#H-111

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Memorandum 90-68

Subject: Study H-111 - Assignment and Sublease (Reconsideration of Kendall Legislation)

Attached to this memorandum are several letters from Ernest E. Johnson of Los Angeles, suggesting that the Commission reconsider the Kendall legislation enacted last session on Commission recommendation. That legislation, found at Civil Code Sections 1995.010 to 1995.270, provides basically that the parties to a commercial real property lease may by contract limit or abolish the tenant's right to assign or sublet, subject to general contract restraints on adhesion and unconscionability. The legislation also codifies the rule in Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488 (1985), that a lease clause requiring the landlord's consent to an assignment or sublease that is silent as to the standard for giving or withholding consent is to be construed as requiring that consent will not be withheld unreasonably; however, the reasonableness requirement only applies to leases executed on or after September 23, 1983.

Commissioner Marshall has asked that the Commission review this matter in light of Mr. Johnson's correspondence. Mr. Johnson's letters of January 13 and 23 are directed to the issue of restricting the rule of Kendall to leases executed on or after September 23, 1983. He believes that it was not clear before that date that the landlord could ignore concepts of good faith and fair dealing and that, in any case, public policy demands that the landlord should be held to those requirements regardless of the state of the law at that time.

The Commission's position in the past on this issue has been:

(1) There was no doubt whatsoever before September 23, 1983, that if the parties agreed that there could be no assignment or sublease without the landlord's consent, they understood and intended by their agreement that the giving or withholding of consent was to be in the landlord's sole and absolute discretion.

(2) Although the Commission believes that a commercial reasonableness requirement is sound public policy, this policy should not override the clear agreement and understanding of the parties. Honoring the intention of the parties is a stronger and overriding public policy.

In his letter of April 8, Mr. Johnson reiterates the retroactivity point, and also urges that at least the statute should be narrowed so that a reasonableness requirement applies to technical changes that do not substantially or adversely affect the landlord's rights. He is thinking of situations such as an acquisition of the tenant by a larger company without any change in the operation of the business on the leased premises, other than that the new tenant is a now a larger more solvent company. In this situation, he would argue that even though the lease was executed before September 23, 1983, the landlord's rights are not affected by the transfer and a rule of reasonableness should apply notwithstanding the possible intent to give the landlord sole and absolute discretion over whether to consent to the transfer. This is a matter the Commission has not previously given specific consideration to.

An additional factor the Commission should take into account is the need for certainty in this area. One basis of the Commission's recommendation concerning Kendall was that parties to commercial real property leases need to have certainty in the law so that they may negotiate with a clear understanding of their rights under the governing law; rules should be codified to "protect parties from future changes in currents and tides of judicial philosophy". *Recommendation Relating to Commercial Real Property Leases: Assignment and Sublease,* 20 Cal. L. Revision Comm'n Reports 251 (1990). To turn around and undermine this policy is not good. The Commission itself has established that, as a matter of policy, "unless there is a good reason for doing so, the Commission will not recommend to the Legislature changes in laws that have been enacted upon Commission recommendation". Cal. L. Revision Comm'n, Handbook of Practices and Procedures 10 (Jan. 1988). A related concern, of course, is that if we

do another flip-flop we will need different sets of rules for leases executed and actions taken under the law in effect between legislative revisions.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

OVERTON, LYMAN & PRINCE
AN ASSOCIATION INCLUDING PROFESSIONAL CORPORATIONS
LAWYERS
550 SOUTH FLOWER STREET, 7TH FLOOR
LOS ANGELES, CALIFORNIA 90071-2567
TELEPHONE (213) 683-1100

ERNEST E. JOHNSON
PROFESSIONAL CORPORATION

DIRECT DIAL (213) 683-5263

GEORGE W. PRINCE, JR. 1887-1971
EUGENE OVERTON 1880-1970
EDWARD D. LYMAN 1881-1962

TELECOPIER (213) 627-7795
CABLE ADDRESS "OLAP"

April 9, 1990

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

Re: Assignment and Sublease/
Use Restrictions Tentative Recommendations

Dear Mr. Sterling:

Thank you for your letter of March 30th; I did in fact receive the material from Professor Coskran with his letter of March 29th and please consider this letter to be my comments.

