a duty to the original Tenant to mitigate by promptly terminating the lease and avoiding the accumulation of delinquent rent?

ASSIGNMENT & SUBLEASE.

Tenant subleases to Sublessee. Lessor accepts a voluntary surrender of the leasehold by the Tenant. What is the effect on the sublease?

ASSIGNMENT & SUBLEASE.

What Tenant obligations under the lease "run" to and are enforceable against a non-assuming Assignee by the Lessor?

ASSIGNMENT & SUBLEASE.

Should the Dumpor's case rule be changed? A Lessor consents to an assignment by the Tenant, pursuant to a lease clause requiring that the Tenant get that consent. The rule in effect knocks out the consent requirement for any further assignments unless the clause expressly provides that it is binding on the Tenant's successors and assigns.

ASSIGNMENT & SUBLEASE; BREACH REMEDIES.

A non-assuming Assignee can apparently avoid any further liability to the Lessor from accruing by just abandoning the premises. Should this rule be changed?

ASSIGNMENT & SUBLEASE; BREACH REMEDIES.

Assignee breachs the lease and abandons the premises. The Lessor, pursuant to properly drafted lease provisions, elects to use the "Lock-In" remedy under Civil Code Section 1951.4. The lease continues in effect and the rent and other obligations continue to accrue. What relief does the original Tenant have from the continuing personal liability?

TERMINATION OF PERIODIC TENANCY.

Civil Code Section 1946 provides for termination of a month to month tenancy by giving a 30 day notice. If the notice is served with less than 30 days before the termination date stated in the notice, is the notice totally ineffective or is it effective as of the expiration of the required 30 days? (This was one of the questions involved in a 1984 unpublished opinion--Kaplan v. Lopatin.)

FITNESS.

Does an Implied Warranty of Fitness apply in a commercial lease in the same manner that an Implied Warranty of Habitability applies in a residential lease?

FITNESS.

What issues are involved when the leased property is subject to hazardous waste laws and how should these issues be resolved?

RETALIATION.

Do the protections against retaliation by the Lessor, developed in the residential tenancy area, apply in commercial tenancies?

LATE CHARGE.

Is a late charge, in addition to interest, a valid liquidated damage? If so, are there any limitations on the amount ? Should there be requirements for prominent disclosure?

RENT CONTROL.

What issues are involved in commercial rent control and how should they be resolved?

REAL PROPERTY TAXES.

Lease provides for the Tenant to pay all or part of the real property taxes. Lessor sells his interest in the property, which triggers a reassessment and substantial increase in property taxes. Should there be a requirement that this potential source of increase be disclosed in the lease?

USE:EXCLUSIVES.

What are the rules regarding enforceability of provisions granting a shopping center tenant the exclusive right to sell certain merchandise or provide certain services?

TERM COMMENCEMENT: RULE AGAINST PERPETUITIES.

A lease term is specified to commence upon completion of construction. Should the law be clarified with respect to the possible application of the Rule Against Perpetuities? (I mentioned Wong v. DiGrazia (1963) 60 Cal.2d 525 to the person who suggested this topic and he felt that the case did not sufficiently resolve the problem.

UNLAWFUL DETAINER: PRELIMINARY NOTICE.

Code of Civil Procedure Section 1162 specifies the manner for service of notices to pay rent or quit. The section may have been prepared with just residential tenancies in mind and may cause some problems with respect to service in commercial tenancies. For example, subsection 2 provides that if the tenant is absent from his place of residence and usual place of business, notice can be served by leaving a copy at either place and sending a copy by mail to the tenant's residence. Should the section be modified to provide a distinction between service on a residential and a commercial tenant?

UNLAWFUL DETAINER: PRELIMINARY NOTICE; STATUTE OF LIMITATIONS.

Code of Civil Procedure Section 1161(2) provides in part that a notice to pay rent or quit may be served at any time within one year after the rent becomes due. Does this mean that the Lessor may not recover more than 1 year's back rent from the date of giving the notice (or from the date of filing the unlawful detainer action)? Does it operate as a statute of limitations on bringing an Unlawful Detainer action? How is the statute of limitations determined for bringing an Unlawful Detainer action?

UNLAWFUL DETAINER: RENT PENDING APPEAL.

Can the Lessor accept rent pending resolution of an appeal without waiving his declared forfeiture of the lease and any nonmonetary defaults on which it was based?

Memo 86-71
Study H-111

Source: California Real Property Journal, Spring 1986, Real Property Law Section of The State Bar of California.

Lease Transfer Restraints: Must Consenting Adults Be Reasonable?

by William G. Coskran, Los Angeles

Suppose that a commercial lease clause states that the tenant cannot assign or sublet without the lessor's prior written consent. The clause does not expressly require the lessor to be "reasonable" in withholding consent, nor does it expressly allow the lessor to be "arbitrary" in withholding consent. The California Supreme Court, in a five to two split decision, recently imposed a reasonableness standard on the lessor in that situation. The lessor may refuse consent only if there is a "commercially reasonable objection." *Kendall v. Ernest Pestana, Inc.* (1985) 40 Cal.3d 488, 200 Cal. Rptr. 818. This article will examine the case, some unresolved issues and some ramifications.

