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Kendall v. Ernest Pestana, Inc.: Landlords May Not Unreasonably Withhold Consent to Commercial Lease Assignments

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I. INTRODUCTION

A landlord who recently learned of his tenant's desire to assign the remaining lease term balance on his commercial lease considers his alternatives. Examining the relevant lease provision, the landlord confirms his suspicion that the lease does not require him to consent to any such transfer. The relevant lease provision provides that the "lessee shall not assign or otherwise transfer his interests in the leased premises without consent of Lessor and any transfer without Lessor's consent shall be voidable at Lessor's option." Wanting to obtain the increased market rental rates, the landlord decides to withhold his consent to the assignment until such time as he can obtain the increased prevailing market rental rates.

The tenant, having just sold his business to the proposed assignee, is looking forward to the increased rental payments from the assignee; he then formally discloses to the landlord his interest in assigning the lease. Upon learning of the landlord's desire to keep the increased rent for himself, the tenant informs the proposed assignee who files a suit to force the landlord to consent to the assignment.

The California Supreme Court was recently confronted with precisely this question in *Kendall v. Ernest Pestana, Inc.*[1] The issue before the court was whether a lessor may arbitrarily refuse to consent to a lease transfer proposed by the tenant. The appellate court held for the landlord.[2] However, other appellate court decisions were in conflict with this result.[3]

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

2. Kendall v. Ernest Pestana, Inc., 163 Cal. App. 3d 11, 209 Cal. Rptr. 135 (1984), *vacated*, 40 Cal. 3d 488, 709 P.2d 837, 220 Cal. Rptr. 818 (1985).

3. *See, e.g.*, Schweiso v. Williams, 150 Cal. App. 3d 883, 198 Cal. Rptr. 238 (1984); Cohen v. Ratinoff, 147 Cal. App. 3d 321, 195 Cal. Rptr. 84 (1983). Both *Schweiso* and *Cohen* were decided in favor of the lessee. *See infra* notes 30-36 and accompanying text.

II. GENERAL BACKGROUND OF ASSIGNMENTS AND ALIENABILITY

California conforms to the general principle that property of any kind is freely alienable;[4] similarly, a leasehold interest is freely transferable.[5] A lessee has an absolute right to assign[6] or sublet[7] the premises absent a contrary provision in the lease prohibiting or restricting such a transfer.[8] Restrictions prohibiting assignments or subletting are valid exertions of a lessor's authority.[9] Such constraints are justified as "reasonable protection of the interest of the lessor";[10] in addition, they give "to the lessor a needed control over the person entrusted with the lessor's property and to whom he must look for the performance of the covenants contained in the lease."[11]

Limitations on the freedom of alienation are "strictly construed and interpreted against the party for whose benefit they are created . . . ."[12] "[C]ovenants limiting the free alienation of property . . . are barely tolerated and must be strictly construed."[13] Further, when forfeiture is foreseeable, restrictive clauses must be narrowly construed to limit restraints on alienation.[14]

A. Legal Historical Background

California courts, apparently for the first time, examined consent as a prerequisite for assignments in *Kendis v. Cohn*.[15] The lease provision stated that the lessee "may, with written consent of said lessors, assign said lease to any person or persons of good character and

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4. "Property of any kind may be transferred . . . ." CAL. CIV. CODE § 1044 (West 1982).

5. Kassan v. Stout, 9 Cal. 3d 39, 43, 507 P.2d 87, 89, 106 Cal. Rptr. 783, 785 (1973); H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE, *Landlord and Tenant* § 27:92, at 415-19 (1977) [hereinafter MILLER & STARR]; R. JOHNSON & M. MOSKOBITZ, CALIFORNIA REAL ESTATE LAW AND PRACTICE, *Assignments and Subletting* §§ 172.01-172.64 [hereinafter JOHNSON & MOSKOBITZ]; 42 CAL. JUR. 3D *Landlord and Tenant* § 184 (1978).

6. Morris v. Iden, 23 Cal. App. 388, 395, 138 P. 120, 123 (1913).

7. Chandler v. Hart, 161 Cal. 405, 415, 119 P. 516, 520 (1911).

8. M. Friedman & Co. v. Sterling Furniture Co., 140 Cal. App. 685, 688, 35 P.2d 1064, 1065 (1934).

9. Boston Properties v. Pirelli Tire Corp., 134 Cal. App. 3d 985, 185 Cal. Rptr. 56 (1982); Crowell v. City of Riverside, 26 Cal. App. 2d 566, 572, 80 P.2d 120, 122-23 (1938).

10. R. SCHOSHINSKI, AMERICAN LAW OF LANDLORD AND TENANT, *Transfer of Leasehold* § 8:15, at 579 (1980).

11. 2 POWELL ON REAL PROPERTY, *Estate for Years* § 246[1] at 372.97 (1949 & Supp. 1985).

12. JOHNSON & MOSKOBITZ, *supra* note 5 at § 172.10. *See also* R. SCHOSHINSKI, *supra* note 10, at 583-88; 2 POWELL ON REAL PROPERTY, *supra* note 11, § 246[1], at 372.97.

13. Chapman v. Great W. Gypsum Co., 216 Cal. 420, 426, 14 P.2d 758, 760 (1932). The *Chapman* holding was reaffirmed and quoted in *Kendall*, 40 Cal. 3d at 494, 709 P.2d at 840, 220 Cal. Rptr. at 821.

14. "A condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created." CAL. CIV. CODE § 1442 (West Supp. 1986).

15. 90 Cal. App. 41, 265 P. 844 (1928).

repute and satisfactory to the lessors . . . ."[16] The court concluded that where the assignment is contingent upon the assignee being a person of "good character and repute and *satisfactory to the lessors*," lessors are "the sole judge[s] of . . . [their] own satisfaction, subject only to the limitations that [they] must act in good faith."[17] It has been suggested that the *Kendis* opinion stands for the proposition that a lessor

> might be totally unreasonable in finding a prospective assignee unsatisfactory. Yet, if genuinely satisfied with the assignee, the [lessor] could not withhold his consent in order to obtain additional benefits for himself. Such an act would amount to bad faith and would relieve the lessee of the restrictions on his right to assign the lease.[18]

Permitting an unreasonable withholding of consent was reviewed and expanded upon in *Richard v. Degen & Brody, Inc.*[19] In that case, the court held that " 'where a subletting or assignment of the leased premises without the consent of the lessor is prohibited, he may withhold his assent arbitrarily and without regard to the qualifications of the proposed assignee . . . .' "[20] While this is the majority rule, it has come under scrutiny in recent years for its harsh consequences.[21] In California, courts have consistently and liberally provided exceptions to the harsh consequences of the lessor having such an absolute power over the lessee.[22]

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16. *Id.* at 64, 265 P. at 853.

17. *Id.* at 66, 265 P. at 854.

18. Kehr, *Lease Assignments: The Landlord's Consent*, 55 CAL. ST. B.J. 108, 111 (1980) (interpreting the holding of *Kendis*, 90 Cal. App. at 67-68, 265 P. at 854).

19. 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960).

20. *Id.* at 299, 5 Cal. Rptr. at 269 (quoting 51 C.J.S. *Landlord and Tenant* § 36 (1968)).

21. *See, e.g., Kendall*, 40 Cal. 3d at 496, 709 P.2d at 841, 220 Cal. Rptr. at 822.