1. As with the recommendation relating to Commercial Real Property Leases, dated February 19, 1989, I feel the tentative recommendations concerning remedies and concerning use restrictions are heavily biased in the landlord's favor and do not sufficiently take into account the practical operation of such provisions.

Philosophically, I believe that a lease constitutes a conveyance of an interest in property and that the tenant is accordingly the owner of a large bundle of those rights, privileges, powers and immunities we call property. While the landlord is certainly entitled to all reasonable protection for his rights, privileges, powers and immunities, so too the tenant is deserving of protection.

Clearly if circumstances change adversely and particularly if a leasehold declines in value, the landlord will insist upon his full rent as provided in the lease; but if the circumstances change positively or if the value of the leasehold increases substantially, I have difficulty seeing why the landlord is entitled to extract more from the tenant than he contracted for in his lease. To me, the landlord should be required to have some commercially reasonable justification for a refusal to consent to a change in use or an assignment or a subleasing. Any broker, agent or employee will seek to maximize the return and will rationalize a demand for a tribute or increased rent on the ground that he is only asking for current market.

2. Application. It is critical to emphasize that these recommendations concerning assignment, sublease and use apply to a broad range of circumstances, many of which have no material or adverse consequences to the landlord's rights. As I read the statutes the application is determined by the definition of "transfer" contained in Section 1995.020 without any qualification or clarification. Thus an assignment or transfer and the consequent right of the landlord to extract increased rent, etc. would occur where (for example)

a. The tenant dies and his widow, children or heirs take over the business and continue to operate the business as before.

b. The tenant merges with or is acquired by a second corporation and operations continue on the premises substantially as before.

c. An individual or partnership determines to incorporate and accordingly the lease is technically assigned.

d. A change in the composition of a partnership through the death, withdrawal or admission of a partner without any substantial change in the continuing business being transacted on the premises.

e. An owner decides to retire and sell to his employees.

To me such things as the foregoing do not constitute a substantial change and do not adversely impact upon the landlord, particularly where the assignor remains liable. Through application of a requirement of reasonableness, of good faith and fair dealing and a ban on unreasonable restraints on alienation, this problem can be resolved.

In other situations, a business expands or contracts or requires different premises. To limit assignment rights in such a situation constitutes in my judgment, a restraint on alienation and reasonableness should be required.

Similar considerations apply with respect to a change of use. The operation of a men's clothing store may become unprofitable and the owner determined to operate a women's clothing store, or a jewelry shop may convert to a stationery shop. If the use descriptions in the lease are specific such a change could constitute a breach of the lease giving the landlord the right to

demand extra rent or a payment for consent, though there has been no adverse or substantial impact upon the landlord. Of course this is something that must be analyzed in each individual case as there may already be a women's clothing store or a stationery shop in the shopping center. But here too, the requirement of commercial reasonableness and the application of the covenant of good faith and fair dealing would seem appropriate, rather than allowing the landlord the absolute unfettered right to enforce his will. And as a practical matter the broker, agent or employee would feel it was his DUTY to demand payment if permitted.

3. Leases in Practice. Many of the problems discussed in the recommendations and in the literature on the subject deal with theoretical situations and not what in fact happens in the real world of the small business. The very large tenants would have attorneys specializing in the field and in fact would be experienced in negotiating leases. There would in fact be an arm's length negotiation between substantially equal parties in connection with the lease. But the practicalities are that most small business tenants do not use a special attorney if indeed they use any attorney at all. The landlord has a tendency to deal with them on a take it or leave it basis and I am afraid that many of these tenants buy the sizzle rather than examining the details because they frankly do not think in terms of the future possibilities. Sometimes the use provisions in a lease will describe "general business office" but other times it is more specific such as "insurance agency" which is where the change of use problems arise. Some small business clients are sufficiently sophisticated to provide for changes in a partnership composition or death, but I have run into very few who provide for incorporation or merger or the sale of a business, etc. It may be that a large part of the problem I see is the fault of the small business tenant and his failure to adequately protect himself, but the fact remains that in many situations the small business tenant is at a distinct disadvantage in negotiating with the large experienced and well represented landlord. And accordingly, in my opinion the requirement of good faith and fair dealing, of commercial reasonableness and of bans on unreasonable restraints on alienation such as the case of Kendall v. Pestana sought to impose are of great importance. The bans on contracts of adhesion, etc. is not sufficient protection in my opinion.