I. FACTS

If you have not already read the case, it might be a good idea to draw a diagram of the players and plays to accompany the following description. First, the lessor (City of San Jose) leased airport hanger space to the prime tenant (Perlitchs). Second, the prime tenant subleased to a sublessee (Bixler). Third, the prime tenant/sublessor (Perlitches) assigned all interest in the prime lease to an assignee (Pestana). Fourth, the sublessee (Bixler) proposed to assign his interests in the sublease, as part of a sale of his business, to the proposed assignee of the sublease (Kendall and O'Haras). The proposed assignee of the sublease (Kendall & O'Haras) had a stronger financial position than the sublessee (Bixler). The sublessee (Bixler) requested consent to the proposed assignment from the prime tenant/sublessor's assignee (Pestana). Consent was denied, and the prime tenant/sublessor's assignee (Pestana) allegedly demanded increased rent and other deal sweeteners as a condition of consent. The proposed assignee of the sublessee (Kendall & O'Haras) brought action against the prime tenant/sublessor's assignee (Pestana) for declaratory and injunctive relief and damages. The proposed assignee of the sublease (Kendall & O'Haras) contended in effect that the prime tenant/sublessor's assignee (Pestana) was bound by a reasonableness standard and that he was unreasonable in withholding and conditioning consent. The trial court sustained a demurrer to the complaint without leave to amend, and on appeal, this was deemed to include a judgment of dismissal of the action. The California Supreme Court reversed.

The clause in dispute was contained in the sublease. It prohibited assignment, sublease or other specific actions without prior written consent of the sublessor. Other terms provided for a five year term with options for four additional five year terms, a rent escalation every ten years proportionate to the prime lease rent increase, and use for an aircraft maintenance business. The sublease was apparently drafted and executed in 1969 (with a term to commence January 1, 1970). This is significant because the court discusses the issue of retroactive application of its ruling.

The case involves a sublessor's successor using a commercial sublease clause to justify refusing consent to a proposed assignment by the sublessee to third parties. It will be more simple factually, to deal with the issues involved in this case in a more common context. Suppose the lessor uses a commercial prime lease clause to justify refusing consent to a proposed assignment or sublease by a tenant to a third party. The issues and their resolution will be the same. Also, although the parties in the case were fighting over a proposed assignment, the court expressly extended its holding to subleases.

II. GENERAL BACKGROUND

Back in the days when gentlemen dressed in metal suits and protected lands of the manor aboard a trusty steed, a lessor had an absolute right to determine the occupant. Lessors today feel there is a shift from feudal to futile. The common law squirmed from the shackles of early feudal tenures and developed a policy favoring transferability of property interests and discouraging restraints on alienation. California codified this policy many years ago in *Cal. Civ. Code* Sec. 711: "Conditions restraining alienation, when repugnant to the interest created, are void." However, the rule against restraints is not absolute and reasonable restraints to protect justifiable interests are permitted. (*Wellenkamp v. Bank of America* (1978) 21 Cal.3rd 943, 148 Cal. Rptr. 379.) The policy and statute, deceptively short and simple, have provided many hours of debate for lawyers, judges and legislators over the past several years. I found myself humming the tune to the saga of the "due on transfer" clause when I read *Kendall*.

The leasehold is a transferable property interest. Absent a valid restriction, the tenant may assign or sublease at will. But, the lessor is permitted to negotiate an agreement that restricts tenant transfers. This restriction on assignment and subleasing is justified because of the lessor's continuing interest in the property, i.e. the right to receive rent and other performance during the lease term and to regain possession upon termination of the lease. The courts have strictly construed the scope of restriction clauses in order to allow maximum freedom to the tenant. Thus, a particular transaction will generally escape the restriction unless the clause expressly takes it into consideration. For example, a simple prohibition against assignment or subleasing does not take into consideration the type of entity (e.g. a corporate tenant which continues to hold the lease while its stock is transferred), the type of interest transferred (e.g. a license) or the type of transfer (e.g. an involuntary transfer by death).

The common law rule regarding leasehold assignments and subleases can be simply summarized. Restrictions are disliked, permitted and strictly construed.

III. CLAUSE TYPES

Clauses which restrict or condition an assignment or sublease by a tenant typically fall into one of the following categories.

1. Lessor's consent is required, but no express standard is specified. The clause does not expressly require the lessor to be reasonable, nor does it expressly permit the lessor to refuse consent in his sole discretion. The *Kendall* case involves this type of clause.

2. Lessor's consent is required, and an objective reasonableness standard is expressly provided. An example is the common phrase that "consent shall not be unreasonably withheld." The parties expressly agree to a reasonableness standard, so there is no need to invoke the *Kendall* rule of mandatory

reasonableness.

3. Lessor's consent is required and a subjective standard of sole discretion is expressly provided. For example, "consent may be withheld in the sole and absolute subjective discretion of the lessor." Sometimes such a clause will provide that the lessor may "arbitrarily withhold consent." The word "arbitrary" and its derivatives seem to unnecessarily inflame the passions of some readers and may cloud the issue.

4. Lessor's consent is required and conditioned upon certain specific and express requirements being met. The requirements will vary depending on the particular transaction. Typically they will involve credit and operation standards.

5. Lessor's consent is required per one of the above alternatives, but specific types of transactions are exempted from the future consent requirements. For example, an exemption for subleases to the tenant's franchisees may be appropriate in some situations.

