

#H-111

ns53y
01/24/89

Memorandum 89-25

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--
draft of recommendation)

Attached to this memorandum is a draft of the recommendation relating to assignment and sublease. The draft incorporates changes made at the Commission's January meeting in Irvine. The Commission has not completed consideration of comments received on the tentative recommendation, and the current draft retains notes concerning the comments received. The notes concerning comments start at Section 1995.230 of the draft.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

#H-111

ns53y
01/24/89

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, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loyola L.A. L. Rev. 405, 462-468 (1989).

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 alienation⁶ and the implied contractual duty of good faith and fair dealing⁷. 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

5. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loyola L.A. L. Rev. 405, 433-438 (1989); *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

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

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 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, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 *Loyola L.A. L. Rev.* 405, 445-447 (1989).

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.

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.

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. 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 lessor has the remedy described in California Civil Code Section 1951.4 (lessor may continue lease in effect after lessee's breach and abandonment if lessee may sublet or assign, subject only to reasonable limitations).

(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 to do~~ any of the following conditions is satisfied:

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

(2) ~~Sublet~~ The lease permits the lessee to sublet the property, assign ~~his~~ the lessee's interest in the lease, or both, subject to express standards or conditions, provided the standards and conditions are reasonable at the time the lease is executed and the lessor does not require compliance with any ~~unreasonable standard for, nor any unreasonable condition on, such subletting or assignment,~~ standard or condition that has become unreasonable at the time the lessee seeks to

sublet or assign. For purposes of this paragraph, an express standard or condition is presumed to be reasonable; this presumption is a presumption affecting the burden of proof.

(3) Sublet The lease permits the lessee to 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 not unreasonably be withheld or the lease is construed to include an implied standard that such consent shall not unreasonably withheld.

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

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

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

(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.

Comment. Subdivision (a) of Section 1951.4 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)(1) 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). Under subdivision (b)(1), a lessor may not include a prohibition against subletting or assignment and thereafter take advantage of the remedy of this section by waiving the prohibition; the lessee must have a legal right to sublet or assign subject only to reasonable limitations from the outset if the landlord is to have the remedy provided in this section.

The parties may agree to express standards and conditions for assignment and sublease. Section 1995.260 (transfer restriction in commercial lease subject to standards and conditions). Subdivision (b)(2) is amended to make clear that an express standard or condition on transfer is presumed reasonable. This is consistent with cases involving the reasonableness standard generally and with the underlying philosophy of this chapter. See Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loyola L.A. L. Rev. 405, 747 (1989). 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, although originally reasonable, 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."). However, subdivision (b)(2) does not permit the lessor to take advantage of the remedy provided in this section by including in the lease a standard or condition that is originally unreasonable and thereafter waive it; the lessee must have a legal right to sublet or assign subject only to reasonable limitations from the outset if the landlord is to have the remedy provided in this section.

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). Under this subdivision a lessor may not take advantage of the remedy provided in this section by including in the lease a clause that gives the lessor absolute discretion or the right unreasonably to withhold consent or that subjects the lessor's consent to unreasonable limitations, and thereafter waiving the clause; the lessee must have a legal right to sublet or assign subject only to reasonable limitations from the outset if the lessor is to have the remedy provided in this section.

Under subdivision (c), 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, would not constitute a termination of the lessee's right to possession, so long as the lessor does not make the election to terminate the lessee's right to possession.

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

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

The amendments apply to leases executed before, on, or after the operative date of the amendments, except as provided in Section 1952.

Note. This section has been revised consistent with the Commission's policy decisions at the January meeting in Irvine.

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.

§ 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 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. Cf. Comment to Section 1995.220 (transfer restriction strictly construed).

§ 1995.030. Transitional provision

1995.030. Except as provided in Section 1995.250, this chapter applies to a lease executed before, on, or after January 1, 1990.

Note. This section is new, pursuant to the Commission's decision at the January meeting in Irvine.

