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***Kendall v. Pestana*: Standard of Reasonableness Applied to Commercial Assignment Clauses**

In *Kendall v. Ernest Pestana, Inc.*,¹ the California Supreme Court considered a provision in a commercial lease requiring written consent of the lessor before the lessee could assign the lease or sublet the premises.² The question presented was whether a lessor could unreasonably and arbitrarily withhold consent in the absence of a provision prohibiting the unreasonable withholding of consent.³ The court held that when an assignment requires the prior consent of the lessor, the lessor may not withhold consent unless a commercially reasonable objection to the assignee or the proposed use exists.⁴

Part I of this Note sets forth the facts of *Kendall* and summarizes the majority and dissenting opinions. Part II presents the legal background of approval clauses with respect to leading California cases. Part III analyzes the effect *Kendall* will have on existing and future leases. Also, the probable effect *Kendall* will have on the statutory remedies provided in the California Civil Code is considered. This Note concludes that *Kendall* should be applied only to leases entered into before 1971 and applied prospectively.

I. THE CASE

A. The Facts

The City of San Jose leased 14,400 square feet of hangar space at the city-owned San Jose Municipal Airport to Irving and Janice Perlitch.⁵ The Perlitches subsequently entered into a twenty-five year sublease with Robert Bixler.⁶ The rental rate under the sublease was to increase every ten years in the same proportion as rents increased on the master lease with the City of San Jose.⁷ Bixler intended to

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

2. Although the case involved a lease assignment, the holding was extended to subleases as well. *Kendall*, 40 Cal. 3d at 493 n.2, 709 P.2d at 839 n.2, 220 Cal. Rptr. at 820 n.2. This note will omit references to subleases.

3. *Kendall*, 40 Cal. 3d at 493, 709 P.2d at 839, 220 Cal. Rptr. at 820.

4. *Id.* at 507, 709 P.2d at 849, 220 Cal. Rptr. at 830.

5. *Id.* at 493, 709 P.2d at 839, 220 Cal. Rptr. at 820.

6. *Id.*

7. *Id.*

use the premises for an airplane maintenance business.⁸ Shortly after contracting with Bixler, the Perlitches assigned their interest to Ernest Pestana. Pestana became Bixler's new lessor.⁹

Bixler conducted the airplane maintenance business until 1981 when he agreed to sell the business to Jack Kendall.¹⁰ The proposed sale of the business included the equipment, inventory, and improvements on the property.¹¹ In addition, the sale included the existing lease which Kendall agreed to assume. The proposed assignee, Kendall, had a stronger financial statement and greater net worth than did the assignor, Bixler.¹²

The lease provided that written consent of the lessor, Pestana, was required before the lessee, Bixler, could assign the lease.¹³ A provision of the lease rendered the lease voidable at the option of the lessor if the lessee failed to obtain consent to assignment.¹⁴ Pestana refused to consent to the proposed assignment, claiming an absolute right of the lessor to refuse assignment.¹⁵ The proposed assignee, Kendall, brought suit seeking a declaration that the unreasonable refusal of Pestana to consent to the assignment of the lease was an unlawful restraint on alienation.¹⁶ In addition, Kendall alleged that Pestana demanded increased rent and other onerous terms as a condition to consent.¹⁷ In sustaining the demurrer to the complaint, the trial court upheld the lessor's refusal to consent to the assignment.¹⁸

B. The Opinions

1. The Majority

The California Supreme Court reversed the order sustaining the demurrer to the complaint.¹⁹ The court ruled that a commercial lease that limits assignments or subleases to those consented to by the lessor require that the lessor consent to assignment unless a commercially reasonable objection exists.²⁰ The unreasonable withholding of con-

8. *Id.*

9. *Id.* at 494, 709 P.2d at 840, 220 Cal. Rptr. at 821.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* at 507, 709 P.2d at 849, 220 Cal. Rptr. at 220.

20. *Id.* The court did not address the question of the legal effect of covenanting for the right to withhold consent arbitrarily and capriciously. *Id.*

sent was held to be a restraint on alienation and a violation of the implied duty of good faith and fair dealing.²¹

a. *Restraint on Alienation*

At common law, a lessor could withhold consent to an assignment for any or no reason.²² The court noted that the impetus for the change from the common law majority view to the rule adopted in *Kendall* came from two sources.²³ First, the *Kendall* court recognized that the law favors the free alienation of property.²⁴ The policy against restraints on alienation pertains to leasehold interests as coveyances.²⁵ While restrictions on the alienability of leasehold interests are permitted, the restrictions are strictly construed against the lessor.²⁶ In support of this proposition, the court cited California Civil Code section 711²⁷ which provides that conditions restraining alienation are void when repugnant to the interest created.²⁸ Restraints that result in forfeiture are scrutinized carefully.²⁹ The greater the restraint resulting from enforcement of the clause, the greater the justification must be to enforce that clause.³⁰

A lessor has an undeniable interest in exercising control over the person in possession of the lessor's property.³¹ The lessor must look to the tenant for the performance of the covenants contained in the lease.³² The court, however, rejected the notion that a lessor's interest in the tenant is absolute.³³ Relationships between lessors and lessees have become increasingly impersonal.³⁴ Moreover, the lessor's interests are protected because the original lessee remains liable to

21. *Id.*

22. 2 POWELL, POWELL ON REAL PROPERTY § 246(1), at 372.97 (1985).

23. *Kendall*, 40 Cal. 3d at 499, 709 P.2d at 843, 220 Cal. Rptr. at 824.