6. Assignment and Subleasing are absolutely prohibited, and nothing is said about consent.

7. There are clauses which are used either as alternatives or additions to a consent type restriction. The clause might provide that the lessor is entitled to receive all or part of the profit generated by the assignment or sublease transaction, or it might provide that the lessor has the option to "recapture" the premises if the tenant elects to assign or sublet. There are many sophisticated variations of these clauses.

The *Kendall* case involves the type 1 clause. The case has no impact on the type 2 clause, except for language in the case discussing what may or may not be considered reasonable. Clause types 3 through 6 are not expressly involved in the case, but there may be clues to the attitude of the present court toward them. The same is true of the type 7 clause which provides for "recapture" of the premises by the lessor. A fertile, but perhaps fickle, footnote (number 17) appears to expressly deal with the type 7 clause giving the lessor the right to profit from the assignment or sublease transaction. However, there may be hazards for the lessor who accepts the apparent invitation to rely on such a clause. There will be more about the type 3 through 7 clauses later.

IV. CONSENT STANDARD: AN OVERVIEW

Assume a clause requires the lessor's prior written consent to an assignment or sublease. Is the lessor bound by a reasonableness/objective standard or a sole discretion/subjective standard? The traditional rule has two components. First, a clause expressly providing for the sole discretion/subjective standard is valid and reasonableness is not mandatory. Second, if the clause does not expressly provide for the reasonableness/objective standard, the lessor is free to use the sole discretion/subjective standard. The clause involved in the *Kendall* case required the lessor's consent and did not expressly provide for the reasonableness/objective standard. Thus, under the traditional rule, the lessor would have been free to use the sole discretion/subjective standard.

Some jurisdictions have reconsidered the traditional view and rejected it. Persons who dislike the traditional view call the rejection cases "the modern trend." Those who like the traditional view call the rejection cases "the minority view." There are two main positions resulting, so far, from a disenchantment with the traditional view. It is important to recognize the choices that the Supreme Court had when it rejected the traditional rule in the *Kendall* case. It is also important to recognize the choices it will have when it faces the issues involved in the other types of transfer restriction or condition clauses.

"Back in the days when gentlemen dressed in metal suits and protected lands of the manor aboard a trusty steed, a lessor had an absolute right to determine the occupant. Lessors today feel there is a shift from feudal to futile."

1. *Reasonableness/Objective Standard Mandatory.* Some courts take the approach that the sole discretion/subjective standard is against public policy and void. Consent refusal must be based on a commercially reasonable objective reason even if a sole discretion/subjective standard was negotiated for and expressly stated in the lease. Most of the cases rejecting the traditional rule seem to take this approach. However, there has been little discussion of the relative merits of different solutions that can follow rejection of the traditional rule.

2. *Construction In Favor of Reasonableness/Objection Standard.* The *Restatement* adopts the view that a reasonableness/objective standard will be imposed on the lessor unless a freely negotiated provision in the lease gives the lessor the absolute right to withhold consent. (*Rest. 2d Property*, Sec. 15.2(2) (1977).) This approach places the emphasis on disclosure, negotiation and bargaining power.

Remedy Limited. A decision by the Alaska Supreme Court presents a possible third approach. (*Hendrickson v. Freericks* (Alaska 1980) 620 P.2d 205.) The lease clause involved in the case prohibited assignment or subleasing without the lessor's prior consent, and there was no express consent standard. The court appeared to favor the Restatement position. However, since the tenant assigned without asking consent or notifying the lessor, the court considered it unnecessary to determine whether reasonable grounds for refusal existed. The Court concluded that even if the tenant breached the clause, the lessor might be limited to damages. The lessor will not be allowed to terminate the lease unless the equities compel a forfeiture. You balance the termination loss to the tenant and the assignee or sublessee against the non-termination detriment to the lessor. This approach would shift the focus from the justification for the consent refusal to the appropriateness of the remedy for the prohibited transfer. Consider the difficulties of proof at trial. For example, suppose we look at the loss or damage to the lessor of a percentage rent lease as of the time the tenant is vacating and the third party is entering. We are predicting what the third party will produce in the future compared with what the tenant would have produced in the future. If we look at the loss or damage to the lessor some time after the tenant has vacated and the third party has entered, we are comparing what the third party has produced with what the tenant would have produced.

There are similarities between the two main positions but there is a significant difference. They both result from a belief that the traditional rule is no longer viable. They both impose a reasonableness/objective standard on the lessor where the clause requires consent but is silent about the standard. However, they produce opposite results if a freely negotiated provision expressly calls for a sole discretion/subjective standard.

V. CALIFORNIA PRE KENDALL

The document containing the disputed clause in *Kendall* was executed in 1969. At that time, the most current California case dealing speci-

fically with the consent standard issue was *Richard v. Degen & Brody, Inc.* (1960) 181 Cal. App. 2d 289, 5 Cal. Rptr. 263, decided about nine years earlier. The clause in the *Richard* case prohibited assignment or subleasing without the lessor's written consent and it did not expressly provide for the consent standard. The tenant specifically contended that the lessor could not "arbitrarily" refuse consent to a sublease. The court rejected the contention with the comment that it was "untenable" and followed the traditional majority view. There was no discussion of the merits of or objections to that view. *Kendall* involves the same type of clause.