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). Neither the law governing unreasonable restraints on alienation (see, e.g., Civil Code § 711) nor the law governing the implied covenant of good faith and fair dealing (see, e.g., California Lettuce Growers v. Union Sugar Co., 45 Cal. 2d 474, 289 P. 2d 785 (1955)) prevents the enforcement of a restriction on transfer in accordance with the express terms of the restriction. It should be noted, however, that subdivision (a) remains subject to general principles limiting freedom of contract. See, e.g., 1 B. Witkin, Summary of California Law Contracts §§ 23-36 (9th ed. 1987) (adhesion and unconscionable contract doctrines).

Subdivision (b) codifies the common law rule that a tenant may 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).

§ 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). This section is also consistent with the common law rule that lease restrictions on involuntary transfer are strictly construed. See discussion in Coskran, *Assignment & Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loyola L.A. L. Rev. 405, 524-531 (1989); cf. Section 1995.020(e) ("transfer" defined).

§ 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 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 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 appropriate 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.

--Gordon W. Jones of Safeway

§ 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.

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 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 as a condition for consent. *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 that the landlord may elect either to consent 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 Comment to Section 1951.4.

NOTE. The staff has relocated subdivision (d) from the statute to the last paragraph of the Comment, consistent with the Commission's decision concerning Section 1951.4(c)(3).

Gordon W. Jones of Safeway 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 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 standard of commercial reasonableness developed in the cases. The staff agrees and would delete the reference to a subjective standard of reasonableness.

§ 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, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 Loyola L.A. L. Rev. 405, 433-435 (1989); *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. The Legislative Counsel has reorganized the sequence of provisions of this section in the draft bill. The staff will revise this section to conform to the bill when the Commission's report is printed.

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 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 finds this provision very confusing and, unless it serves a significant purpose, would delete it. Joel R. Hall of The Gap 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 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 should clarify the landlord "has not acted reasonably" concept. Professor Coskran suggests, and the staff agrees, that the provision should be revised thus:

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 failed, within a reasonable time, to state a reasonable objection to the transfer.

While this formulation only indirectly picks up a landlord's unreasonable demand for excessive fees for investigation of the tenant's request, the draft itself is cleaner and more understandable than the original version.

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., 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.

--Joel Hall of The Gap

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

--Gordon W. Jones of Safeway

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 of Safeway.

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 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.

--Joel R. Hall of The Gap

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. While this argument may apply to future leases, it does not resolve the issue as to pre-Kendall leases that are silent as to these issues.

§ 1995.260. Transfer restriction subject to standards and conditions

1995.260. A restriction on transfer of a tenant's interest in a lease may provide that the 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.

Comment. 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.

NOTE. Joel R. Hall of The Gap 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 Kendall 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. For example, a landlord's demand for increased rent as a condition for consenting to a transfer may be perfectly reasonable where there is a legitimate basis for the demand, such as where the tenant under a percentage of profits lease seeks to transfer to a nonprofit organization.

Mr. Hall would question this policy. "Either the parties negotiate this issue or they don't. If they don't then the appreciated rental value belongs to the tenant under well established law and it is unreasonable per se (also under well established law) for a landlord to condition his consent on receiving all or any portion of it when the reasonableness standard applies."

Along the same lines, Robert J. Berton of San Diego 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. However, codification of this rule could, again, create the implication that a landlord's demand for increased rent as a condition for consenting to a transfer is unreasonable, even though the landlord may have a perfectly legitimate basis for the demand, such as in the example above of a percentage of profits lease being transferred by the tenant to a nonprofit organization. Professor Coskran's study concludes that a provision such as this, "intended to be simple and avoid litigation could end up creating more practical problems and litigation than it avoids."

One problem with the above discussion is that it assumes Section 1995.260 applies to a lease which requires the landlord's consent to a transfer, whereas our intent in drawing the section was to apply it to a case where the lease does not require the landlord's consent to a transfer. We are talking in this section about standards and conditions for transfer, as opposed to standards and conditions for consenting to a transfer. This confusion could be addressed by adding clarifying language to the Comment, e.g.:

This section does not apply, and Section 1995.240 does apply, to a restriction on transfer of a tenant's interest in a lease that requires the landlord's consent for transfer.