24. *Id.* at 495, 709 P.2d at 840, 220 Cal. Rptr. at 821.

25. *Id.* at 499, 709 P.2d at 843, 220 Cal. Rptr. at 824.

26. *Id.* at 495, 709 P.2d at 840, 220 Cal. Rptr. at 821 (citing *Chapman v. Great W. Gypsum Co.*, 216 Cal. 420, 426, 14 P.2d 758, 758 (1932); SCHOSHINSKI, AMERICAN LAW OF LANDLORD AND TENANT § 8.16, at 583-88 (1980); 2 POWELL, POWELL ON REAL PROPERTY § 246(1), at 372.97-98 (1985)).

27. CAL. CIV. CODE § 711.

28. *Id.*

29. *Kendall*, 40 Cal. 3d at 495-96, 709 P.2d at 840-41, 220 Cal. Rptr. at 821-22.

30. *Id.* at 498, 709 P.2d at 843, 220 Cal. Rptr. at 824 (quoting *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 949, 582 P.2d 970, 973, 148 Cal. Rptr. 379, 383 (1978)).

31. *Kendall*, 40 Cal. 3d at 499, 709 P.2d at 844, 220 Cal. Rptr. at 822 (quoting RESTATEMENT (SECOND) OF PROPERTY § 15.2(2) (1977)).

32. *Kendall*, 40 Cal. 3d at 500, 709 P.2d at 844, 220 Cal. Rptr. at 822.

33. *Id.* at 502, 709 P.2d at 846, 220 Cal. Rptr. at 827.

34. *Id.* at 499, 709 P.2d at 844, 220 Cal. Rptr. at 821 (quoting 2 POWELL, POWELL ON REAL PROPERTY § 246(1), at 372.97-98 (1985)).

the lessor as a surety.³⁵ The original lessee remains accountable to the lessor even if the lessor consents to the assignment and the assignee expressly assumes the obligations of the lease.³⁶ After considering these factors, the court was persuaded that a standard of reasonableness, requiring a commercially reasonable objection to withhold consent, sufficiently protects a lessor's interest in exercising control over the assignment of property.³⁷ A reasonableness standard also furthers the policy favoring free alienation of property.³⁸

b. Good Faith and Fair Dealing

The second consideration favoring a departure from the common law relates to the contractual aspect of a lease.³⁹ The court recognized the increasing emphasis on the duty of good faith and fair dealing inherent in every contract.⁴⁰ This duty obligates a party empowered with discretion to exercise that discretion in good faith.⁴¹ When a lessor retains the discretionary power to approve or disapprove a proposed assignee the decision should conform to commercially reasonable standards.⁴² This argument implicitly suggests that the parties did not bargain for a lease provision granting the lessor absolute discretion to approve assignments.⁴³

c. Additional Majority Arguments

Having established affirmative grounds to support the opinion, the court considered justifications favoring the common law rule. First, traditional concepts of ownership and control over property placed a lessor under no obligation to look to anyone other than the lessee

35. *Id.* at 500, 709 P.2d at 844, 220 Cal. Rptr. at 825 (citing *Peiser v. Mettler*, 50 Cal. 2d 594, 602, 328 P.2d 953, 957 (1958); *Samuels v. Ottinger*, 169 Cal. 209, 212, 146 P. 638, 639 (1915)).

36. *Id.*

37. *Id.* at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826.

38. *Id.* at 499, 709 P.2d at 843, 220 Cal. Rptr. at 825.

39. *Id.* at 500, 709 P.2d at 844, 220 Cal. Rptr. at 825.

40. *Id.* (quoting *Cohen v. Ratnoff*, 147 Cal. App. 3d 321, 328, 195 Cal. Rptr. 84, 89 (1983)).

41. *Id.* at 500, 709 P.2d at 845, 220 Cal. Rptr. at 826 (quoting *California Lettuce Growers v. Union Sugar Co.*, 45 Cal. 2d 474, 484, 289 P.2d 785, 791 (1955)).

42. *Id.* at 500, 709 P.2d at 845, 220 Cal. Rptr. at 826.

43. See *infra* notes 68-75 and accompanying text. If two parties negotiated for the inclusion of an assignment clause with knowledge that the lessor had absolute discretion to withhold consent for any reason, the covenant of good faith and fair dealing should not supply terms that are contrary to both the contract and the understanding of the parties. *Id.* See, e.g., *San Francisco Chron.*, Mar. 5, 1986, at ____ (editorial) (discussing *Kendall*) ("Approval clauses have been a matter of negotiation in the past. In the future, it may not be a proper matter for negotiation. . . .").

for the rent.⁴⁴ The court, however, cited the statutory obligation of a lessor to mitigate damages if the lessee abandoned the property.⁴⁵ The lessor must mitigate damages by seeking a substitute lessee.⁴⁶ Thus, if the lessee abandons the premises, future rents are not always fully recoverable from the lessee in breach.⁴⁷ Moreover, the ability of a lessor to refuse an assignment on reasonable grounds remains, preserving valued ownership rights.⁴⁸

The second justification advanced in support of the common law rule was that approval clauses are unambiguous reservations of absolute discretion in the lessor.⁴⁹ The lessee could have bargained for the addition of a reasonableness clause.⁵⁰ The court reviewed the interpretations of approval clauses in a number of cases from other jurisdictions and noted the increasing number of jurisdictions that have rejected the common law rule. Many of these courts have held that a lease requiring consent implicitly represents that consent will not be unreasonably withheld.⁵¹ The court adopted the implicit reasonableness requirement as a corollary to the implied duty of good faith and fair dealing.⁵²

The third argument raised in support of the common law rule was that many leases were prepared in reliance upon the traditional rule.⁵³ The court responded that the reasonableness requirement should not come as a surprise to observers of modern real property law.⁵⁴ Additionally, the contractual nature of leases has been recognized in Califor-

44. *Kendall*, 40 Cal. 3d at 501-02, 709 P.2d at 845-46, 220 Cal. Rptr. at 826-27.