In 1981, a reasonableness/objective standard was imposed on a condominium association. (*Laguna Royale Owners Association v. Darger* (1981) 119 Cal. App. 3d 670, 174. Cal. Rptr. 136.) The Association attempted to block a mini-time-share division by one of the condominium owners. The Association asserted the absolute right to withhold consent and the unit owner asserted the absolute right to transfer. The Court rejected both absolutes and allowed transfer restrictions subject to a reasonableness standard. The Association argued that the traditional rule allowing absolute restrictions on a tenant applied because the unit owner was technically a sublessee. The condominium was developed pursuant to a 99 year ground lease and the unit buyers received an undivided interest in the leasehold. The court took a passing shot at the traditional rule when it said: "Even assuming the continued vitality of the rule that a lessor may arbitrary withhold consent to a sublease ... there is little or no similarity in the relationship between a condominium owner and his fellow owners and that between lessor and lessee or sublessor and sublessee." The common law has long recognized a distinction between a leasehold interest upon which restrictions are liberally allowed, and a fee ownership interest upon which restrictions are strictly limited. Since the Court distinguished the condominium unit interest from the typical leasehold interest, the rule in the *Richard* case was also distinguished.

About nineteen years after the disputed document in *Kendall* was executed, a Court squarely faced and rejected the traditional rule. (*Cohen v. Ratinoff* (1983) 147 Cal. App. 3d 321, 195 Cal. Rptr. 84.) A commercial lease clause prevented assignment or subleasing without the lessor's prior written consent, and there was no express consent standard. The court said that a lessor may refuse consent only where he has a good faith reasonable objection. After several requests by the tenant for consent to an assignment, the lessor's attorney informed the tenant that the lessor could be "as arbitrary as he chooses." This colorful framing of the issue may have encouraged reevaluation of the traditional rule.

The *Cohen* case was followed in quick succession by four cases dealing with the same issue: *Schweiso v. Williams* (1984) 150 Cal. App. 3d 883, 198 Cal. Rptr. 238; *Prestin v. Mobil Oil Co.* (9th Cir. 1984) 741 F.2d 268 (applying the court's perception of California law); *Sade Shoe Co. v. Oschin & Snyder* (1984) 162 Cal. App. 3d 1174, 209 Cal. Rptr. 124; and, *Hamilton v. Dixon* (1985) 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639. All four cases involved commercial leases. All four involved clauses restricting assignment or subleasing without lessor's consent, but with no express consent standard. *Schweiso* and *Prestin* imposed a reasonableness/objective standard on the lessor. In *Schweiso*, the lessors referred to the restriction clause as a "license to steal" and then demanded a "transfer fee" as "blood money." Some might consider this subtle choice of words used to frame the issue as the verbal equivalent of an obscene gesture. The *Sade Shoe Co.* decision seems to say that a sole discretion/subjective refusal is permitted, but that it may constitute tortious interference with prospective economic advantage. This prompted the *Hamilton* Court to comment that it was "bemused" by that apparently "incongruous" result. The lease in the *Hamilton* case was signed in 1970 (the year after execution of the sublease in *Kendall*). The court felt that *Richard* was "clearly the law" at that time and it would be improper to rewrite the bargained rights and reasonable expectations fifteen years later. The Court also commented that the abrogation of the freedom to bargain for a sole discretion/subjective standard should come from the legislature, not the courts. It should be noted that the facts in Hamilton show that it is improper to always characterize the tenant as riding the white horse of virtue in a joust with a greedy lessor. Picture the lessor as a sixty-seven year old widow living alone in a mobile home, her income comes from social security and rent from the leased property. The widow's fixed rent has become a "pittance" due to "shocking double-digit inflation" during the fifteen years since the lease was executed.

This was the variegated background faced by the *Kendall* Court.

In *Schweiso*, the lessors referred to the restriction clause as a "license to steal" and then demanded a "transfer fee" as "blood money."

VI. KENDALL RULE & REASONS

The *Kendall* case imposes a reasonable/objective consent standard on the lessor (or sublessor) of a commercial lease containing a clause that restricts assignment or subleasing without lessor's consent, and that has no express consent standard. The lessor in that situation must have a commercially reasonable objection to justify refusal to consent. The case at least does this, and it may do more.

There are dual bases for the result, flowing from the dual nature of a lease as a conveyance and a contract.

1. *Property Policy Against Restraints on Alienation.* California follows the rule that unreasonable restraints on alienation are prohibited. (*Cal. Civ. Code* Section 711; *Wellenkamp v. Bank of America*) (1978) 21 Cal.3d 943, 148 Cal. Rptr. 379.) The Court borrowed from the "due on transfer" loan security situation in *Wellenkamp* to support and amplify this proposition. You compare the *justification* for the restriction with the *quantum* of restraint in order to determine reasonableness. The Court saw no modern jurisdiction for allowing leases to be exempt from the general policy.

2. *Contract Policy of Good Faith and Fair Dealing.* The duty of good faith and fair dealing is implied in contracts in California. The contractual nature of a lease brings that duty into the lease. The Court concluded that where the lessor retains the discretionary power to grant or withhold consent to an assignment or sublease, the power should be exercised in accordance with commercially reasonable standards.

The Court addressed arguments supporting the traditional common law rule.

1. *Freedom of Personal Choice.* The traditional rule emphasizes the lessor's freedom of personal choice in selecting the tenant. The unconsenting

lessor is not obligated to look to someone else for performance. The Court said that the values used in personal selection are preserved by the commercially reasonable grounds used for withholding consent. Also, the original tenant remains liable to the lessor despite the assignment or sublease. The Court also pointed to certain lease breach, remedy legislation (discussed below) as support for limits on the lessor's freedom of choice.