22. *In re* Huntington Ltd., 654 F.2d 578, 584 (9th Cir. 1981) (anti-assignment provisions are unenforceable against trustee in bankruptcy); Trubowitch v. Riverbank Canning Co., 30 Cal. 2d 335, 342-43, 182 P.2d 182, 187, (1947) (assignee as a tenant with knowledge of the assignment held a waiver); Chapman v. Great W. Gypsum Co., 216 Cal. 420, 426-27, 14 P.2d 758, 760 (1932) (mortgage secured by the lease is not within the assignment clause); Karbelnig v. Brothwell, 244 Cal. App. 2d 333, 341, 53 Cal. Rptr. 335, 340 (1966) (accepting rent with a reservation of rights is not a waiver); Sexton v. Nelson, 228 Cal. App. 2d 248, 258, 39 Cal. Rptr. 407, 413 (1964) (lessee's transfer of lease to corporation wholly owned by lessee does not violate a non-assignment clause); Hoops v. Tate, 104 Cal. App. 2d 486, 487, 231 P.2d 560, 561 (1951) (assignment by one co-tenant to another — husband and wife — exempt from assignment restrictions); Ser-Bye Corp. v. C. P. & G. Markets, 78 Cal. App. 2d 915, 920, 179 P.2d 342, 345 (1947) (a corporate lessee's stock may be transferred to avoid assignment prohibitions); Burns v. McGraw, 75 Cal. App. 2d 481, 484-85, 171 P.2d 148, 152 (1946) (bequeath of leasehold interest not within anti-assignment provision); Joost v. Castel, 33 Cal. App. 2d 138, 141, 91 P.2d 172, 174 (1939) (covenant against assignment does not bind executors); M. Friedman & Co. v. Sterling Furniture Co., 140 Cal. App. 685, 687-88, 35 P.2d 1064, 1065

In *Richardson v. La Rancherita La Jolla, Inc.*,[23] the court examined a corporation's transfer of shares as an attempt to circumvent the nonassignment covenant contained in the lease. While not explicitly requiring a lessor to act reasonably in withholding or giving consent, the court apparently assumed that consent may not be unreasonably denied. The court reasoned that the assignment "was only incidental to [the lessors'] predominant motive for terminating the existing lease to obtain a new lease upon more favorable terms . . . . [The lessors] restricted the negotiations to increasing their financial return and not to preserve their interest as lessor."[24] The court further noted that the lessors had made no inquiry into the financial condition of the successor and presented no evidence that they believed their leasehold interest was threatened by the new owners.[25]

An appellate court evaluating the assignment of an interest in a condominium complex[26] concluded that the Homeowners Association, "in exercising its power to approve or disapprove transfers or assignments [1] . . . must act reasonably, exercising its power in a fair and nondiscriminatory manner . . . ."[27] The lease provision required the lessor's consent prior to any assignment or sublease and did not state consent would not be unreasonably withheld.[28] However, the court stated that the association may "withhold approval only for a reason or reasons rationally related to the protection, preservation and proper operation of the property and the purpose of [the] Associ-

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(1934) (where subletting not expressly prohibited in lease, lessee may sublet); Rutledge v. Barger, 82 Cal. App. 356, 359, 255 P. 537, 538 (1927) (accepting rent from assignee held to be a waiver); Safeway Stores, Inc. v. Buhlinger, 85 Cal. App. 717, 719-20, 258 P. 1013, 1013-14 (1927) (assignment from one partner to another held not to violate covenant against assignment).

23. 98 Cal. App. 3d 73, 159 Cal. Rptr. 285 (1979).

24. *Id.* at 82, 159 Cal. Rptr. at 290.

25. *Id.*

26. Laguna Royale Owners Ass'n v. Darger, 119 Cal. App. 3d 670, 174 Cal. Rptr. 136 (1981).

27. *Id.* at 680, 174 Cal. Rptr. at 142.

28. The lease provision prohibiting assignments reads as follows:

> Subassignee shall not assign or otherwise transfer this agreement, or any right or interest herein, or in or to any of the buildings and improvements on the leased premises nor shall subassignee sublet said premises or any part thereof without the consent or approval of Lessee, and no assignment or transfer, whether voluntary or involuntary, by operation of law, under legal process or proceedings, by assignment for benefit of creditors, by receivership, in bankruptcy, or otherwise, and no such subletting shall be valid or effective without such consent and approval. Should Lessee consent to any such assignment, transfer or subletting, none of the restrictions of this article shall be thereby waived and the same shall apply to each successive encumbrance, assignment, transfer or subletting hereunder and shall be severely binding upon each and every assignee, transferee, subtenant and other successor in interest of subassignee.

Id. at 674 n.2, 174 Cal. Rptr. at 138 n.2.

ation as set forth in its governing instruments."[29]

In *Cohen v. Ratinoff*,[30] the court of appeals considered whether a lessor may arbitrarily withhold consent to an assignment. The court held that

> where . . . the lease provides for an assignment or subletting only with the prior consent of the lessor, a lessor may refuse consent only where he has a good faith reasonable objection to the assignment or sublease, even in the absence of a provision prohibiting the unreasonable or arbitrary withholding of consent to an assignment of a commercial lease.[31]

The court, in rejecting the holding of *Richard v. Degen & Brody, Inc.*,[32] sided with the growing minority of jurisdictions.[33] The court also stated "[e]xamples of bases for such good faith reasonable objection would be inability to fulfill terms of the lease, financial irresponsibility or instability, suitability of premises for intended use, or intended unlawful or undersirable use of premises."[34]

In *Schweiso v. Williams*,[35] the court adopted the holding of *Cohen*. Expanding upon the elements of good faith, the *Schweiso* court held "that denying consent solely on the basis of personal taste, convenience or sensibility or in order that the landlord may charge a higher rent than originally contracted for [are] arbitrary reasons [for withholding consent, and thus fails] the test of good faith and reasonableness under commercial leases."[36]

In *Prestin v. Mobil Oil Corp.*,[37] the Ninth Circuit Court of Appeals, applied California law and rejected *Richard v. Degen & Brody, Inc.* as having "no support in later California cases."[38] The court then concluded "that the California Supreme Court would adopt the rule recently enunciated in *Cohen v. Ratinoff*, . . . that a lessor . . . may refuse consent to an assignment or sublease only when the lessor has a good faith reasonable objection to it."[39]

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29 *Id.* at 680, 174 Cal. Rptr. at 142.

30. 147 Cal. App. 3d 321, 195 Cal. Rptr. 84 (1983).

31. *Id.* at 330, 195 Cal. Rptr. at 89.

32. 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960).

33. *See Kendall*, 40 Cal. 3d at 496 and n.9, 709 P.2d at 841 and n.9, 220 Cal. Rptr. at 822 and n.9, for other jurisdictions holding minority view. *See also* R. SCHOSHINSKI, *supra* note 10, § 8:15, at 850-51 n.95.

34. *Cohen*, 147 Cal. App. 3d at 330, 195 Cal. Rptr. at 89.

35. 150 Cal. App. 3d 883, 198 Cal. Rptr. 238 (1984).

36. *Id.* at 886, 198 Cal. Rptr. at 240 (footnote omitted).

37. 741 F.2d 268 (9th Cir. 1984).

38. *Id.* at 271. This case was decided prior to Hamilton v. Dixon, 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639 (1985), where the court followed the *Degen & Brody* holding.

39. *Prestin*, 741 F.2d at 271.

The court in *Hamilton v. Dixon*,[40] on the other hand, refused to follow previous appeals court cases. The court eloquently stated its reasoning that

> [i]n most cases we see little reason for courts to interfere with the freedom of landlords and tenants to negotiate the terms of commercial leases. But here, there is an even more compelling reason *not* to meddle: 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.[41]

Dixon, the lessor, entered into a long term commercial lease with Hamilton, the lessee, wherein Hamilton agreed not to sublet without written consent from Dixon. With Dixon's consent, Hamilton sublet his leasehold interest to Wolfe for the balance of the master lease term. Subsequently, Wolfe sold his interest in the premises to Park, whereupon Hamilton and Park negotiated a new sublease. Hamilton neglected to obtain Dixon's written consent to sublease.[42] The court maintained that the holding of *Richard v. Degen & Brody, Inc.* was valid law or, in the alternative, that the holdings of *Cohen* and *Schweiso* were to be applied prospectively and not retroactively to a fifteen year old lease.[43]

III. COMMERCIAL LEASES: A DEVICE TO ACQUIRE AN INTEREST IN REAL PROPERTY

Of available options, leases[44] are considered the preferable method to secure a location to conduct business. Ownership of commercial property is either too costly for the smaller entrepreneur[45] or unwise for publicly held corporations due to accounting concerns.[46] The majority of businesses simply believe they can realize a greater return

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40. 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639 (1985).

