#H-111

ns69d
12/29/88

First Supplement to Memorandum 89-5

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--further comments)

Enclosed is a letter from Joel R. Hall of The Gap, Inc., commenting further on the assignment and sublease tentative recommendation.

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

Section 1995.240 makes clear that the parties to a lease may include in their lease any provisions relating to the landlord's consent to a transfer, including an express provision that the landlord's consent may not be unreasonably withheld. The Comment states that the meaning of "unreasonably withheld" here is governed by the intent of the parties.

In Mr. Hall's previous letter, he objected to the Comment, noting that reasonableness is an objective concept expounded in case law and is not subjective. The staff responded that where the parties have negotiated a reasonableness requirement, it is the intent of the parties, not the judicial standard of commercial reasonableness, that governs the construction of the clause.

Mr. Hall now replies that there was no meeting of minds between landlord and tenant on the meaning of "reasonably withheld", or they wouldn't be in court. They had an opportunity to put specifics in the lease but did not do so. In this situation, the "reasonableness" clause must be read to be an express statement of the implied reasonableness requirement. He would delete from the Comment the note that the meaning of the clause is governed by the intent of the parties.

§ 1995.260. Transfer restriction subject to standards and conditions

This section permits the parties to restrict transfer of a lessee's interest subject to any standard or condition, including a provision that the landlord is entitled to some or all of any excess

consideration received by the tenant for the transfer. Mr. Hall previously objected to this provision because it implies a landlord's demand for consideration is per se reasonable. He now renews his objection, stating "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."

The problem the staff has with Mr. Hall's analysis 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 resolved by adding clarifying language along the following lines to either the section or Comment:

> 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.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

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December 28, 1988

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Attn: Nathaniel Sterling, Esq.
Assistant Executive Secretary

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

Dear Mr. Sterling:

I am gratified that the Commission has accepted several of my suggestions along with those of Gordon W. Jones of Safeway and others speaking from the tenant's viewpoint. However, there is one point in which there may have been a misunderstanding by the Commission's staff. On another point I believe the Commission's purpose is ill-advised. I should like to offer a reply.

1. Regarding Proposed Section 1995.240. This Section reaffirms, under the freedom of contract principle, that:

> **"1995.240. A restriction on transfer of a tenant's interest in a lease may require the landlord's consent for transfer subject to any express standard or condition for giving or withholding consent, including but not limited to any of the following:**
>
> **(a) The landlord's consent may not be unreasonably withheld.**
>
> **(b) The landlord's consent may be withheld subject to express standards or conditions.**
>
> **(c) The landlord has absolute discretion to give or withhold consent, including the right to unreasonably withhold consent.**
>
> **(d) The landlord may elect either to consent or to terminate the tenant's right to possession."**

the gap

In the Comment to this Section, second paragraph, appears the following statement: **"The meaning of 'unreasonably withheld' under subdivision (a) is governed by the intent of the parties."** In my comment letter of December 13, 1988, I disputed this statement and argued that the meaning of reasonable consent is governed by the objective standards developed by case law. Thereafter, in your Note the Commission's staff position was as follows:

> **"...The staff disagrees. Under subdivision (a) we are not dealing with a reasonableness standard implied by law, but a reasonableness standard negotiated by the parties. In this situation it is the understanding of the parties and their circumstances that must control the meaning. "Unreasonably withheld" under subdivision (a) may have a different meaning from the commercial reasonableness concept of Section 1995.250, where the law implies a reasonableness standard."**

I <u>am</u> aware that in the subdivision (a) we are dealing with an express reasonableness standard instead of an implied one. That is the only difference. My argument is the same in either case. I had assumed that the function of subdivision (a) is to simply reaffirm that the parties may contract for the express reasonableness standard without going any further and setting forth <u>specific</u> standards of reasonableness (e.g. a minimum financial net worth requirement). Thus, one must still answer the question of whether the landlord's rejection was reasonable or unreasonable. That question is answered by measuring the landlord's response against the case law on this subject.

As an example, if under the reasonableness standard (whether express or implied) the landlord demanded a rent increase or the payment of all of the profits to him as a condition of consent, the case law compels the conclusion that the landlord was unreasonable. It is insufficient to ask the parties what their intent was because the landlord's intent was to raise the rent (or take the profit) and the tenant's intent was just the opposite. The fact that they are in court litigating the issue demonstrates that there is no meeting of the minds or an "intent" on this subject.