2. *Unambiguous Reservation of Sole Discretion.* Another justification for the traditional rule is that the absence of an express reasonableness standard results in an unambiguous reservation of sole discretion. The tenant failed to bargain for a reasonableness standard, so the law should not rewrite the contract. The Court concluded that the clause is not unambiguous, also, it pointed out that recognition of the implied duty of good faith and fair dealing is not a rewriting of the contract. It is important to keep in mind the type of clause that the court was dealing with when considering the ambiguity argument. The clause does *not* expressly provide any consent standard. The argument does not address a negotiated clause that expressly provides for a sole discretion/subjective consent standard.

3. *Retroactive Change & Legislative Responsibility.* The *Kendall* dissent argued the unfairness of rejecting the common law traditional rule retroactively. Look at the sequence. The *Richard* case, which adopted the traditional rule, was decided in 1960. The disputed document in the *Kendall* case was executed in 1969. *Cohen,* the first California case directly rejecting the traditional rule, was decided in 1983. The dissent stated that the lessor's counsel was entitled to rely on the traditional rule as the state of the law in California when the document was executed. Now, the contract is being rewritten by a retroactive rejection of the traditional rule. The dissent suggested that if the traditional rule should be changed, the legislature should make the change. The majority opinion responded that the traditional rule has not been universally followed and it has never been adopted by the Supreme Court. The Court commented that "the trend in favor of the minority rule should come as no surprise to observers of the changing state of real property law in the 20th century." What would you have advised a client in 1969? Before *Cohen,* the transfer restriction issue receiving the most attention in California was the enforceability of a "due on transfer or encumbrance" clause in a deed of trust. Did the cases in that area alert you to a possible application to leases? Note that the Supreme Court did not clearly start its journey toward *Wellenkamp* until 1971. (*La Sala v. American Sav. & Loan Ass'n.* (1971) 5 Cal.3d 864, 97 Cal. Rptr. 849.)

4. *Lessor's Right to Increased Value.* Sometimes the rental value of property increases beyond the agreed rent. Sometimes a lessor uses a proposed assignment or sublease as a device to demand increased rent as a condition of consent. This was apparently the situation in *Kendall.* The Court rejected the argument that the lessor has the right to the increase in rental value in this situation. The lessor made his bargain and is not automatically entitled to the benefit of increased value during the lease term. The lessor could have bargained for and expressly included periodic rent increases in the lease. A footnote dealing with other types of increased value reservations will be discussed later. In *Kendall,* there was a provision in the sublease for rent escalation every ten years, proportionate to the prime lease rent increases. However, there was no express provision for a rent increase upon assignment or subleasing; nor was there any provision for the lessor to receive part or all of the profit derived by the tenant from the transaction.

5. *Remedy Legislation.* In 1970, the California Legislature adopted a comprehensive revision of the lessor's remedies upon termination of a lease. Both the *Kendall* majority and dissent use parts of that legislation for support. *Civil Code* section 1951.2 provides that, except as provided in section 1951.4, a lease terminates if either of two situations occur. First, the tenant breaches and abandons. Second, the tenant breaches and the lessor terminates the tenant's right to possession. 1951.2 further provides, in part, that the lessor may recover the excess of the post termination unpaid rent over the amount of rental loss the tenant proves could be reasonably avoided. Thus, the tenant may reduce or avoid these damages by proving what the lessor could receive by reletting to another tenant. The majority opinion comments that this "duty to mitigate" undermines the lessor's freedom to look exclusively to the tenant for performance.

Civil Code section 1951.4 permits the lessor to keep the lease in effect and to continue its enforcement against the tenant. This lock-in remedy must be included in the lease, also, it is available only "if the lease permits" the tenant to sublet, assign, or both, subject only to reasonable limitations. If the lessor's consent is required, the lease must provide that consent "shall not be unreasonably withheld." The remedy is available only if the lessor expressly subjects himself to a reasonableness standard. The dissent argued that the Legislature provided the remedy as an incentive to forgo the right to withhold consent unreasonably. It follows, the dissent argued, that the Legislature must have recognized the contractual right to withhold consent unreasonably. The majority called this speculation. The Court stated that implied statutory recognition of a common law rule that is not the subject of the statute does not codify the rule, also, such implied recognition does not prevent a court from reexamining the rule.

"The *Kendall* decision points out some factors that may be considered in applying the reasonableness/objective standard. They are: financial responsibility of the new party; legality and suitability of the use; need for alterations; and, nature of occupancy."

There is another argument based on section 1951.4 that was not specifically mentioned by the dissent. In order for the lock-in remedy to be available, the lease must permit the tenant to sublet, assign, "or both." The statute clearly requires that the lessor allow *either* a sublease *or* an assignment or both, without restriction or with reasonable restrictions. It just as clearly allows the lessor to prevent either a sublease or an assignment without the reasonableness standard limitation. The majority would most certainly meet this argument with the same response mentioned above.

The remedy legislation package adopted in 1970 was the product of an extensive review by the California Law Revision Commission. It seems that the Commission and the Legislature assumed the existence of the traditional rule in California, but did not specifically consider whether it should be followed or rejected. The remedies revision was a major undertaking and understandably occupied their attention.