45. *Id.* at 502, 709 P.2d at 846, 220 Cal. Rptr. at 827. Cal. Civ. Code § 1951.4. Section 1951.4 relieves the lessor from mitigating damages if certain requirements are met. *See infra* notes 68-73 and accompanying text.

46. *Kendall*, 40 Cal. 3d at 502, 709 P.2d at 846, 220 Cal. Rptr. at 827.

47. *Id.*

48. *Id.*

49. *Id.* at 502, 709 P.2d at 846, 220 Cal. Rptr. at 827.

50. *Id.*

51. *Id.* at 502-03, 709 P.2d at 846-47, 220 Cal. Rptr. at 827-28 (citing *Granite Trust Bldg. Corp. v. Great Atl. & Pac. Tel. Co.*, 36 F. Supp. 77, (D. Mass. 1940); *Gamble v. New Orleans Hous. Mart., Inc.*, 154 So. 2d 625 (La. App. 1963); *Shaker Bldg. Co. v. Fed. Lime & Stone Co.*, 28 Ohio Misc. 246, 277 N.E.2d 584 (1971); *Fernandez v. Vasquez*, 397 So. 2d 1171 (Fla. Dist. Ct. App. 1981); *Boss Barbara, Inc. v. Newbill*, 97 N.M. 239, 638 P.2d 1084 (1982)).

52. Recognizing the obligations imposed by the duty of good faith and fair dealing is not a rewriting of the contract. *Kendall*, 40 Cal. 3d at 503, 709 P.2d at 847, 220 Cal. Rptr. at 828.

53. *Id.* at 503-04, 709 P.2d at 847, 220 Cal. Rptr. at 828.

54. "[T]he trend in favor of the minority rule should come as no surprise to observers of the changing state of real property law in the twentieth century. The minority rule is part of an increasing recognition of the contractual nature of leases and the implications in terms of contractual duties that flow therefrom." *Kendall*, 40 Cal. 3d at 504, 709 P.2d at 847, 220 Cal. Rptr. at 828.

nia law.⁵⁵ The majority also noted that the California Supreme Court had never adopted the common law rule.⁵⁶

A final argument disposed of by the court was that a lessor has a right to realize the increased value of the leased property.⁵⁷ The court rejected this argument and noted that a lessor who has alienated the use and enjoyment of the leased property for consideration is entitled to no more than bargained for.⁵⁸ Any increased value of the property not provided for by the terms of the lease is returned to the lessor upon the expiration of the lease when the lessor regains an appreciated reversionary interest.⁵⁹

2. *The Dissent*

The dissenting opinion embraced the arguments favoring the common law rule. Furthermore, the dissent was convinced by an additional argument not raised by the litigants, but suggested by the court of appeal.⁶⁰ This argument was that a universal reasonableness requirement had been considered and rejected by the legislature when sections 1951.2 and 1951.4 of the California Civil Code were enacted.⁶¹

The dissent pointed out that California Civil Code section 1951.2⁶² provides a remedy for a lessor when the lessee breaches the lease by either abandoning the property or by having the right to possession

55. *Id.* (citing *Green v. Superior Court*, 10 Cal. 3d 616, 624, 517 P.2d 1168, 1173, 111 Cal. Rptr. 704, 709 (1974)).

56. *Id.*

57. *Id.*

58. *Id.* at 504, 709 P.2d at 847-48, 220 Cal. Rptr. at 829. "[T]he landlord agreed to dispose of possession for the limited term and he could not reasonably anticipate any more than what was given to him by the terms of the lease." (quoting 4 MILLER & STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 27.93, at 321 (1984 Supp.)).

59. *Kendall*, 40 Cal. 3d at 505, 709 P.2d at 848, 220 Cal. Rptr. at 829.

60. *Id.*

61. *Id.* at 507, 709 P.2d at 849, 220 Cal. Rptr. at 829.

62. CAL. CIV. CODE § 1951.2. Section 1951.2 provides in pertinent part:

(a) Except as otherwise provided in Section 1951.4, if a lessee of real property breaches the lease and abandons the property before the end of the term or if his right to possession is terminated by the lessor because of a breach of the lease, the lease terminates. Upon such termination, the lessor may recover from the lessee:

(1) The worth at the time of award of the unpaid rent which had been earned at the time of termination;

(2) The worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that the lessee proves could have been reasonably avoided;

(3) Subject to subdivision (c), the worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award exceeds the amount of such rental loss that the lessee proves could be reasonably avoided; and

(4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease or which in the ordinary course of things would be likely to result therefrom.

terminated by the lessor before the expiration of the lease.⁶³ A lessor may recover the rents that would have become due had the lease continued until expiration.⁶⁴ From this amount the lessor must subtract the amount recovered or recoverable from reletting the property.⁶⁵ Section 1951.2 requires a lessor either to mitigate damages or accept a lesser recovery.⁶⁶ The burden of proving avoidable loss is born by the lessee who must prove that the lessor could have relet the premises.⁶⁷

Furthermore, the dissent noted that in 1970 the California Legislature enacted section 1951.4 of the Civil Code.⁶⁸ Section 1951.4 allows a lessor to avoid the statutory duty to mitigate damages by contracting

(c) The lessor may recover damages under paragraph (3) of subdivision (a) only if:

(1) The lease provides that the damages he may recover include the worth of the time of award of the amount by which the unpaid rent for the balance of the term after the time of award, or for any shorter period of time specified in the lease, exceeds the amount of such rental loss for the same period that the lessee proves could be reasonably avoided; or

(2) The lessor relet the property prior to the time of award and proves that in reletting the property he acted reasonably and in a good-faith effort to mitigate the damages, but the recovery of damages under this paragraph is subject to any limitations specified in the lease.