I had also assumed that if the parties wished to express their intent, subdivision (b) was designed to afford them that opportunity by setting forth express standards. Perhaps the disputed sentence in the Comment should be amended to refer to subdivision (b) rather than (a): **"The meaning of 'unreasonably withheld' under subdivision <u>(b)</u> is governed by the intent of the parties."**

In summary, subdivision (a) is simply the reaffirmation of the right of the parties to provide for the express reasonableness standard but without an elaboration of express standards themselves (which is presumably the function of subdivision (b)). As such, the meaning of reasonable consent in this Section (which is express) is no different from the meaning of the commercial reasonableness concept of Section 1995.250 (which is implied) - both are determined by the case law on the subject.

In light of the foregoing, I hope that the Commission will reconsider their position on the questionable sentence in the Comment.

2. Regarding Proposed Section 1995.260. I believe the Commission's rationale in retaining this Section is misguided. In the Commissions's Note:[1]

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

I strongly disagree with the underlined portions of these comments. If the Commission wants to "state the law in an accessible form," then in addition to Robert J. Berton's proposal (Exhibit 1) the statute should read as follows:

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[1]See Tentative Recommendation (annotated), Note on page 22.

"Section 1995.260. Allocation of Consideration

1995.260. In the absence of an express agreement between the parties allocating some or all of any consideration the tenant receives from a transferee in excess of the rent under the lease, such a restriction in a lease where a standard of reasonable consent applies shall be deemed unreasonable."

Now the parties are free to contract for an allocation of the profit as intended by Kendall. Barring this, the existing, overwhelming common law rule is applied.

The Commission's inclusion of the present Section 1995.260 does not "insulate the parties from shifts in judicial philosophy."[2] It blatantly reverses the common law rule on this subject - followed throughout the United States - in favor of landlords. It is naive to argue that **"the existence of this Section would not necessarily be the basis for such an argument..."**[3] (i.e. that such a condition is now rendered reasonable). On the contrary, this is a very potent argument in the landlord's favor that such a condition, in a reasonable consent scenario, is now sanctified as reasonable by legislative decree. Any experienced commercial lease negotiator knows this.

Indeed, this policy of reversal is expressed in the second paragraph of the Commission's Comment although the language purports to take a neutral stand. If the Commission is saying that such a condition of consent (absent an express profits clause in the lease) is not per se unreasonable but rather its reasonableness is a question of fact to be determined under the circumstances, then when would such a condition be reasonable and when would it not? It is ingenuous to rely on the "facts and circumstances" argument.

If a landlord demands more than the rent he could obtain on the street ("market rent"), I suppose the Commission would consider this condition to be unreasonable. But of what value is this? The landlord would never get that rent from anyone else. If landlord demanded market rent or less, is this reasonable? I assume that the Commission would say yes. Therefore, since the landlord can only obtain, in the reality of the marketplace, no

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[2] See Tentative Recommendation (annotated), Note on page 22.

[3] Ibid.

more than the market rent, then Section 1995.260 and the Comment completely legitimizes the demand for profit and renders it tantamount to being per se reasonable. In the real world the landlord would never ask for more than market rent. He might, at first, have an opinion that such value is higher than it really is but very soon the forces of the market would compel him to adjust his demand to the "real" market rent.

While I gladly support the suggestion of Robert P. Berton on this Section (Exhibit 1), I feel that a far more important issue is the damage done by the inclusion of Section 1995.260. Its presence in the statutory scheme as well as the Commission's position on it as reflected in the Comment are unfairly pro-landlord - subverting the avowed purpose of the Commission and of Kendall to allow the parties' freedom of contract to determine this issue and embarks on a serious and ill-advised reversal of the existing and overwhelming American common law on this point. I protest its inclusion in the strongest terms.

As I stated in my December 13th letter (page 10), 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.

I am grateful not only for the inclusion in the Tentative Recommendation of some of my prior suggestions contained in my December 13 letter but also for the opportunity to voice my supplemental comments here. I sincerely hope it will offer additional guidance to the Commission in assessing its proposal by considering the viewpoints of commercial tenants in an effort to arrive at a statute fair to all parties.

Respectfully submitted,

Joel R. Hall
Senior Attorney

JRH:cb

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