4. Specifically with respect to the tentative recommendation on remedies, I suggest that the language might specifically allow punitive damages in the event of a wrongful withholding of consent. I would read recommended Section 1995.310 as allowing for any contractual damages and, as the note indicates,

under certain circumstances this could be a tort. But it seems likely to me that a landlord would bluff and delay where this was to his advantage and that accordingly additional protection should be given to the tenant in the event of an unreasonable withholding of consent in a timely manner. It should be emphasized that a landlord's refusal to consent to an assignment could destroy a sale or transfer of the business or a merger or other corporate reorganization and that a recourse to the courts could only lead to a damage recovery several years down the line long after the proposed merger or sale or reorganization had fallen through.

Somewhat similarly I am concerned about Section 1995.330 when applied to these nonsubstantial changes or assignments. Consider the application of Section 1995.330(c) in the case of a merger, or a reorganization, or a debt, or an incorporation or the sale of a business. In my judgment you are giving the landlord too much power to demand tribute when his rights would not be adversely nor materially affected. For example, consider the acquisition of a small manufacturing business by a larger corporation which contemplates continuing operations as in the past; technically, the landlord could refuse consent to the assignment and demand that the seller (who may be elderly or in poor health or even deceased) continued to pay the rent under the original lease.

5. My comments on the recommendation on use restrictions are similar to the comments I had on the earlier recommendation concerning assignment and sublease. In my opinion, the usage of the date of September 23, 1983 is inappropriate. The rise in the concept of requiring good faith and fair dealing and requiring commercial reasonableness was apparent even before but was made emphatic by the Wellenkamp case in 1978.

While there is much to be said for having an identical public policy relating to use and to assignment restrictions, in my opinion that public policy should be a statutory requirement of commercial reasonableness and of good faith and fair dealing. The statute dealing with assignment restrictions has been criticized as "landlord oriented" and I do not believe that same mistake should be made with respect to use. Indeed I would urge the Commission to reconsider its recommendation concerning assignments and subleasing.

6. Frankly I fail to see why there should be permission for an absolute prohibition in the change of use regardless of how trivial, or inconsequential or reasonable that change of use may be. Similarly, I am concerned by the statement that "the parties might negotiate such a provision because the landlord needs to be

able to exercise the landlord's best business judgment without being subject to second guessing by the tenant and the courts"; I suggest that the Law Revision Commission should be concerned with both with the landlord's needs and the tenant's needs which with all due respect seem to be given rather little weight. What of the tenant who winds up with a use restriction providing for the manufacture of a product that becomes obsolescent or uneconomic? Why should he be prohibited from changing to a similar type of business where the change in use does not adversely or unreasonably affect the landlord? Why should the tenant be forced to continue in the same type of business described in the lease?

Again to a large extent this problem relates to the definition of use contained in the lease and, here also, the tenant may be largely responsible because he failed to incur the expense of a skilled attorney or of extended negotiations. But as a practical matter many tenants simply to not make sufficient effort to negotiate changes in the printed form the landlord presents to him. Accordingly in my judgment it would be appropriate for the law to require that any restriction on the use of leased property or any refusal to approve a change in use must be commercially reasonable (Section 1997.230) and that the landlord is not entitled to "sole and absolute discretion" (Section 1997.250). Landlords have not shown themselves deserving of such divine authority and I would urge the Law Revision Commission to balance the respective rights and obligations of the parties.

7. A minor comment on Section 1997.270. As with the earlier restriction on assignment and sublease, I do not understand the reference to "execution of the option" as contained in Section 1997.270(b). Is this intended to refer to the "exercise" or is it intended to refer to the date of execution of the document containing the option which will normally be the same as the original lease. Logically it would seem to me that it should refer to the date upon which the option rights are exercised and that in effect a new lease, etc. would date from that time.