41. *Id.* at 1009, 214 Cal. Rptr. at 642 (emphasis in original).

42. *Id.* at 1007, 214 Cal. Rptr. at 640.

43. *Id.* at 1009, 214 Cal. Rptr. at 642.

44. Leasing has its roots in Phoenician civilization which was located in the western coast region of the Mediterranean Sea. At approximately 1400 B.C., merchants leased ships to exploit their opportunities. R. PRITCHARD & T. HINDELANG, THE LEASE BUY DECISION, 1-3 (1980).

45. Several factors go into the leasing decision. One fundamental factor is a shortage of funds where there is virtually no choice: either the needed space is leased or the organization does without. While this may be a determining factor in the leasing analysis, other factors include the following: 1) the lessee's potential savings from reduced payments and inability to take advantage of tax benefits of ownership; 2) an alternative source of capital; and 3) a conservation of existing credit. For a detailed explanation of these and other factors, see R. PRITCHARD & T. HINDELANG *supra* note 44, at 3-7.

46. Corporations, according to generally accepted accounting principles, are required to record the cost of assets in their accounting records. As the real property increases in value, the total assets on the corporate books remain the same; hence, they are undervalued. Publicly held corporations are vulnerable because individuals or other corporations are often able to purchase the company's stock for much less

on their investment by utilizing the funds in business operations rather than investing funds in real property.[47]

Renting is generally a short term arrangement when the rate of utilization is insufficient to warrant purchasing.[48] For example, if an item is needed only for a short duration, the capital outlay will generally not warrant its purchase. Thus, renting may be a viable alternative.[49] Renting, having a short term connotation, however, is contrary to underlying business philosophies, making such an alternative unacceptable; a basic business principle is that a commercial

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than the market value of the company's assets. When this occurs, the company is closed and the assets are sold individually at a profit.

Closely held corporations, while not subject to this possibility of acquisition, are nevertheless wise to hold all their real property outside of the corporation. The primary advantage is the tax savings that are available in the event that the property is sold. If the property were held inside the corporation, and the corporation was sold, the shareholders would only be able to acquire the proceeds from the sale of the property as dividends which are taxed as ordinary income. However, if the shareholder were to hold the property as a partnership or individually and lease it to the corporation, then the proceeds are long term capital gains which are subject to a reduced tax rate.

47. Actual cash outlay is only one factor to be considered when evaluating the desirability of property acquisition. Opportunity costs, what the capital could earn invested elsewhere, must also be considered. Thus, the required capital expenditure for purchasing may be offset by the increased earnings at a higher yield if invested in the business. If a firm is earning an adequate rate of return on its investments (for example, if 25 percent annual rate of return is assumed) the capital freed by leasing would potentially earn 25 percent per year for the company. C. BAKER & R. HAYES, LEASE FINANCING, A PRACTICAL GUIDE, 13 (1981).

> For example, for a piece of equipment worth $10,000.00 the down payment would generally be 15 and 25 percent ($1,500 to $2,500). The lease deposit would be 10 month lease payments (first month plus one month for each year of the life of the contract). This would be $1322 if the equipment was worth $10,000 and there was an implicit interest rate of 10 percent per annum. All other things being equal, there would be $2,000 in down payment to purchase and $1322 to lease. This means that the company has $678 available in capital for reinvestment. If the capital return is 25 percent per year, the company could make $1759 more by leasing instead of purchasing (assuming that the initial $678 was reinvested, with the interest, each year for ten years).

Id at 13. *See also* R. PRITCHARD & T. HINDELANG, *supra* note 44, at 89.

48. C. BAKER & R. HAYES, *supra* note 47, at 8.

49. [C]onsider a large wheelbarrow costing about $125 and having a useful economic life of 5 years. Such wheelbarrows may be rented for about $4.00 per day. From the viewpoint of the renter, who may need the wheelbarrow for only two or three days a year, purchasing would represent an unwarranted expense. In addition, the wheelbarrow would have to be stored, resulting in the loss of valuable storage space. From the viewpoint of the owner of the wheelbarrow, renting may be very profitable. If, for example, the wheelbarrow were rented only one day in five, the owner would gross 365 divided by 5 X $4 = $292 per year. Over the five year life, the owner would gross $1,460 on an investment of $125.

R. PRITCHARD & T. HINDELANG, *supra* note 44, at 8.

venture must be established and maintained as an ongoing concern.[50] Moreover, businesses are often required to make substantial modifications to the existing structures, such as erecting offices and installing machinery and equipment, at substantial expense. Consequently, a month—to—month tenancy created by renting fails to afford necessary protection from such reoccurring expenditures.

Leasing best suits the needs of businesses since leasing affords a means to secure long term location commitments, avoid relocation costs, yield a determinable lease rent, and predict expenditures which aid planning. Additionally, by leasing rather than purchasing, the lessee obtains the greatest possible leverage.[51]

IV. FACTUAL BACKGROUND OF THE CASE

Assignee, Jack Kendall, Grady O'Hara and Vicki O'Hara, plaintiffs and appellants, sought a declaratory judgment against the lessor, Ernest Pestana, Inc., on the basis that the refusal of the lessor to consent to the assignment of the lease was unreasonable and constituted an unlawful restraint on alienation.[52] After the trial court sustained a demurrer to the complaint, plaintiffs appealed.

The City of San Jose, the property owner, leased hangar space at the San Jose Municipal Airport to Irving and Janice Perlitch, who subsequently assigned their interest to Ernest Pestana, Inc.[53] However, prior to Ernest Pestana, Inc. acquiring the leasehold interest, the Perlitches had sublet the property to Robert Bixler for a 25 year period,[54] commencing January 1, 1970, for the purpose of conducting an airplane maintenance business.[55]

In 1981, the plaintiffs agreed to purchase the business from Bixler. The assets consisted of equipment, inventory, improvements on the property, and the existing lease. The plaintiffs had a stronger financial statement and greater net worth than Bixler, and were willing to be bound by the terms of the leases.[56]

Bixler's lease required the lessor's written consent prior to any as-

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50. The concept of "asset" makes sense only when there is an ongoing concern. Assets are defined as "the probable future economic benefits obtained or controlled by an entity as a result of past transactions or events." J. WILLIAMS, K. STANGA, & W. HOLDER, INTERMEDIATE ACCOUNTING 42 (1984).

51. *See* N. HECHT, LONG TERM LEASE PLANNING AND DRAFTING 31 (1974).

52. *Kendall*, 40 Cal. 3d at 494, 709 P.2d at 840, 220 Cal. Rptr. at 821 (quoting Plaintiff's complaint) (footnote omitted).

53. For clarity, the lease by the City of San Jose which was eventually assigned to Ernest Pestana, will hereinafter be referred to as the master lease.

54. The sublease was for one five year period with four five year options to renew. The sublease provided for an escalation of the lease payments as the payments on the master lease were increased every ten years. *Kendall*, 40 Cal. 3d at 493, 709 P.2d at 839, 220 Cal. Rptr. at 820.