VII. KENDALL GUIDELINES FOR REASONABLENESS

The *Kendall* decision points out some factors that may be considered in applying the reasonableness/objective standard. They are: financial responsibility of the new party; legality and

suitability of the use; need for alterations; and, nature of occupancy. The Court mentions other situations where a court has considered the lessor's objection as reasonable. They are: the desire to have one lead tenant in order to preserve the building image; the desire to preserve tenant mix in a shopping center; and, the belief that a proposed specialty restaurant would not succeed at the location. The court considers it unreasonable to deny consent solely on the basis of personal taste, convenience or sensibility, or for the purpose of charging more rent than originally agreed. Other examples can be found in cases involving clauses that contain an express reasonableness standard.

VIII. OTHER ISSUES

Is an *express* sole discretion/subjective standard permissible? Suppose the clause requires the lessor's consent and provides expressly that the lessor may withhold consent in his sole and absolute discretion. A court could reject the traditional common law rule but still have a choice with such a clause. One choice is to totally reject the sole discretion/subjective standard and mandate a reasonableness/objective standard in all situations. The other choice is to impose a reasonableness/objective standard only in the absence of a freely negotiated express sole discretion/subjective standard. The latter choice is suggested by the Restatement. A mandatory reasonableness/objective standard choice must be based on a public policy so strong that it removes the matter from free bargaining of the parties. The Restatement choice is based on a policy of clear disclosure and free bargaining.

Unfortunately, bad facts or colorful language may obscure the issue involved in the choice. For example, consider the following way of framing the issue. Should we allow a lessor to withhold consent *arbitrarily* and *unreasonably* in order to extort money that was not bargained for? The language and assumed facts seem to demand that we prevent the temptation of this unsavory behavior, however, a lessor might want a sole discretion/subjective standard clause for reasons other than extracting an unbargained profit. As a matter of fact, there are much more effective and clearly legal ways the lessor can tie the rent to the value of the property or the value of the dollar. Litigation in court or by arbitration will determine the reasonableness or unreasonableness of a particular objection, unless the parties mutually agree. A lessor may wish to avoid the expenditure of money, time and energy involved in litigation, he may consider it inappropriate for a judge or jury to apply hindsight to "second guess" his judgment concerning his property. The Lessor may be willing to bargain and give the tenant something in return for the right to have his judgment unquestioned. Consider a different way of framing the issue. Should we allow a lessor to bargain for an express clause that would avoid litigation over his exercise of judgment concerning a proposed assignment or sublease? Perhaps there is some middle ground between "reasonable" on the one hand and "arbitrary and unreasonable" on the other.

There is also a practical consideration involved in the choice between the mandatory reasonableness position and the Restatement position. The policy supporting a mandatory reasonableness standard must be sufficiently strong to warrant the litigation potential. Obviously, the law considers policies supporting "reasonableness" sufficiently strong in a variety of contexts, however, it should not be overlooked in making the policy choices here. While there are extremes at both ends of a reasonableness-unreasonableness spectrum, there may be a significant area of dispute in between the two. Leasing transactions come in a variety of shapes limited only by one's imagination, reasons for objecting to a particular assignment or sublease may also come in many varieties. The parties may dispute the reasonableness of a particular type of objection, or they may dispute the presence of facts to support a particular objection. As an example, consider the case of a simple percentage rent lease, in which the tenant proposes to assign to a party who will conduct a different type of business. Most would agree that the lessor may reasonably object if the new party will produce substantially lower rentals. Suppose now that the lease provides that the premises may be used "for any lawful purpose." The original tenant could conceivably properly change the type of business and reduce the rentals. Is it still reasonable to object, just because an assignee will be the cause of the reduction in rentals, rather than the assignee/lessee?

It would be more appropriate to ask whether your opinion will be shared by a judge and jury.

The clause in *Kendall* did not contain an express standard for consent. The Court was not required to decide the validity of a negotiated and expressed sole discretion/subjective consent standard, the Court only had to decide whether to imply a reasonableness/objective consent standard in the absence of any express standard. It is dangerous to draw inferences from the language used to resolve that narrow issue, however, we will all search for clues until the broader issue is resolved by litigation or legislation.

The Court used broad general language to criticize the traditional common law rules and to support a reasonableness/objective standard. Much of that language could be applied to an express sole discretion/subjective standard clause, on the other hand, the Court referred to the Restatement as support for modern rejection of the traditional common law rule. The Court clearly recognized the impact of the Restatement position, it commented in footnote 14 that the Restatement rule would validate a clause giving the lessor "absolute discretion" or "absolutely prohibiting" an assignment (or sublease). However, the court added, the case does not involve the question of the validity of those clause types.

Two distinct bases are used in *Kendall* to support the reasonableness/objective standard (reference section VI above): the property policy against restraints on alienation; and the contract policy implying the duty of good faith and fair dealing.

"Should we allow a lessor to withhold consent *arbitrarily* and *unreasonably* in order to extort money that was not bargained for?"

If we focus on the policy against restraints on alienation, it may seem that there is little or no room for a sole discretion/subjective standard. *Cal. Civ. Code* section 711 sounds rather strict: "Conditions restraining alienation, when repugnant to the interest created, are void." So far, the Supreme Court has mellowed the statutory language only to the extent of allowing "reasonable" restraints. However, the 1972 adoption of section 711 has not been perceived as a dramatic departure from the common law rule against restraints. The sole discretion/subjective restriction against transfer of a leasehold was a recognized exception to the strict policy. The Supreme Court cases mandating reasonableness in restrictions have not dealt with leasehold transfer restrictions.