I apologize for the length and nature of these comments, but I have not had sufficient time in my practice to do the thorough job this subject really requires, but I did want to express my opinion, which may constitute another view and is based upon my some 35 years of practice, during the course of which questions and problems with respect to assignment and subleasing and change of use have arisen only when some unforeseen event occurred and the landlord sought to use this event to extract a payment or an increase to the then current market rate. In fact the situation was analogous to the due-on-sale clauses ultimately

resolved in Wellenkamp where the financial institutions sought to use a sale or transfer as a method of increasing their interest payment without regard to their security.

I wish I could identify a tenant organization or small business tenants who would be willing to devote the time and expense necessary to appropriately respond to your request; but unfortunately I am not aware of any and can only suggest that it might be appropriate to retain an expert to present the landlord's side and a second expert to present the tenant's side. I am afraid that is the only way I can see for a full presentation of conflicting views to be adequately presented.

Because they have a bearing upon the subjects discussed in the two new tentative recommendations, I am enclosing copies of my earlier letters relating to the legislation concerning assignment and sublease based upon the Commission's recommendation of February 1989 which unfortunately, I had not heard of until November 1989 after the legislation was adopted. I would still urge that that matter be reconsidered. While I would personally advocate a requirement of commercial reasonability and good faith and fair dealing, at the very least I would urge that the definition of assignment be narrowed so as not to apply to technical changes not substantially or adversely affecting landlord's property rights. Of course, this is consistent with my general view that there needs to be a balancing between the rights of tenants and the rights of landlords; that refusals to give consent to assignments or subleases or changes in use must be reasonable and in some manner relate to the protection of the landlord's legitimate interests in his property; they should be a shield to protect the landlord and not a sword with which to strike down the unwary tenant.

Sincerely,

Ernest E. Johnson

EEJ:kla

cc: Arthur K. Marshall
William G. Coskran

OVERTON, LYMAN & PRINCE
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
LAWYERS
550 SOUTH FLOWER STREET
LOS ANGELES, CALIFORNIA 90071-2467
TELEPHONE (213) 683-1100

ERNEST E. JOHNSON
PROFESSIONAL CORPORATION

DIRECT DIAL (213) 683-5263

GEORGE W. PRINCE, JR. (1887-1971)
EUGENE OVERTON (1880-1970)
EDWARD D. LYMAN (1881-1962)

TELECOPIER (213) 627-7788
CABLE ADDRESS "OLAP"

January 23, 1990

Mr. Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4733

Dear Mr. Sterling:

I continue to think about this Kendall legislation and your letter of January 3, 1990; and particularly the flat assertion that the law was clear before Kendall and/or Cohen. I respectfully disagree.

In your letter of January 3, 1990, you state that "the commission found little doubt that before the Cohen case in 1983 parties to a lease....understood and intended...that the landlord had sole discretion."

Similarly, in the Recommendation of the LRC dated February 1989, reference is made to protecting "the interest of parties who relied on the pre-Kendall rule of absolute landlord discretion...".

I respectfully disagree and quite frankly question how these flat assertions can be made with such confidence:

1. The "continuing vitality" of the Richard case had been questioned and then distinguished in Laguna Royale Owners Association vs. Darger in 1981 (119 CalApp3rd 670).

2. As pointed out by Mr. Kehr, in his California State Bar Journal article in March 1980, the Richard rule was shaky authority. The issue had not been presented to the Supreme Court, Richard cites little authority and is not particularly persuasive.

3. The 1979 case of Richardson vs. La Rancherita La Jolla Inc. 98 (CalApp3rd 73), did not directly deal with the Richard case but assumed that the landlords actions must relate

to the protection of its legitimate interest.

4. The Restatement Second of Property at Section 15.2 (1977) adopted the "minority" rule requiring commercially reasonable objections on the part of the landlord.

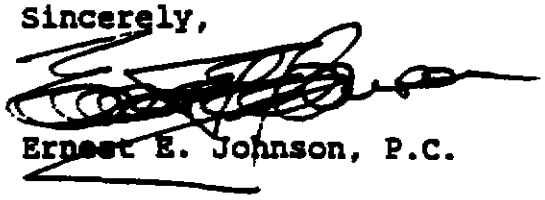
5. Numerous cases had limited the application of covenants against assignment in situations involving mortgages, sub-leases, transfers through probate, involuntary transfers, transfers among partners etc. as described in Mr. Kehr's article and in the opinion in Kendall vs. Pestana itself.