55. *Id.*

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

signment; failure to obtain consent would render the lease voidable at the option of lessor.[57] Bixler complied with the provision by requesting consent from Ernest Pestana, the successor in interest to the master lease. Ernest Pestana denied consent to the assignment, maintaining that he had an absolute right to refuse any such request.[58] Ernest Pestana imposed several conditions to consenting to the assignment, including increased rents.[59]

V. THE MAJORITY OPINION

The issue presented was whether a lessor of commercial property may unreasonably or arbitrarily withhold his consent to an assignment of the lease in the absence of a lease provision that such consent would not be unreasonably withheld.[60] In an opinion written by Justice Broussard the court specifically addressed assignments, although the holding applies equally to subleases.[61]

In a case of first impression, Justice Broussard concentrated on the dual makeup of a lease as both a conveyance of an interest in real property and as a contract.[62] The court adopted the growing minority rule that a lessor may not refuse consent to an assignment or sublease unless the objection is based on good faith and the lessor has valid commercial justifications for his actions.[63]

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57. The sublease between the Perlitches and Bixler provides the following:

> Lessee shall not assign this lease, or any interest therein, and shall not sublet the said premises or any part thereof, or any right or privilege appurtenant thereto, or suffer any other person (the agents and servants of Lessee excepted) to occupy or use said premises, or any portion thereof, without written consent of Lessor first had and obtained, and a consent to one assignment, subletting, occupation or use by any other person, shall not be deemed to be a consent to any subsequent assignment, subletting, occupation or use by another person. Any such assignment or subletting without this consent shall be void, and shall, at the option of Lessor, terminate this lease. This lease shall not, nor shall any interest therein, be assignable, as to the interest of lessee, by operation of alaw [*sic*], without the written consent of Lessor.

Id. at 494 n.5, 709 P.2d at 840 n.5, 220 Cal. Rptr. at 821 n.5.

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

59. *Id.* (quoting respondent's complaint).

60. *Id.* at 498, 709 P.2d at 843, 220 Cal. Rptr. at 824.

61. *Id.* at 492, 709 P.2d at 839, 220 Cal. Rptr. at 820. The *Kendall* court did not expand its decision to residential leases. However, some courts have been willing to apply the minority rule to residential leases. *See, e.g.*, Schweiso v. Williams, 150 Cal. App. 3d 833, 886 n.3, 198 Cal. Rptr. 238, 240 n.3 (1984).

62. *Kendall*, 40 Cal. 3d at 498, 709 P.2d at 843, 220 Cal. Rptr. at 824.

63. *Id.* at 496, 709 P.2d at 841, 220 Cal. Rptr. at 822.

A. *Policy Against Restraints on Alienation*

The court, recognizing the long standing tradition that property should be easily transferable, noted that a leasehold interest in property is no exception to the rule against restraints or alienation.[64] In discussing the lessor's reversionary interest in the property, the court construed his concern in the leased premises as being primarily focused upon the income derived from the demised premises; who may be in possession or manage the premises is only relevant to the extent it affects income.[65] Thus, contractual restrictions are permitted to the extent they protect the lessor's reversionary interest.[66]

The court noted that the majority of jurisdictions, including California, permit the lessor's withholding of consent to an assignment irrespective of how arbitrary or unreasonable the action may be under the circumstances.[67] The court recognized that Civil Code section 711[68] prevents only unreasonable restraints on alienation. The test enunciated in *Wellenkamp v. Bank of America*[69] which required a comparison of the justification for the restraint against the amount of restraint, was applied by the *Kendall* court to evaluate the lease provision.[70] The court noted that " 'the greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for the enforcement.' "[71]

Utilizing the *Wellenkamp* test, the *Kendall* court acknowledged the validity of the lessor's interest in evaluating the assignee's ability to perform under the lease as being justified so as not to create a con-

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

65. *Id.* at 494, 709 P.2d at 841, 220 Cal. Rptr. at 822 (quoting R. SCHOSHINSKI, *supra*, note 10).

66. While restraints on alienation are permitted, they are strictly interpreted; this is true especially where there is a forfeiture of an interest. *Kendall*, 40 Cal. 3d at 495-96, 709 P.2d at 840-41, 220 Cal. Rptr. at 821-22. *See also* CAL. CIV. CODE § 1442 (West 1982) (forfeiture provisions *must* be strictly construed).

67. California courts have readily applied various legal doctrines to avoid the strict implementation of the arbitrary or unreasonable decisions of the lessor. *See, e.g.*, Trubowitch v. Riverbank Canning Co., 30 Cal. 2d 335, 342-43, 182 P.2d 182, 187 (1947) (applying waiver where the lessor voluntarily deals with the assignee with knowledge of the assignment); Buchanan v. Banta, 204 Cal. 73, 77-78, 226 P. 547, 548 (1928) (applying the doctrine of waiver where the landlord accepted payments from the assignee); Karbelnig v. Brothwell, 244 Cal. App. 2d 333, 341, 53 Cal. Rptr. 335, 340 (1966) (applying estoppel to forfeiture provision where the landlord accepts rent from the assignee); Group Property, Inc. v. Bruce, 113 Cal. App. 2d 549, 556-57, 248 P.2d 761, 765-66 (1952) (applying waiver where the lessor had knowledge of the lessee's breach for several months, yet continued to accept rent); Bedford Investments Co. v. Folb, 79 Cal. App. 2d 363, 366, 180 P.2d 361, 363 (1947) (applying waiver of forfeiture provision where the landlord accepts payments with knowledge of the assignment).

68. In its entirety, this section reads: "[c]onditions restraining alienation, where repugnant to the interest created, are void." CAL. CIV. CODE § 711 (West 1982).

69. 21 Cal. 2d 943, 948, 592 P.2d 970, 973, 148 Cal. Rptr. 379, 382 (1978).

70. *Kendall*, 40 Cal. 3d at 498-99, 709 P.2d at 843, 220 Cal. Rptr. at 824.

71. *Id.*, 709 P.2d at 843, 220 Cal. Rptr. at 824 (quoting *Wellenkamp*, 21 Cal. 3d at 949, 709 P.2d at 973, 148 Cal. Rptr. at 382).

dition which is repugnant to the interest created in the lease. The court concluded that the lessor's interests are protected since there are valid reasonable rationales for the lessor refusing consent. The court, however, added a cautionary note that " *'if such an assignment provision is implemented in such a manner that its underlying purpose is perverted by the arbitrary or unreasonable withholding of consent, an unreasonable restraint on alienation is established.'* "[72]

B. The Contract Nature of a Lease

In essence, a lease is nothing more than a contract to temporarily transfer the right of possession to real property. Consequently, in addition to the restraints on alienation which limit the lessor's ability to prevent assignments, implied covenants attached to contracts similarly diminish the lessor's ability to prevent assignments. A significant implied covenant is the duty of good faith and fair dealing. The court noted "the increased recognition of and emphasis on the duty of good faith and fair dealing inherent in every contract."[73] The court reasoned that where "the lessor retains the discretionary power to approve or disapprove an assignee proposed by the other party to the contract; this discretionary power should therefore be exercised in accordance with commercially reasonable standards."[74] Under this approach, whether the lessor's refusal to consent was reasonable under the circumstances is a factual question.[75]

According to the minority rule adopted by this court, factors which the lessor may consider include the following: "financial responsibility of the proposed assignee; suitability of the use for the particular property; legality of the proposed use; need for alteration of the premises; and nature of the occupancy . . . ."[76] Where the lessor withholds consent to an assignment based upon legitimate commercial reasons, the court will uphold his decision.[77] Thus, the court, in

72. *Kendall*, 40 Cal. 3d at 499, 709 P.2d at 843, 220 Cal. Rptr. at 824 (quoting Cohen v. Ratinoff, 147 Cal. App. 3d 321, 329, 195 Cal. Rptr. 84, 88 (1983)) (italics in *Kendall*).

73. *Kendall*, 40 Cal. 3d at 500, 709 P.2d at 844, 220 Cal. Rptr. at 825 (quoting Cohen v. Ratinoff, 147 Cal. App. 2d 321, 329, 195 Cal. Rptr. 84, 88 (1983)).

74. *Kendall*, 40 Cal. 3d at 500, 709 P.2d at 845, 220 Cal. Rptr. at 826.

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

76. *Id.* Other factors may include the following: "the credit rating of the new tenant; the similarity of the proposed use to the previous use; the nature or character of the new tenant — the use may be similar, but the quality of the tenant quite different; the requirements of the new tenant for services furnished by the lessor; the impact of the new tenant on common facilities." CAL. CIV. CODE § 1951.4 (West 1985) (Law Revision Commission Comment (1970)).