(d) Efforts by the lessor to mitigate the damages caused by the lessee's breach of the lease do not waive the lessor's right to recover damages under this section.

Id.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. California Law Revision Commission, *Recommendation Relating to Real Property Leases*, 9 CAL. L. REVISION COMM'N 153, 166 (1969) [Hereinafter cited as *Recommendation*]. For two recent cases interpreting § 1951.2, see *California Safety Center, Inc. v. Jax Car Sales of California, Inc.*, 164 Cal. App. 3d 992, 1000, 211 Cal. Rptr. 39, 44 (1985) (interpreting phrase at the time of the award to mean at the time of judgment pursuant to the § 1951.2 action rather than the time of the prior unlawful detainer judgment); *Sanders Constr. Co. v. San Joaquin First Fed. Sav. & Loan Ass'n*, 136 Cal. App. 3d 387, 401, 186 Cal. Rptr. 218, 227 (1982) (factors to take into account when applying § 1951.2 in an action for breach of contract). See also Comment, *Landlord-Tenant Legislation: Revising an Old Common Law Relationship*, 2 PAC. L.J. 259 (1971).

68. CAL. CIV. CODE § 1951.4. Section 1951.4 provides in pertinent part:

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

(b) Even though a lessee of real property has breached his 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 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:

(1) Sublet the property, assign his interest in the lease, or both.

(2) Sublet the property, assign his interest in the lease, or both, subject to standards or conditions, and the lessor does not require compliance with any unreasonable standard for, nor any unreasonable condition on, such subletting or assignment.

(3) Sublet the property, assign his interest in the lease, or both, with the consent of the lessor, and the lease provides that such consent shall not unreasonably be withheld.

Id.

to shift that duty to the lessee.⁶⁹ Section 1951.4 permits a lessor to continue to collect the rent as it becomes due, irrespective of potential reletting, if the lessor has not terminated the lessee's right of possession.⁷⁰ To take advantage of 1951.4, however, the lease must provide that the lessee may sublease or assign the lease.⁷¹ The right to assign or sublet can either be subject to the lessor's consent or conditioned on expressed standards. The only limitation is that consent not be unreasonably withheld⁷² and that the standards are reasonable.⁷³

The dissent argued that by enacting Civil Code sections 1951.2 and 1951.4, the legislature considered the position of lessors who desire the right to unreasonably withhold consent.⁷⁴ The cost of an absolute right to withhold consent is the loss of the remedy outlined in section 1951.4.⁷⁵ Therefore, a lessor contracting for absolute discretion would have to mitigate damages pursuant to section 1951.2.

The majority admitted that section 1951.4 implicitly recognizes that, absent a reasonableness clause, a lessor might believe a right to arbitrarily withhold consent exists.⁷⁶ Nevertheless, the majority responded that implicit recognition of a common law rule does not codify that rule.⁷⁷ Thus, the majority found that the decision would not frustrate the legislative purpose of Civil Code Sections 1951.2 and 1951.4.⁷⁸

II. LEGAL BACKGROUND

The common law rule permitting a lessor to withhold consent to

69. *Kendall*, 40 Cal. 3d at 510, 709 P.2d at 852, 220 Cal. Rptr. at 833 (Lucas, J., dissenting) (quoting *Kendall v. Ernest Pestana, Inc.*, 163 Cal. App. 3d 11, 17, 209 Cal. Rptr. 135, 138 (1984)); see also, *Recommendation*, *supra* note 67, at 168-69 (1969).

70. CAL. CIV. CODE § 1951.4.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Kendall*, 40 Cal. 3d at 510, 709 P.2d at 852, 220 Cal. Rptr. at 833 (Lucas, J., dissenting) (quoting *Kendall v. Ernst Pestana, Inc.* 163 Cal. App. 3d 11, 17, 209 Cal. Rptr. 135, 138 (1984)). The Court stated:

Thus, the California Legislature has considered the situation of lessors contracting for the right (and then exercising it) of unreasonably withholding consent to an assignment. That it has provided an increased measure of damages (and thus an incentive) to those who forego this right is a clear recognition that this contractual right does exist.

Id.

75. *Id.* See also *Recommendation*, *supra* note 67, at 168-69 (1969).

76. *Kendall*, 40 Cal. 3d at 506, 709 P.2d at 849, 220 Cal. Rptr. at 830. "[S]ection 1951.4 impliedly recognizes that absent a 'reasonableness' clause, a lessor might believe that he or she had a common law right arbitrarily to withhold consent to assignment, and thus frustrate the statutory scheme." *Id.* How this belief frustrates the statutory scheme was not articulated. The loss of a lessor's 1951.4 remedy occasioned by omitting a reasonableness clause would seem to carry forth the intent of the statute.

77. *Kendall*, 40 Cal. 3d at 506, 709 P.2d at 849, 220 Cal. Rptr. at 830.