6. With the increasing interest in covenants of good faith and fair dealing, and the due on sale cases such as LaSala vs. American Savings and Loan Association (1971, 5 Cal3rd 864) and particularly Wellenkamp vs. Bank of America (1978 28 Cal3rd 943) it seemed clear where the law was going. Admittedly, prior to Cohen and Kendall, the most recent case directly on point was Richard. But a statement of what the law is does not necessarily consist of a citation of the last case but instead an analysis of what the courts would now find; on that basis, I submit the law was becoming increasingly clear through the 1970's that a landlord must have some commercially reasonable objection or it could not withhold its consent to an assignment or sub-lease and this, of course, was what the Kendall decision ultimately concluded.

I am similarly confused by the statements on page 6 of the Commissions Recommendation referring to several cases as constituting a "narrow judicial construction of pre-Kendall leases" and "expressly limiting retroactivity of Kendall". I have since reviewed both the Hogan and Airport Plaza cases, and do not find them supportive of that proposition. Instead they expressly support and apply Kendall but determine that in the specific cases the landlord had a "commercially reasonable objection". For example, in Hogan, there was a percentage lease and it was clear from the evidence that, following the assignment, the landlord would probably receive less. Airport Plaza involved an effort to hypothecate the lease which could have a severe impact upon the landlord. Earlier I commented that Kreisher hardly seemed authoritative for a limited retroactivity because of the overwhelming franchise aspect in that case as well as the breaches of the lease, the $2,000,000.00 verdict on a $30,000.00 assignment, etc. etc.

I reread the opinion in Kendall vs. Pestana and frankly, find it persuasive. Accordingly, I continue to be concerned about the "taking" of valuable property rights to appreciation from tenants with long term leases.

Sincerely,



Ernest E. Johnson, P.C.

EEJ:alw
cc: Judge Arthur K. Marshall
Professor Roger Bernhardt

OVERTON, LYMAN & PRINCE
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
LAWYERS
550 SOUTH FLOWER STREET
LOS ANGELES, CALIFORNIA 90071-2467
TELEPHONE (213) 683-1100

ERNEST E. JOHNSON
PROFESSIONAL CORPORATION

DIRECT DIAL (213) 683-5283

GEORGE W. PRINCE, JR. 1887-1971
EUGENE OVERTON 1880-1970
EDWARD D. LYMAN 1881-1962

TELECOPIER (213) 627-7795
CABLE ADDRESS "OLAP"

January 13, 1990

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

Re: **Kendall Legislation**

Dear Mr. Sterling:

Thank you for your letter of January 3, 1990. I do have a few comments. Unfortunately the day to day practice of law does not permit sufficient time for the research and study that is necessary for so complicated a subject but I do have a few thoughts which I trust will be of assistance:

1. I do not believe that status of the law in California in 1983 (i.e pre-Cohen) was at all clear. Mr. Kehr's article in the California State Bar Journal, March 19, 1980, emphasizes the extremely thin nature of the authority for the proposition that California allowed a landlord to arbitrarily refuse consent to an assignment; apparently this was based on one appellate court case which contained little analysis or authority. And as Mr. Kehr emphasizes the Supreme Court had made its distaste for limitations on alienation abundantly clear for some time and then when Wellenkamp was handed down in 1978 there was additional strong authority questioning the Richard rule asserting the landlord's unlimited right. For your convenience I am enclosing a copy of Mr. Kehr's article. You might also review the Hasting's Law Journal Note in 1970 which also discusses the judicial attitude and sharply criticizes the "majority view".

2. Prior to 1980, I was expressing opinions to clients to the effect that they should take the position that these covenants could not be arbitrarily enforced and that covenants of good faith and fair dealing were applicable. Admittedly the cases did not clearly support that position until Kendall was determined but nevertheless it was, as Mr. Kehr said, a very reasonable prediction of the law in California, particularly in view of the thin authority presented by the Richard case and the strong currents to the contrary contained in the cases dealing with covenants of good faith and fair dealing, the Due-On-Sale clauses and for that matter in the series of cases which had

strictly construed covenants against assignment and refused to apply them in merger, death etc. situations.