Suppose a court determines that there are important reasons to allow parties to freely bargain for an express sole discretion/subjective consent restriction on leasehold transfers, such a determination could easily fall within the language of section 711. The statute adopts the common law rule on restraints (except as now modified by *Kendall*) and a freely negotiated express sole discretion/subjective clause is not "repugnant" to the interest created. The question is, how likely is a court to adopt this interpretation.

Do the "due on transfer" secured credit cases preclude a sole discretion/subjective consent standard? One would have to lack common sense and a sensitivity to recent history to ignore the broad path the Court cut on its trip to *Wellenkamp*. That case is cited in *Kendall* for the proposition that section 711 forbids only unreasonable restraints. The *Wellenkamp* family of cases involved secured credit transactions with restrictions on the encumbrance, installment sale and conveyance of a fee simple interest. Some lease transactions are, in substance, secured credit transactions, however, in general, there are many practical and theoretical distinctions between a fee simple absolute secured credit transaction and a lease transaction. The *Kendall* Court did not find the reasons supporting the common law exemption of leaseholds from the strict prohibition against restraints persuasive for modern times, the Court would have to be convinced that there are modern reasons to support the survival of a freely bargained and express sole discretion/subjective standard in a leasehold. If so convinced, the Court could conclude that it is "reasonable" to allow parties to freely bargain for an express sole discretion/subjective consent restriction on a leasehold transfer. If that conclusion is true, the *restriction* could be considered reasonable even if the *objections* to the transfer are not. Since Court did not find argued distinctions compelling in the "due on transfer" cases, it would be unwise at this point to bet the family home on the Court finding distinctions compelling in the lease cases. It would also be unwise to expect Garn and St. Germain to come to the aid of lessors as they did for lenders. (*Garn-St. Germain Depository Institutions Act of 1982*, Part C).

If we focus on the contract policy of an implied duty of good faith and fair dealing to support the reasonableness/objective standard, there seems to be more flexibility for drafting. The Restatement position allows a freely negotiated express provision, the lessor negotiates for a sole discretion/subjective consent standard, and the tenant agrees to it as part of the bargain. It is difficult to say that the exercise of that sole discretion is a violation of good faith and fair dealing, and it is also difficult to say that the exercise of that negotiated for sole discretion is not part of the reasonable expectations of the tenant. The tenant may be the victim of an adhesion situation, but in such a case the clause would not meet the free negotiation requirement, and would probably fail on those grounds, however, negotiation with a proposed anchor tenant for a shopping center would tend to dispel the belief that tenants are always in the weaker position. One might argue that the tenant is not acting in good faith and dealing fairly if he agrees to a sole discretion/subjective clause as part of the bargain and then seeks to deny its benefits to the lessor. In *Kendall*, the clause did not contain an express standard, however in such a case it would be much easier to see how reasonable expectations, good faith and fair dealing could produce a reasonableness standard.

"One would have to lack common sense and a sensitivity to recent history to ignore the broad path the Court cut on its trip to *Wellenkamp*."

The other types of clauses mentioned in section III above involve the same basic issue as the express sole discretion/subjective consent clause. To what extent are the parties free to negotiate restrictions on a leasehold transfer?

The type 4 clause involves a list of express requirements to be met for a permissible assignment or sublease. If a reasonableness/objective standard is mandatory, those requirements must meet the test of reasonableness, however if only free negotiation is required, they need not meet the test of reasonableness. If a mandatory reasonableness standard is imposed, it will be difficult for a tenant to establish that a specific requirement, that is part of the original agreement, is now, unreasonable. The Supreme Court has given a qualified endorsement to a list of specific requirements. (*Seaman's Direct Buying Service, Inc. v. Standard Oil Co.* (1984) 36 Cal.3d 752, 206 Cal. Rptr. 354.), unfortunately, the case did not involve a lease restriction. The Court said that the parties cannot disclaim the covenant of good faith, however, they can, "within reasonable limits at least," agree on standards by which the covenant is measured. Now all we have to do is figure out what the "reasonable limits" are. A clue might be found in a footnote which refers to *Cal. Commercial Code* section 1102, which permits standards that are not "manifestly unreasonable."

The type 6 clause prohibits assignment and subleasing and says nothing about consent, however if a reasonableness/objective standard is mandatory, the lessor cannot refuse consent without a reasonable objection. The Restatement position approves of a freely negotiated provision giving the lessor an "absolute right to withhold consent." Does a provision which prohibits an assignment or sublease give the lessor an absolute right to withhold consent?, it would seem so, but perhaps it would be wise to expressly so state.

The type 7 clause allows the lessor to get possession or profit when an assignment or sublease is proposed. There are several varieties, but they all face the same issue of mandatory reasonableness vs. free negotiation. A Restatement comment expressly approves a lessor's right of first refusal to acquire the interest a tenant proposes to transfer, this is considered valid even though it may effectively prevent transfer to a third party. The *Kendall* Court, in footnote 17, comments on a clause allowing the lessor to profit from an assignment or a sublease transaction. In response to an amicus request, the Court affirmed the principle 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." This is certainly consistent with the Restatement position. The profit in an assignment or sublease transaction is usually generated by a leasehold bonus value, i.e., the excess of rental value over rent, the lessor's receipt of that profit is not intrinsically evil. Suppose, however, a clause requires that *all* of the profit from the transaction goes to the lessor, this provision would significantly dampen a tenant's enthusiasm for an assignment or sublease. Has the court approved such a clause, or does the word "allocation" imply that only a sharing of the profits is permissible?