78. *Id.* at 506-07, 709 P.2d at 848-49, 220 Cal. Rptr. at 830.

transfer leased property developed during the feudal period of English history.⁷⁹ The common law rule first was applied in California in *Richard v. Degen & Brody, Inc.*⁸⁰ *Richard* concerned a lease that provided that any assignment or sublet without written consent of the lessor was voidable by the lessor.⁸¹ The court found that the lessee sublet a portion of the premises without the consent of the lessor.⁸² The lessor brought suit after the new tenant had taken possession and established a business not in conformance with the lease.⁸³ Relying upon the traditional common law view, the court held the lessee had no remedy against the lessor for his refusal to consent.⁸⁴

The *Kendall* court noted that *Richard* has not been cited often in support of the common law rule.⁸⁵ The rule has since been expressly rejected by the same court of appeal that had decided *Richard* more than two decades earlier.⁸⁶ In *Cohen v. Ratnoff*,⁸⁷ the lessee, a seller of carpets and drapes, entered into a lease requiring the written consent of the lessor to any lease or assignment.⁸⁸ The lessee contracted to sell his business and the remainder of his lease to another carpet company.⁸⁹ Following the lessor's refusal to consent to the assignment, the proposed assignee terminated the purchase agreement.⁹⁰ The

79. *Laguna Royale Owners Ass'n v. Darger*, 119 Cal. App. 3d 670, 681, 174 Cal. Rptr. 136, 143 (1981) (condominium association must reasonably exercise power to approve or disapprove transfers, withholding approval only for reasons relating to the protection, preservation and operation of the property). See also Comment, *The Approval Clause in a Lease: Toward a Standard of Reasonableness*, 17 U.S.F.L. Rev. 681 (1983).

80. 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960).

81. *Id.* at 292, 5 Cal. Rptr. at 265.

82. *Id.*

83. *Id.*

84. *Id.* at 299, 5 Cal. Rptr. at 269.

85. *Kendall*, 40 Cal. 3d at 496, 709 P.2d at 842, 220 Cal. Rptr. at 823. The majority noted that *Richard* was neither followed nor cited to support the common law rule until 1981. However, other commentators advised of the authority of *Richard* as law. See M. DEAN, F. NICHOLAS & R. CAPLAN, *COMMERCIAL REAL PROPERTY LEASE PRACTICE* 159 (1976) ("A tenant should insist that the landlord agree not to unreasonably withhold its consent to a proposed assignment, encumbrance, or subletting, and most landlords agree to such a clause. Without such an agreement the landlord can arbitrarily withhold its consent or attach conditions to the granting of its consent, and the tenant is without recourse.") (citing *Richard v. Degen & Brody, Inc.*, 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960)). M. DEAN, F. NICHOLAS & R. CAPLAN, *supra*, § 3110, at 159; MILLER & STARR, *supra* note 58, § 27.92, at 416 ("A landlord is under no duty to give his consent to an assignment or sublease. In absence of a lease provision that his consent will not be unreasonably withheld, the landlord may arbitrarily withhold his consent.") (citing *Richard v. Degen & Brody, Inc.*, 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960)).

86. The Court of Appeal for the Second District decided both *Richard* and *Cohen v. Ratnoff*, 147 Cal. App. 3d 321, 195 Cal. Rptr. 84 (1983).

87. 147 Cal. App. 3d 321, 195 Cal. Rptr. 84 (1983).

88. *Id.* at 324-25, 195 Cal. Rptr. at 85.

89. *Id.* at 325, 195 Cal. Rptr. at 86.

90. *Id.*

court of appeal held that the lessee could recover for breach of contract and bad faith breach of contract for the lessor's wrongful refusal to consent.⁹¹ The *Cohen* court cited the implied duty of good faith and fair dealing as well as the policy against restraints on alienation in support of the holding.⁹² Shortly after *Cohen*, two additional cases adopted the rule formulated in *Cohen*.⁹³

The California Court of Appeal for the Fourth District refused to discard the common law rule in *Hamilton v. Dixon*.⁹⁴ In *Hamilton* a lease was entered into sixteen years earlier when the common law rule allowed the lessor to withhold consent for any or no reason.⁹⁵ The court noted the tacit approval by the legislature of the right to withhold consent arbitrarily in California Civil Code sections 1951.2 and 1951.4.⁹⁶ Therefore, the court viewed the legislation as expressly recognizing the right of lessors to bargain for the ability to withhold consent arbitrarily.⁹⁷ The court concluded that any abrogation of this right should come from the legislature and not the courts.⁹⁸

III. LEGAL RAMIFICATIONS

A few California appellate courts recently adopted a reasonableness requirement concerning assignments.⁹⁹ The California Supreme Court has affirmed these holdings in *Kendall*. The tension between the dual nature of a lease as a conveyance of a leasehold interest and as a

91. *Id.* at 328, 195 Cal. Rptr. at 89.

92. *Id.*

93. *Schweiso v. Williams*, 150 Cal. App. 3d 883, 886, 198 Cal. Rptr. 238, 240 (1984) (lessor's attempt to extract "blood money" from lessee pursuant to approval clause presented triable issue of fact regarding reasonableness of withholding consent); *Prestin v. Mobil Oil Corp.*, 741 F.2d 268, 271 (9th Cir. 1984) (applying California law, triable issue of fact existed whether franchisor unreasonably withheld consent to assignment, thereby breaching implied duty of good faith and fair dealing).