77. For example, other jurisdictions adopting the minority position have held the

effect, creates a presumption that the leasehold interest is transferable, thereby requiring the lessor to justify his action.

Factors which will not justify withholding of consent include personal taste, convenience, sensibility, and a desire to increase the rent.[78] Attempting to gain terms which are more advantageous than originally bargained for "has nothing to do with the permissible purposes of the restraint on alienation — to protect the lessor's interest in preservation of the property and performance of the lease covenants."[79] The court generally will not allow the lessor to gain any economic benefit from refusing to consent to an assignment unless the benefit was within the scope of the original contract.[80]

C. Abolishing the Majority Rule

According to the court, three reasons are used to justify the majority rule,[81] none of which was found to override the policy considerations of the minority rule.[82] The court first addressed the long standing contention that since the lessor selected the tenant, he is not compelled to accept rental payments from anyone other than the original lessee.[83] However, the court explained that California has eroded this traditional principle by adopting the rule that lessors have a duty to mitigate their damages;[84] therefore, the lessor is required to make a good faith attempt to obtain a substitute lessee. Additionally, the court noted, as a means to preserve the lessor's legitimate interest in the property, he may still refuse consent to any proposed assignee where the refusal can be supported by reasonable commercial principles.[85]

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following to be reasonable: lessor's objective to have only one "lead tenant" to preserve the tenant mix of the buildings as the tenant's international headquarters was reasonable (Arrington v. Walter E. Heller Int'l Corp., 30 Ill. App. 3d 631, 333 N.E.2d 50 (1975)); lessor's refusal to consent where lessor reasonably believed the proposed business would fail (List v. Dahnke, 638 P.2d 824 (Colo. Ct. App. 1981)); and lessor's wish to obtain a favorable tenant mix in a commercial shopping center was also upheld (Warmack v. Merchants Nat'l Bank of Fort Smith, 272 Ark. App. 166, 612 S.W.2d 733 (1981)).

78. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826.

79. *Id. See also supra* notes 34-35 and accompanying text.

80. See *infra* notes 153-160 and accompanying text regarding the possible provisions which may be contracted for in advance of the assignment.

81. The majority rule holds that consent may be unreasonably or arbitrarily withheld absent a lease provision to the contrary. *See* Richard v. Degen & Brody, Inc., 181 Cal. App. 2d at 289, 299, 5 Cal. Rptr. 263, 269 (1960).

82. *Kendall*, 40 Cal. 3d at 501, 709 P.2d at 845, 220 Cal. Rptr. at 826.

83. *Id.* at 501-02, 709 P.2d at 845-46, 220 Cal. Rptr. at 826-27.

84. While at common law the lessor need look only to the lessee for payment, California law requires the lessor to seek a new tenant to reduce damages. CAL. CIV. CODE § 1951.2 (West 1985).

85. *Kendall*, 40 Cal. 3d at 502, 709 P.2d at 846, 220 Cal. Rptr. at 827. Although not emphasized by the court, the lessor's interests are also protected since the original tenant remains liable under the lease, irrespective of the assignment. Peiser v. Mettler, 50

Next, the court examined the proposition that the contract's language unequivocally grants the lessor the power to arbitrarily or unreasonably withhold consent. Simply stated, the lease provision should be interpreted by its plain meaning,[86] and the courts should not rewrite the contract for the parties.[87] Moreover, the lessee could have negotiated for consent not to be unreasonably withheld.

In adopting the minority view,[88] the court concluded that "the assertion that an approval clause 'clearly and unambiguously' grants the lessor absolute discretion over assignments is untenable."[89] Especially considering the contract nature of the lease and the corresponding duty of good faith and fair dealing implicit in every contract, recognition of such principles does not constitute a rewriting of the contract.[90]

The third argument supporting the majority position was that the court should apply long standing case law following the majority rule, since leases were created in reliance on that position. Further, adopting the minority position would unjustly deprive the parties of benefits previously negotiated.[91]

The *Kendall* court rejected this argument, emphasizing the fact that the California Supreme Court has never adopted the majority rule;[92] therefore, it is subject to review by this court.[93] The growing trend supporting the adoption of the minority rule which has its basis in the well recognized implied covenant of good faith and fair deal-

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Cal. 2d 594, 602, 328 P.2d 953, 957 (1958); Samuels v. Ottinger, 169 Cal. 209, 212, 146 P. 638, 639 (1915). Theoretically, this would tend to reduce the potential danger to the lessor should an assignee default on the lease.

86. *See, e.g.*, Argonaut Ins. Co. v. Transport Indem. Co., 6 Cal. 3d 496, 502, 492 P.2d 673, 680, 99 Cal. Rptr. 617, 620 (1972); Tahoe Nat'l Bank v. Phillips, 4 Cal. 3d 11, 20, 480 P.2d 320, 327, 92 Cal. Rptr. 704, 711 (1971); Delta Dynamics, Inc. v. Arioto, 69 Cal. 2d 525, 528-29, 446 P.2d 785, 787, 72 Cal. Rptr. 785, 787 (1968); Pacific Gas and Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 69 Cal. 2d 33, 37, 442 P.2d 641, 644, 69 Cal. Rptr. 561, 564 (1968); Kurland v. United Pacific Ins. Co., 251 Cal. App. 2d 112, 115-16, 59 Cal. Rptr. 258, 260 (1967). *See also* 14 CAL. JUR. 3d *Contracts* §§ 1164-65 (1974).

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

88. The minority position is also supported by the RESTATEMENT (SECOND) OF PROPERTY § 15.2(2) (1977).

89. *Kendall*, 40 Cal. 3d at 503, 709 P.2d at 847, 220 Cal. Rptr. at 828.

90. *Id.*

91. *Id.* at 503-04, 709 P.2d at 847, 220 Cal. Rptr. at 828. While the court does not discuss the option of only prospective enforcement, it has been suggested. *See, e.g.*, Hamilton v. Dixon, 168 Cal. App. 2d 1004, 1008, 214 Cal. Rptr. 639, 642 (1985).

92. The court also argues that the legislature has likewise never adopted the majority rule. *See infra* note 96 and accompanying text.

93. *Kendall*, 40 Cal. 3d at 504, 709 P.2d at 847, 220 Cal. Rptr. at 828.

ing, also refutes the majority rule.[94] The court concluded that it has a duty to amend the law when "reason and equity demand it."[95]

A fourth rationale endorsing the majority rule was proffered by the respondent. In essence, the argument states "that any increase in the market value of real property during the term of a lease properly belongs to the lessor, not the lessee."[96] The court rejected this contention by noting that the lessee acquires the benefits and burdens associated with the leasehold interest created. Thus, the lessee is entitled to the benefits of increased rental value since he has also assumed the risk that the market rate value may decrease. The lessor's interest is limited to his reversionary interest in the demised premises.[97]

D. Legislative Intent Is Not a Bar to the Minority Rule

Next, the court addressed the issue whether the legislature, in adopting section 1951.4 of the Civil Code,[98] rejected the minority rule by permitting the lessor the right to arbitrarily withhold consent.[99] The general remedies available to the lessor confronted with a breaching lessee are enumerated in section 1951.2 of the Civil Code.[100] This section requires the lessor to mitigate his damages; otherwise, a credit is given to the lessee for any amounts he pays for breaching the lease.[101]

However, where the written lease provision provides for reasonableness on the part of the lessor for his consent to an assignment, the lessor has a more favorable remedy for the lessee's breach under section 1951.4 of the Civil Code. This statute provides that "the lease continues in effect . . . and [that] the lessor may enforce all his rights and remedies under the lease, including the right to recover the rent

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94. *Id.*

95. *Id.* (quoting Rodriguez v. Bethlehem Steel Corp., 12 Cal. 3d 382, 394, 525 P.2d 669, 676, 115 Cal. Rptr. 765, 772 (1974)). The court's reasoning, while conclusive for leases entered into after its decision, does not address the question of prospective enforcement.