3. I reviewed the Kreisher case and quite frankly do not find it very persuasive. The essence of the situation was the franchise agreement and the impact of the specific franchise laws in California; I think a fair reading of the opinion would conclude that the lease aspect was intimately interrelated with and secondary to the franchise aspects of the relationship. And even the Kreisher opinion emphasizes the criticisms of the Richard rule etc. Clearly a DCA decision overturning a $2,000,000.00 verdict for refusal to consent to a $30,000.00 assignment of a gas station franchise and lease under peculiar facts and clouded by claims of breach is of limited application.

4. The bottom line is that I do not believe it is at all fair to say that the law was settled prior to Cohen and Kendall. Similarly, I do think the policy arguments supporting the Kendall position were given rather short shrift.

5. I did not mean to indicate that the matter was handled secretly etc. but I must say that I have practiced in this area for many years and am a member of the Real Property section. I attempt to read all the materials that come my way and did not notice any reference to the details or nature of this study. I subsequently talked with two prominent commercial realtors in Los Angeles who were totally unaware of the legislation until I brought it to their attention in November/December. Similarly, I talked with some of my lawyer friends about the matter and was met with a complete lack of any awareness. I did notice a brief reference in the December 1988 Annual report to the fact that a study was in process with no indication of details. The Los Angeles County Law Library advised me in December 1989 that they had never received any report nor draft and had none available. Accordingly, I communicated directly with the Law Revision Commission and very promptly received a copy. Unfortunately, most of the organized bar in this area, primarily represent landlords and building owners. Before the legislature the support is described as the "Building Owners and Managers Association of California and the Executive Committee of the Real Property Law Section".

6. My practice largely involves representing small business corporations most of whom tend to be tenants. I am a conservative republican but I find little merit in awarding landlords windfall profits beyond what they bargained for in their leases because of fortuitus events involving the tenant.

Building owners have tremendous economic and political

clout. Most law firms and accounting firms specializing in the field represent landlords; tenants are not organized and would normally be represented by their regular counsel if at all. The very large tenants you mentioned such as the GSA, Safeway and the Gap, are in an entirely different category; for one thing, they tend to be repeat tenants who are in an economic position to bargain very effectively. Nor do the consumer groups etc. have any particular interest in the small business man and, of course, the problem does not concern the poverty stricken. I am afraid it is as some of the writers say: the voiceless people in American politics today are the middle class and the small business man.

7. Of course, the landlord is entitled to protection and should have the right to reject an assignment where there is any risk or potential damage to his premises. But, I do not think he should be entitled to object <u>solely</u> because of his desire for more money. In practice, the problem arises only where there has been an appreciation in the value of the leasehold. Should the landlord be entitled to a windfall profit beyond the rent he contracted? Should the tenant be entitled to the increase in the value of his leasehold? The answer to this question will have a direct bearing upon the tenants willingness to sell his business, willingness to move to a new location etc. In other words, the new legislation will, in fact, restrain alienation in many situations.

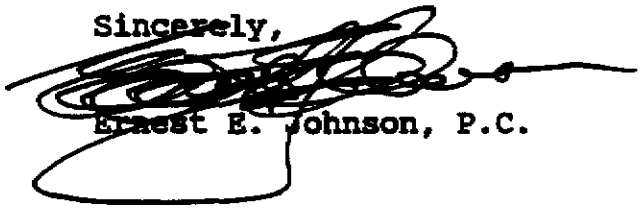
8. And then whatever happened to the covenant of good faith and fair dealing?

9. I reviewed Professor Coskran's background study, and frankly, would not construe it as a clarion call to correct a serious wrong. It discusses the economic arguments, pro and con, and exhaustively reviews the area citing, but apparently rejecting, Mr. Kehr's article. It indicates that (despite all the theoretical reasons which are discussed in detail) the essence of the problem is, in reality, who will get the profits involved.

Quite frankly, I was surprised to see the Law Revision Commission come down so strongly in support of the landlord's rights to all profits in commercial situations and find this logically inconsistent with the exclusion of residential application. Residential leases are normally of shorter duration and do not involve profits of the magnitude involved in commercial leases; but this does not seem a basis for exclusion.

I hope the foregoing comments from "another view point" may be of assistance.

Sincerely,



Ernest E. Johnson, P.C.

EEJ:alw
cc: Judge Arthur K. Marshall