94. 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639 (1985). *Hamilton* involved the plight of elderly widow Thelma Dixon. *Id.* at 1008, 214 Cal. Rptr. at 643. Thelma and her husband, acting as lessors, entered into a 24-year commercial lease for a monthly rental of \$375 for the entire term. This rent plus a \$259 monthly social security payment represented her only income. The lessee would have been required to pay \$53,200 for the remainder of the term. *Id.* The tenant subleased the property without written consent required by the lease. The tenant expected to receive \$331,800 from the subtenant. Thelma terminated the lease in response to the lessee's unconsented sublease. *Id.* at 1006, 214 Cal. Rptr. at 641.

95. "The master lease was signed in 1970 when *Richard* was clearly the law and the provision was indisputably enforceable. The legal mutations which created the new species called implied covenants of good faith and fair dealing were mere spores in the halls of ivy then." *Hamilton*, 168 Cal. App. 3d at 1010, 214 Cal. Rptr. at 642.

96. *Hamilton*, 168 Cal. App. at 1010-11, 214 Cal. Rptr. at 642-43.

97. *Id.*

98. *Id.* at 1011, 214 Cal. Rptr. at 643.

99. See *Schweiso v. Williams*, 150 Cal. App. 3d 883, 886, 198 Cal. Rptr. 238, 240 (1984) (lessor may refuse consent based only on good faith reasonable objection); *Prestin v. Mobil Oil Corp.*, 741 F.2d 268, 271 (9th cir. 1984) (good faith reasonable objection required to refuse

contract has long been recognized in California.¹⁰⁰ The common law, while abhorring restraints on alienation, nonetheless viewed restraints upon transfers of leaseholds as subordinate to the absolute ownership of the lessor.¹⁰¹ Likewise, the covenant of good faith and fair dealing implied in contracts is a well established principle in California law.¹⁰² Nevertheless, the application of these recognized legal principles to assignment clauses in commercial leases poses some uncertainties.

A. *The Standard of Reasonableness*

California law now requires that when consent is necessary to assign a commercial lease, a lessor may not unreasonably withhold consent.¹⁰³ Whether a lessor's refusal to consent was reasonable is a question of fact.¹⁰⁴ Some of the factors the trier of fact may consider in applying the standards of commercial reasonableness are: Financial responsibility of the proposed assignee;¹⁰⁵ suitability of the use for

consent to assignment or sublet); *Cohen v. Ratnoff*, 147 Cal. App. 3d 321, 330, 195 Cal. Rptr. 84, 89 (1983) (good faith reasonable objection required of lessor to refuse consent to assign or sublet); *see also*, *Sade Shoe Co. v. Oschin & Snyder*, 162 Cal. App. 3d 1174, 1179, 209 Cal. Rptr. 124, 126 (1984) (refusal to consent may result in intentional interference with prospective economic advantage); *Laguna Royale Owners Ass'n v. Darger*, 119 Cal. App. 3d 670, 682, 174 Cal. Rptr. 136, 143 (1981) (condominium association must act reasonably in approving or disapproving transfers; *Richard* distinguished); *Richardson v. La Rancherita La Jolla, Inc.*, 98 Cal. App. 3d 73, 82, 159 Cal. Rptr. 285, 290 (1979) (lessor's withholding consent was tortious interference with contract). *But see* *Hamilton v. Dixon*, 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639, 642 (1985) (common law rule valid where lease entered into when *Richard* was clearly enforceable); *Thrifty Oil Co. v. A. Batarse*, 174 Cal. App. 3d 770, 776, 220 Cal. Rptr. 285, 289 (1985) (lessee's failure to request lessor's approval to assignment constituted breach irrespective of status of common law rule).

100. California Civil Code § 1925 recognizes a lease as a contract. "Hiring is a contract by which one gives to another the temporary possession and use of property, other than money for reward, and the latter agrees to return the same to the former at a future time." CAL. CIV. CODE § 1925. The courts have traditionally viewed a lease as both conveyance and contract. *See* *Medico-Dental Bldg. Co. v. Horton & Converse*, 21 Cal. 2d 411, 418, 132 P.2d 457, 462 (1942) ("While it is true that a lease is primarily a conveyance . . . it also presents the aspect of a contract.") *Id.* at 418, 132 P.2d at 462. *See also* *Recommendation*, *supra* note 67, at 158 (1969); Comment, *supra* note 79, at 259.

101. 2 POWELL, POWELL ON REAL PROPERTY § 246(1), at 372.97 (1985).

102. *See* *Universal Sales Corp., Ltd. v. California Press Mfg. Co.*, 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942) ("In every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing."); *California Lettuce Growers v. Union Sugar Co.*, 45 Cal. 2d 474, 484, 289 P.2d 785, 791 (1955) ("[W]here a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing.").

103. *Kendall*, 40 Cal. 3d at 507, 709 P.2d at 849, 220 Cal. Rptr. at 830.

104. *Id.* at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826.

105. *Id.* *See generally* Comment, *supra* note 79, at 697-98.

the particular property;¹⁰⁶ legality of the proposed use;¹⁰⁷ need for alteration of the premises;¹⁰⁸ and the nature of the occupancy.¹⁰⁹ Denying consent solely on the basis of personal taste, convenience, or sensibility is not commercially reasonable.¹¹⁰ In addition, courts will not consider a denial of consent reasonable if the purpose of the denial is to allow the lessor to increase rent.¹¹¹

The extent to which the reasonableness requirement will increase litigation is unknown. Many commercial leases contain reasonableness clauses principally to allow the lessor to elect between the remedies afforded by Civil Code sections 1951.2 and 1951.4.¹¹² Thus, the issue of reasonableness is currently triable when provided for in the lease. Furthermore, even under the common law rule, aggrieved lessees could gain access to the courts under the doctrines of waiver and estoppel.¹¹³ Nevertheless, gray areas exist regarding the reasonableness of lessor justifications for refusal to consent.¹¹⁴ Lessors will predicate their denial of consent to assignment on safe harbors recognized by the court as reasonable objections.¹¹⁵ Tenants will contest these justifications by marshaling evidence of unreasonable intent.¹¹⁶ More

106. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98.

107. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98.

108. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98.

109. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98.

110. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98.

111. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826. *See generally* Comment, *supra* note 79, at 697-98. Many existing leases contain clauses which provide that the lessor recover the overage from a lessee who subleases or assigns the premises for more than the lessee formerly paid as rent. The majority affirmed the principle that parties to commercial leases can contract to allocate appreciated rentals subsequent to a transfer of the leasehold. *Kendall*, 40 Cal. 3d at 505 n.17, 709 P.2d at 848 n.17, 220 Cal. Rptr. at 829 n.17.

112. *See, e.g.,* M. DEAN, F. NICHOLAS & R. CAPLAN, *supra* note 85, at 159; *Recommendation*, *supra* note 67, at 169 (1969).

113. *Kendall*, 40 Cal. 3d at 495, 709 P.2d at 841, 220 Cal. Rptr. at 822. *See* Kern Sunset Oil Co. v. Good Rds. Oil Co., 214 Cal. 435, 6 P.2d 71, 73-4 (1931) (breach of lease waived by lessor's acceptance of oil well royalty payments); *Buchanan v. Banta*, 204 Cal. 73, 76, 266 P. 547, 548 (1928) (lessor's acceptance of rent with full knowledge of transfer and without protest precluded forfeiture or breach of lease); *Randol v. Tatum*, 98 Cal. 390, 397, 33 P. 433, 435 (1893) (lessor's acceptance of rent with knowledge of assignment constituted waiver of consent provision); *Sexton v. Nelson*, 228 Cal. App. 248, 258, 39 Cal. Rptr. 407, 413 (1964) (lessor electing to impose forfeiture for unauthorized assignment must give notice of his intention in the premises); *see also* CAL. CIV. CODE § 1179 (allowing court to relieve tenant from a forfeiture of lease if hardship demonstrated under circumstances).

114. *See generally* Comment, *supra* note 79, at 694-98.

115. *See supra* notes 104-11 and accompanying text.

116. *See id.*

specific guidelines determining what constitutes a commercially reasonable objection awaits refinement by courts applying *Kendall*.

B. Effect on Existing Leases

The most perplexing aspect of *Kendall* concerns the application of Civil Code section 1951.4 to existing leases written without reasonableness provisions. The lease in *Kendall* required the approval of the lessor before assignment. No language in the approval clause limited the discretion of the lessor.¹¹⁷ The court in *Kendall* supplemented the lease with language requiring a commercially reasonable objection in order to withhold consent.¹¹⁸ The question then arises whether lessors of similarly drafted leases will now be afforded the remedy provided in Civil Code section 1951.4. Formerly a consent clause without a reasonableness clause foreclosed the lessor from electing to hold the lessee to the lease since the lease did not meet the requirements of the section.¹¹⁹ *Kendall* arguably makes the 1951.4 remedy available in all commercial leases subject to the implied reasonableness requirement.¹²⁰

The determination of this issue bears significantly upon the rights of lessors and lessees under existing leases. If the lessee is solvent and the lessor does not have the desire, facilities, or ability to either manage the property or acquire a suitable tenant, section 1951.4 becomes an important remedy.¹²¹ Parties to existing leases were not likely to have bargained for or contemplated the provisions of this remedy when applied to leases not containing reasonableness clauses. The dilemma facing courts applying *Kendall* will be to decide whether to deny a lessor section 1951.4 relief although the terms of the lease, as interpreted by the court in *Kendall*, qualify for the remedy.

C. Prospective Effect

After *Kendall*, leases could include a reasonableness clause, expressly

117. Paragraph 13 of the sublease in *Kendall* reads in pertinent part: "Lessee shall not assign this lease . . . or suffer any other person to occupy or use said premises, or any portion thereof, without written consent of lessor first had and obtained . . ." *Kendall*, 40 Cal. 3d at 494 n.5, 709 P.2d at 840 n.5, 220 Cal. Rptr. at 821 n.5.

118. *Kendall*, 40 Cal. 3d at 508, 709 P.2d at 850, 220 Cal. Rptr. at 831 (Lucas, J., dissenting).

119. See *supra* notes 71-73 and accompanying text.

120. CAL. CIV. CODE § 1951.4. Section 1951.4 requires that the lease provide for the remedy. *Id.* The California Supreme Court hinted that an implied-by-law reasonableness requirement will not meet the requirements of the provision as "[t]he lease must expressly state that such consent will not be unreasonably withheld." *Kendall*, 40 Cal. 3d at 506, 709 P.2d at 849, 220 Cal. Rptr. at 830 (emphasis added).