The word "allocation" might refer to apportionment between the parties or to a shifting from one party to another.

There is another significant issue left unresolved by the *Kendall* decision. Do residential tenancies come within the same rule? the Court, in footnote 1, expressly left the answer to another day. It is interesting to note that the few statutes mentioned in footnote 13 reject the traditional rule either for residential leases only or for both residential and commercial leases. If the clause does not contain an express standard, it seems that the desire to provide a residential consumer with notice and an opportunity to bargain will result in an implied reasonableness standard. If the clause expressly provides for a sole discretion/subjective standard, we are back to the issue of mandatory reasonableness vs. freedom to negotiate. The ultimate resolution might depend on the type of residential tenancy more than on the distinction between a residential and a commercial lease. Consider two situations. First, the lessor is renting units in a large apartment complex, as an ongoing business. Second, the lessor is renting the family home and furnishings on a temporary, short-term, basis, due to an assignment to another locale.

IX. TENANT RECOURSE; LESSOR REMORSE

What remedies are available against a lessor who improperly rejects a sublet or assignment transaction? The tenant and the third party can go ahead with the assignment or sublease, however, faced with the lessor's objection, a knowledgeable third party would probably be reluctant to step into a transaction fraught with the potential of litigation. The third party will probably want either a solid indemnity protection from the tenant or a different deal; at a different place or time, the lessor might draft to limit the tenant's remedy to completion of the transaction. This technique was based on drafting the clause so that the lessor's unreasonableness would excuse the consent requirement, but the lessor carefully made no covenant to be reasonable. (54 ALR 3d 679.) The reasonableness/objective standard is based, at least partly, on the *covenant* or *duty* of good faith and fair dealing, however it is unlikely that a California Court would deny contractual damages to the tenant based on the technical distinction between a condition and a covenant.

The lessor may also be subject to damages on a tort theory, this increases the likelihood that punitive, as well as compensatory, damages will be sought. California recognizes the tort of intentional interference with contractual relations. (*Seaman's Direct Buying Service, Inc. v. Standard*, supra; *Richardson v. La Rancherita La Jolla* (1979) 98 Cal. App. 3d 73, 159 Cal. Rptr. 285.) This theory also expands the potential plaintiffs to include the third parties as well as the tenants. The Court in the *Seaman's* case resisted, at least temporarily, the temptation to engage in creative tort making. A breach of the covenant of good faith and fair dealing may give rise to a tort action only if there is a special relationship, such as insurer-insured. The court has not yet had to decide whether the lessor-tenant relationship is sufficiently special to generate a tort. The Court in *Kendall* noted that the *Cohen v. Ratinoff* pleadings sought punitive damages based on "bad faith breach of contract." It commented, in footnote 11, that it expressed no view on the merits of that claim, however, the court noted that not every good faith and fair dealing breach gives rise to a tort action.

A lessor subject to a reasonableness standard who refuses consent without careful reflection, is a thrill seeker.

X. LESSOR DRAFTING

A lessor who is convinced that a freely negotiated sole discretion/subjective standard will be upheld can expressly draft one into the restriction clause. A lessor so convinced seems overly optimistic at this point, a subsequent attempt to enforce the clause would be a high stakes bet unless there is further support for the Restatement position in California.

A lessor may wish to voluntarily undertake a reasonableness/objective standard to have the lock-in remedy available under *Civ. Code* section 1951.4. This remedy allows the lessor to keep the lease in effect and enforce performance even though the tenant has breached the lease and abandoned the premises.

A detailed use clause can be relied upon to carry a broad load when an assignment or sublease is proposed. A specific designation of the type and quality of both operator and operation can avoid many misunderstandings later.

A clause restricting assignment or sublease without consent can include some specific standards and conditions, the lessor will want a non-exclusive list. These specifics, agreed to in advance of any dispute concerning transfer, will provide more guidance than just the general language of reasonableness.

The lessor should consider specific requirements for furnishing satisfactory evidence of compliance with standards. Investigation of facts and review of documents may be required, opinions of accountants, lawyers and other professionals may be required. What about the time and expenses involved in assuring informed consent?

A lessor who wishes the rent to keep pace with the value of the dollar and the property has always had more effective ways of doing so than withholding consent to a transfer. Rent escalations or short term leases (with or without a right of first refusal to extend) are obvious examples, these sound remarkably similar to the devices used by lenders to avoid the impact of the court's restriction of the "due on transfer" clause. There is a curious incongruity here. While mandatory reasonableness/objective standard would be adopted for the purpose of protecting tenants, the adoption, or threat of adoption, of a mandatory reasonableness/objective standard may cause lessors to rely on devices that raise the rent more effectively and more frequently.

CONCLUSION

I would be remiss if I omitted a special acknowledgment to the lessors who, without express lease authorization, colorfully threaten to blow a deal unless they receive unbargained sweeteners, without them, this article would probably not be possible or necessary. ■

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