96. *Kendall*, 40 Cal. 3d at 504, 709 P.2d at 847, 220 Cal. Rptr. at 828.

97. *Id.* In adopting this position, the court changes the expectations of many lessors; lessors can no longer reap the benefits of increased rental rates by adjusting the rent as a condition to consent as they once had.

98. CAL. CIV. CODE § 1951.4 (West 1985). This section affords the lessor the right not to relet the premises and sue for damages. *See infra* note 128 for complete text.

99. The appellate court held that the legislature rejected the minority position by allowing an arbitrary withholding of consent. Kendall v. Ernest Pestana, Inc., 163 Cal. App. 3d 11, 16, 209 Cal. Rptr. 135, 138 (1984). This argument was also raised in *Hamilton*, where the court reasoned that when the legislature provided rights to the lessor, the legislature, and not the courts, should determine the abrogation of any of these rights. Hamilton v Dixon, 168 Cal. App. 3d 1004, 1010, 214 Cal. Rptr. 639, 642-43 (1985).

100. CAL. CIV. CODE § 1951.2 (West 1985). *See infra* note 139 for complete text.

101. *Id.* § 1951.2(c)(2).

as it becomes due under the lease . . . .",[102] notwithstanding the mitigation requirement of section 1941.2 of the Civil Code. In essence, where the lessee breaches the lease, section 1941.4 allows the lessor to contractually shift the burden of reletting the premises to the lessee.[103]

The court recognized that section 1951.4 of the Civil Code assumes, "absent a 'reasonableness' clause, [that] a lessor might believe that he . . . had a common law right arbitrarily to withhold consent to an assignment . . . ."[104] However, the court concluded that the "implicit recognition in a statute of an existing common law rule that is not the subject of the statute does not constitute a codification of that rule and certainly does not prevent a court from reexamining it."[105] Thus, the court concluded that the legislature did not reject the minority rule.

VI. THE DISSENTING OPINION

Justice Lucas, in his dissent, emphasized three main points.[106] First, he addressed the plain meaning of the lease; he determined that the lease as written was absent ambiguity and the courts should not rewrite the lease by adding provisions which were not contemplated by the parties.[107]

Second, the dissent maintained that retroactive enforcement was improper since permitting arbitrary withholding of consent had been the majority rule. Therefore, the parties should be allowed to rely upon the law as it existed when the contract was formed.[108]

Third, noting the distinctions between the remedies available under sections 1951.2 and 1951.4 of the Civil Code, the dissent argued that the legislature rejected the minority rule.[109]

VII. A CAVEAT FOR THE LESSEE

The *Kendall* decision greatly increases the lessee's economic bene-

102. *Id.* § 1951.4(b)(2).
103. *Kendall*, 40 Cal. 3d at 505, 709 P.2d at 848, 220 Cal. Rptr. at 829.
104. *Id.* at 506, 709 P.2d at 849, 220 Cal. Rptr. at 830.
105. *Id.*
106. The dissenting opinion is a restatement of the appellate court's decision. *Kendall*, 40 Cal. 3d at 507, 709 P.2d at 849, 220 Cal. Rptr. at 830 (Lucas, J., dissenting) (joined by Mosk, J.).
107. *Kendall*, 40 Cal. 3d at 507-08, 709 P.2d at 850, 220 Cal. Rptr. at 831.
108. *Id.* at 508-09, 709 P.2d at 850-51, 220 Cal. Rptr. at 831-32.
109. *Id.* at 510-11, 709 P.2d at 851-52, 220 Cal. Rptr. at 832-33.

fits of leasing by reapportioning the appreciation in rental values from the lessor to the lessee, at least where nothing is stated in the contract.[110] Upon the assignment or sublease, the lessee retains rental payments exceeding the original lease. While these benefits are available to the lessee, certain precautions should be noted.

A. The Need To Give Notice

While *Hamilton v. Dixon*[111] and *Richard v. Degen & Brody, Inc.*,[112] were specifically overruled by the court in *Kendall*,[113] the court failed to state precisely on what grounds *Hamilton* was overruled, and neglected entirely to mention *Thrifty Oil Company v. Batarse*.[114] *Hamilton* differed factually from *Kendall* in that consent for the assignment was requested after the business had been sold and the sublessee had taken possession.[115] Likewise, in *Thrifty*, the lessee sublet the premises without notifying the lessor prior to the sublessee taking possession.[116] Conversely, the lessor in *Kendall* was notified prior to the assignment.[117]

While the denial of consent to an assignment or sublease may be justified only by commercially valid reasons according to *Kendall*,[118] the lessee is nonetheless required to give notice of the prospective assignment if such consent is required in the lease agreement,[119] regardless of the suitability of the prospective tenant. Accordingly, although the court in *Hamilton* justified its decision on the lessor's ability to arbitrarily withhold consent,[120] it could have alternatively relied upon the lack of good faith by the lessee in not requesting consent prior to assignment.

The necessity of requesting consent prior to the lessee's transfer stems from the good faith and fair dealing requirement, implicit in every contract,[121] of which common courtesy is an essential ele-

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110. Absent a contract provision to the contrary, the lessee is the beneficiary of increased rental payments when the property is subleased. *Kendall*, 40 Cal. 3d at 505 n.17, 709 P.2d at 848 n.17, 220 Cal. Rptr. at 829 n.17. *See infra* notes 153-56 and accompanying text for options available to lessors to circumvent this result.

111. 168 Cal. App. 3d 1004, 214 Cal. Rptr. 639 (1985).

112. 181 Cal. App. 2d 289, 5 Cal. Rptr. 263 (1960).

113. *Kendall*, 40 Cal. 3d at 498, 709 P.2d at 843, 220 Cal. Rptr. at 824.

114. 174 Cal. App. 3d 770, 220 Cal. Rptr. 285 (1985).

115. *Hamilton*, 168 Cal. App. 3d at 1007, 214 Cal. Rptr. at 641. "The [trial] court awarded possession to Dixon, finding Hamilton materially breached the lease by failing to secure Dixon's written consent to the sublease, thus justifying the landlord's unilateral termination." *Id.*

116. *Thrifty*, 174 Cal. App. 3d at 775, 220 Cal. Rptr. at 289.

117. *Kendall*, 40 Cal. 3d at 494, 709 P.2d at 840, 220 Cal. Rptr. at 821.

118. *Id.* at 497, 709 P.2d at 842, 220 Cal. Rptr. at 823.

119. *Thrifty*, 174 Cal. App. 3d at 775, 220 Cal. Rptr. at 289.

120. *Hamilton*, 168 Cal. App. 3d at 1009, 214 Cal. Rptr. at 642.