121. See *Recommendation*, *supra* note 67, at 168 (1969). See, e.g., Cockran, *Recovery Based on Future Rent After Lessee's Breach*, 44 L.A. B. BULL. 199, 228-29 (1969).

prohibit all assignment, or covenant for the right to arbitrarily and capriciously withhold consent.¹²² The effect *Kendall* will have on clauses prohibiting any assignment or reserving absolute discretion is uncertain.¹²³ A footnote in *Kendall* pointed out that the issue was not considered by the court because the lease did not provide for an absolute prohibition.¹²⁴ Reference to a reasonableness clause in California Civil Code section 1951.4 evidences the intent of the legislature to provide parties with an election of remedies.¹²⁵ Had no difference been intended between Civil Code sections 1951.2 and 1951.4, the legislature would have made both remedies applicable to all leases without reference to a reasonableness requirement.¹²⁶ If the court were to strike down absolute prohibitions on assignments, or prohibit covenanting for the right of the lessor to withhold consent for any reason, no advantage would exist for leases drafted without reasonableness clauses. Conceivably these leases could be subject to a reasonableness requirement, yet the leases would not be entitled to the California Civil Code section 1951.4 remedy.¹²⁷

D. Recommendation

California Civil Code section 1952.2 renders the provisions of Civil Code sections 1951.2 and 1951.4 inapplicable to any lease executed before July 1, 1971¹²⁸ or later leases the terms of which were fixed before July 1, 1971.¹²⁹ The section applies prospectively to ensure that leases negotiated without knowledge of the Civil Code sections are

122. The lease in *Kendall* was silent concerning any limitations on the lessor's discretion to withhold consent. A question remains if contracting for the right to withhold consent arbitrarily will be allowed. Such a provision could be struck down as an unacceptable restraint on alienation, or as contrary to public policy. A narrow reading of the holding in *Kendall* would not disturb such provisions; however, the tenor of the opinion is hostile to restrictive covenants in commercial lease assignment clauses.

123. An absolute prohibition of assignment might be contemplated by a lessor desiring the continued identification or presence of a particular lessee. Restrictive use provisions may perform a similar function. See generally M. DEAN, F. NICHOLAS & R. CAPLAN, *supra* note 85, §§ 3.58, 3.110, at 104, 108.

124. Footnote 14 reads: "This case does not present the question of the validity of a clause absolutely prohibiting assignment, or granting absolute discretion over assignment to the lessor. We note that under the Restatement rule such a provision would be valid if freely negotiated." *Kendall*, 40 Cal. 3d at 500 n.14, 709 P.2d at 844 n.14, 220 Cal. Rptr. at 825 n.14.

125. *Recommendation, supra* note 67, at 157-69 (1969).

126. *Id.* See *supra* notes 61-75 and accompanying text.

127. See *supra* notes 68-75 and accompanying text.

128. CAL. CIV. CODE § 1952.2. Section 1952.2 reads: "Sections 1951 to 1952, inclusive, do not apply to: (a) Any lease executed before July 1, 1971. (b) Any lease executed on or after July 1, 1971, if the terms of the lease, option, or other agreement executed before July 1, 1971." *Id.*

129. *Id.*

not affected.¹³⁰ The lease at issue in *Kendall* was entered into on January 1, 1970.¹³¹ In *Kendall* no problem is presented by reliance of the parties on the California Civil Code remedy scheme since the lease predates the enactment of the legislation.¹³² Parties to leases entered into after July 1, 1971, however, relied not solely on the common law rule applied in *Richard*, but on the statutory remedies as well. The expectations of these parties should not be displaced by the court's most recent recognition of modern contract principles. Many parties relied upon legislative recognition of these same contract principles embodied in Civil Code sections 1951.2 and 1951.4.¹³³ Therefore, the holding of *Kendall* should be confined to those leases entered into before July 1, 1971. *Kendall* should also be applied prospectively to leases that are silent regarding the discretion of lessors to withhold consent. Application of *Kendall* in such a manner preserves the concept of a meaningful election of remedies intended by the legislature.¹³⁴

CONCLUSION

California now joins a minority of states requiring a commercially reasonable objection as a basis for withholding consent to an assignment of a lease. The underlying reasons for adopting the reasonableness requirement include the interest in the free alienation of property and the implied covenant of good faith and fair dealing. Concern for the protection of lessor's reversionary interest is secured by allowing reasonable objections to a proposed assignee.

The majority in *Kendall*, however, did not adequately consider the statutory remedies provided in California Civil Code sections 1951.2 and 1951.4. The *Kendall* opinion is difficult to reconcile with the distinctions set forth in the Civil Code and with the legislative intent to provide an election of remedies in the event of breach or aban-

130. *Recommendation, supra* note 67, at 163 (1969).

131. *Kendall*, 40 Cal. App. 3d at 493, 709 P.2d at 839, 220 Cal. Rptr. at 820.

132. *Id.*

133. *Recommendation, supra* note 67, at 158 (1969). The Committee Report reads in pertinent part:

Section 1925 of the Civil Code provides that a lease is a contract. Historically, however, a lease of real property has been regarded as a conveyance of an interest in land . . . The California courts state that a lease is both a contract and a conveyance and apply a mixture of contract and property principles to lease cases. This mixture, however, is generally unsatisfactory. . . . [The Act] would provide the lessor with a reasonable choice of remedies comparable to that available to the promisee when the promisor has breached a contract.

Id. at 157-58. See also *supra* note 100 and accompanying text.

134. See *supra* notes 125-26 and accompanying text.

donment. The effect of implying a reasonableness standard into a lease was not discussed by the court. One possible result would be to permit the lessor to elect remedies, a choice formerly unavailable to lessors in the absence of a reasonableness clause in the lease. A more likely result would be to hold the lessor to the remedy outlined in Civil Code section 1951.2.

To avoid this dilemma, the holding of *Kendall* should apply only to those leases entered into before the enactment of the Civil Code provisions. The rule would also operate prospectively to leases which require lessor consent, but do not qualify in any way the discretion of the lessor to withhold consent. The policies contemplated by *Kendall* would be advanced without unsettling the expectations of existing leases or hampering the operation of the California Civil Code remedies.

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