121. *See supra* note 73 and accompanying text.

ment.[122] The reasoning is "that a request for consent to sublet [or assign] is not a mere formality, as it affords the lessor the opportunity to protect his interests and also minimizes the risks that [the] sublessee [or assignee] will place himself in jeopardy."[123]

Failure to adhere to the prior consent requirement would create unrest and a multiplicity of lawsuits. "Tenants who are unable or who refuse to provide their landlords with sufficient data to allow them to make an informed decision would take matters into their own hands. Litigation would increase and the certainty of contracts would be in question."[124] A lessee would gain the upper hand and benefit from a bad faith assignment since he could assign the property to an objectionable assignee and inform the lessor after the assignment. This would effectively force the landlord to institute costly litigation to declare the assignment invalid. Should the assignee ultimately breach, the landlord might be forced to first mitigate his damages prior to seeking indemnification from the original lessee.[125] Even though the lessee remains liable under the lease subsequent to an assignment,[126] the high cost of litigation hinders any potential recovery.[127]

B. Effect of Civil Code Sections 1951.2 and 1951.4

Following *Kendall*, the assignment clause contains a reasonableness standard; thus, the lessor's remedy for a lessee's breach lies with section 1951.4 of the California Civil Code.[128] Accordingly, the burden of procuring a new tenant falls on the lessee, provided that the

122. *Thrifty*, 174 Cal. App. 3d at 775, 220 Cal. Rptr. at 289.
123. *Id.*
124. *Id.* at 776, 220 Cal. Rptr. at 289.
125. *See infra* note 128 and accompanying text regarding mitigation of damages.
126. *See* 42 CAL. JUR. 3D *Landlord and Tenant* § 207 (1978).
127. Exceptions, however, do exist. For example, in *Hamilton*, the original lease provided for $375 per month for the entire lease term. The sublessee's rent was initially $1,500 per month, but was then increased an additional $150 per month each succeeding year. *Hamilton*, 168 Cal. App. 3d at 1007, 214 Cal. Rptr. at 640. The lessor was to receive a total of $53,250 over the remaining term of the leases (142 months multiplied by the $375 rent paid each month). The total rental payments received according to the sublease equaled $331,800 (computed with annual rent increases), for a difference of $278,550. In *Thrifty*, the lessor desired the premises for its own use. *Thrifty*, 174 Cal. App. 3d at 776-77, 220 Cal. Rptr. at 289-90 (the lessor brought an action for unlawful detainer for breach of a lease covenant). *Kendall* was a long term lease of twenty-five years.

However, the more likely scenario is that the lessor will relet the premises at or above the original lease rental provision and forego a few months rent in the process. The availability of a lawsuit in these actions is quite remote.

128. In essence, this section removes the lessor's mitigation requirement of Califor-

landlord does not terminate the tenant's right to possession.[129] Acts by the lessor to maintain the premises, relet the premises, or appoint a receiver do not constitute a termination of the lessee's right to possession.[130]

In the event a tenant breaches the lease, what options are available to the lessor? First, the lessor may simply do nothing and bring an action for rents under section 1951.4 of the Civil Code.[131] However, this remedy is incomplete at best. 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 . . . ."[132] On its face, the statute necessitates multiple lawsuits during the unexpired lease term or a single lawsuit upon the lease's termination. In most instances, if not all, such an alternative is unacceptable. During the period rents are not being paid, the lessor still has expenditures which must be made for the protection and preservation of his remainder interest in the leasehold estate, such as mortgage, tax, and maintenance payments.[133] Even if a judgment is received in lessor's favor, actual recovery of money is speculative at best. For example, the breaching tenant may avoid payment by filing bankruptcy. Also, abandoned space is prone to random acts of violence and property de-

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nia Civil Code section 1951.2(c)(2) by shifting that duty to the lessee. The statute provides:

> (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.
> (c) For the purposes of subdivision (b), the following do not constitute a termination of the lessee's right to possession:
> (1) Acts of maintenance or preservation or efforts to relet the property.
> (2) The appointment of a receiver upon initiative of the lessor to protect the lessor's interest under the lease.

CAL. CIV. CODE § 1951.4 (West 1985).

129. *Id.* § 1951.4(b).

130. *Id.* § 1951.4(c)(1), (2).

131. According to *Kendall*, a tenant may assign or sublet a leasehold interest, thus invoking section 1951.4 of the California Civil Code. *See supra* note 96 and accompanying text.

132. CAL. CIV. CODE § 1951.4(b) (West 1985) (emphasis added).

133. Even if the lease provides that the tenant is directed to pay taxes or maintenance, a plausible inference is that neither of these payments are being made, since the tenant is failing to pay rent.

struction. Moreover, where the abandoned space is located near other tenants, this may also have a derogatory effect upon their desire to renew leases.

The most appropriate action for the lessor is to file an unlawful detainer action, regain possession, and relet the premises, thereby gaining a cash flow to support necessary payments and thwart undesirable effects. However, such action is inconsistent with section 1951.4: once an unlawful detainer action is obtained, there is a termination of the lessee's rights to possession.[134] Therefore, subsequent to the unlawful detainer judgment, section 1951.2 of the Civil Code and its corresponding remedies apply.[135]

In *Willis v. Soda Shoppes of California, Inc.*,[136] the lessee breached the lease and voluntarily gave up possession. The lessor acquired the keys to the premises and attempted to relet the premises. The premises were ultimately relet approximately four months later, and the lessor filed suit for the unpaid rent, cleaning and repairs, and broker's commissions for the new lease.[137] The court held that, by requesting the keys, the lessor terminated the lessee's right to possession and opportunity to relet the premises. Consequently, section 1951.4 of the Civil Code, which allows rents to accrue, was not applicable.[138] Applying section 1951.2[139] to determine damages, the

134. "[T]he lease continues in effect for so long as the lessor does not terminate lessee's right to possession . . . ." CAL. CIV. CODE § 1951.4(b) (West 1985).

135. "The availability of a remedy under . . . [Civil Code section 1951.4] does not preclude the lessor from terminating the right of a defaulting lessee to possession of the property and then utilizing the remedy provided by section 1951.2 . . . ." CAL. CIV. CODE § 1951.4 (West 1985) (Law Revision Commission Comment (1970)). *See* California Safety Center, Inc. v. Jax Car Sales of Cal., Inc., 164 Cal. App. 3d 992, 999, 211 Cal. Rptr. 39, 44 (1985); Danner v. Jarrett, 144 Cal. App. 3d 164, 166-67, 192 Cal. Rptr. 535, 537 (1983).

136. 134 Cal. App. 3d 899, 184 Cal. Rptr. 761 (1982).

137. *Id.* at 901-02, 184 Cal. Rptr. at 762-63.

138. *Id.* at 903, 184 Cal. Rptr. at 763. The court relied on the returning of the key to the lessor. In addition, the court considered the failure to give notice to the lessee that the reletting would be for the account of lessee. *Id.* The court ignored the statutory provision which states that *"the following do not constitute a termination of the lessee's right to possession: . . . efforts to relet the property."* CAL. CIV. CODE § 1951.4(c) (West 1985) (emphasis added).

139. Civil Code section 1951.2 provides the following:

> (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 has been earned at the time of termination;
>
> (2) The worth at the time of award of the amount by which the unpaid rent

court concluded that the lessor "may not recover more on the breach than the party would have received by performance."[140] Consequently, the lessor could recover only the difference between the amounts to be received under the new lease and the rents which could have been received under the breached lease.[141] Thus, the lessor was denied the rents that accrued from the time that the lessee abandoned the premises to the time of reletting.

However, where the lessor gains possession through an unlawful detainer action, he may recover accrued rents, costs, and expenses incurred in reletting the property from the date of the unlawful detainer judgment to the reletting.[142] Analysis of the case law suggests that if the lessor desires to relet the premises, possession must be ac-

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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.

(b) The "worth at the time of award" of the amounts referred to in paragraphs (1) and (2) of subdivision (a) is computed by allowing interest at such lawful rate as may be specified in the lease, or, if no such rate is specified in the lease, at the legal rate. The worth at the time of award of the amount referred to in paragraph (3) of subdivision (a) is computed by discounting such amount at he discount rate of the Federal Reserve Bank of San Francisco at the time of award plus 1 percent.

(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 at 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 damage 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.

(e) Nothing in this section affects the right of the lessor under a lease of real property to indemnification for liability arising prior to the termination of the lease for personal injuries or property damages where the lease provides for such indemnification.

CAL. CIV. CODE § 1951.2 (West 1985).

140. *Willis*, 134 Cal. App. 3d at 905, 184 Cal. Rptr. at 764 (citing CAL. CIV. CODE § 3358 (West Supp. 1986)).

141. *Willis*, 134 Cal. App. at 905, 184 Cal. Rptr. at 765.

142. *See* Sanders Constr. Co. v. San Joaquin First Fed. Sav. & Loan Ass'n, 136 Cal. App. 3d 387, 400, 186 Cal. Rptr. 218, 226 (1982); Danner v. Jarrett, 144 Cal. App. 3d 166, 167, 192 Cal. Rptr. 535, 537 (1983); California Safety Center, Inc. v. Jax Car Sales of Cal., Inc., 164 Cal. App. 2d 992, 999-1000, 211 Cal. Rptr. 39, 44 (1985).

quired as a result of an unlawful detainer action. This should be done to protect his ability to recover rents and expenses prior to reletting. While there appears to be no justification for distinguishing between a voluntary relinquishment of the premises by the lessee and an involuntary relinquishment, they are, nonetheless, treated differently.

C. Remedies for Lessor's Breach of the Covenant Not to Withhold Consent Unreasonably

When a lessee, desiring to assign or sublet the demised premises, procures a party agreeing to accept the premises and the lessor unreasonably withholds consent, what options are available to the lessee? There are four alternatives available to the lessee: 1) institute an action for specific performance requiring the lessor to consent to the assignment; 2) bring an action for damages resulting from the breached covenant; 3) assign the lease without the lessor's consent; or 4) consider the lease terminated and abandon the demised property. The problem has yet to be addressed by the California courts.

In the New Jersey case of *Ringwood Association, Ltd. v. Jack's Route 23, Inc.*,[143] the original lessee notified the lessor of his intent to transfer the lease to another party. The lessee made several attempts to secure the lessor's consent, but the lessor refused; however, the lessor indicated that he would be willing to enter into a new lease at an increased rent. The lessee eventually abandoned the premises, justifying his action upon the lessor's breach of the covenant not to withhold consent unreasonably. The lessor subsequently brought suit to recover damages, and the lessee raised the defenses of lessor's breach of covenant and failure to mitigate damages.[144]

As the *Ringwood* case illustrates, the remedies available to the lessee upon the lessor's breach are inadequate, with the exception of considering the lease terminated. The lessee is generally unable to locate an assignee or sublessee willing to assent to the transfer without the lessor's consent, where such consent is required for a valid transfer.[145] Such a transferee is subjecting himself to the possibility of a lawsuit which could easily be avoided by leasing space elsewhere.

An action for damages is likewise inadequate since such litigation

143. 153 N.J. Super. 294, 299, 379 A.2d 508, 513 (1977), (*Aff'd*, 166 N.J. Super. 36, 398 A.2d 1315 (1979)).

144. *Id.* at 298-99, 379 A.2d at 510-11.

145. *Id.* at 310, 379 A.2d at 516.

is both costly and time consuming. Furthermore, as noted by the court in *Ringwood*, "[i]n an action for damages it would be impossible to calculate with any degree of accuracy the profits and other benefits which the lessee had lost and would continue to lose in the future as a result of his inability to move his expanding business to a larger location at the opportune time."[146] Also, uncertainty regarding whether there are actual damages is fatal to an action and requires dismissal.[147] Difficulty in computing damages also arises if an action for specific performance is instituted.[148]

Consequently, the only remedy remaining is for the lessee to consider the lease terminated and to vacate the premises.[149] Traditionally, however, absent an express provision in the lease, the breach of a covenant will not justify the termination of a lease.[150] In *C & J Delivery, Inc. v. Vinyard & Lee & Partners, Inc.*,[151] the Missouri Court of Appeals held that when the lessor breached the covenant of first refusal, the lessee was not thereby authorized to terminate the lease.[152] If the California courts adopt this reasoning, the lessee should seek to have a clause inserted in the lease providing an appropriate remedy should the lessor unreasonably withhold consent to an assignment or sublease.

VIII. POSSIBLE LESSOR'S RESPONSE TO *Kendall*

The lessor confronted with the prospect of losing appreciation value of market rental rates may still avoid those losses to a substantial degree. While little can be done for existing leases, new leases may be drafted to avoid undesirable consequences as a result of the *Kendall* decision.

First, as the court in *Kendall* noted, the parties are free to contract among themselves in order to settle the question of allocating rental appreciation.[153] A simple clause stating that any increase in rental payments, resulting from the lessee's assignment or sublease, shall be paid to the lessor, and the lessee shall relinquish any and all rights thereto. This should be sufficient to enable the lessor to retain the

146. *Id.*

147. *See* 23 CAL. JUR. 3d *Damages* § 31 (1975).

148. In *Ringwood*, the court suggested a way to demonstrate certainty as to what damages would be for the lessee to relocate and continue to pay rent. The court correctly discounts this option due to the tremendous financial burden which would be placed upon the lessee. *Ringwood*, 153 N.J. Super. at 310, 379 A.2d at 516.

149. *Id.* at 311, 379 A.2d at 517.

150. *See* 517 C.J.S. *Landlord and Tenant* § 113 (1968) and 49 AM. JUR. 2D *Landlord and Tenant* § 1020 (1970).

151. 647 S.W.2d 564 (Mo. 1983).

152. *Id.* at 569.

153. *Kendall*, 40 Cal. 3d at 505 n.17, 709 P.2d at 848 n.17, 220 Cal. Rptr. at 829 n.17 (quoting amicus curiae brief of Pillsbury, Madison & Sutro).

increase in the rental payments. While at first impression this may seem an easy way to circumvent the previously discussed problems, closer analysis of the proposed provision exposes latent inadequacies. The underlying assumption is that the lessee will charge a higher rental rate upon the transfer of his leasehold interest. The landlord would undoubtedly welcome the rental increase; however, there are no incentives for the lessee to conform to the lessor's desires. In fact, where the lessee has a lease payment less than prevailing market rates he may increase the sales price of the business to reflect the present value of the lease payment savings, thereby circumventing the lease clause.[154] Even if the lessee does not realize or otherwise fails to take advantage of the savings, the business would be more marketable with the lower lease payment and the lessor would have no way of requiring a rate increase.

In an attempt to provide an incentive to the lessee, the lessor may contract to divide the increased rental with the lessee. However, the lessee would generally be more inclined to increase the sales price to recapture a greater percentage.

Another possible contract alternative is to provide that in any transfer of a leasehold interest, the lease payments shall conform to the market rate for similar properties. This may be accomplished by requiring that an independent appraisal be obtained prior to the

154. For example, consider a business opportunity purchaser confronted with the opportunity of acquiring either business A or B; both are exactly the same except for the leases. Business A has a new 8 year lease with a lease payment of $1,500 per month, the current market rate, and business B has 8 years remaining on the currrent lease with a monthly lease payment of $1,000. The present value of the $500 per month savings over the 8 years, assuming an annual interest rate of 12%, is approximately $30,763. Thus, business B would be worth $30,763 more than business A. The tenant could increase his selling price to account for his lower lease payment and prevent the lessor from obtaining the appreciation in rental rates.

The present value of annuity formula is:

$$\text{Present Value} = \text{Amt}\left(\frac{1-\frac{1}{\left(1+\frac{r}{m}\right)^{n\times m}}}{\frac{r}{m}}\right)$$

Amt = Amount of annuity
r = Interest rate per year
n = Number of years
m = Number of payments per year

transfer. This clause would have to be carefully drafted to account for all possible contingencies. For example, should a corporation be the lessee, would a transfer of the majority of shares in the corporation to a new individual or entity be also considered a transfer of the leasehold interest?[155] The concept would be in conformity with *Kendall* since only the rate is being renegotiated, not the ability to assign or sublet the premises. However, "if such an assignment provision is implemented in such a manner that its underlying purpose is perverted by the arbitrary or unreasonable withholding of consent, an unreasonable restraint on alienaton is established" and *Kendall* would be dispositive on the issue.[156]

IX. CONCLUSION

While *Kendall* appreciably facilitates the transferability of leasehold interests, numerous issues remain to be resolved by the California judiciary and legislature. In the short term, the court has transferred the economic benefits derived from appreciation in market rates to the lessee. However, in the long run, an astute lessor will provide for a reevaluation of the lease payments upon a transfer of a leasehold interest.

Kendall's effect on the transferability of leases should not overshadow the responsibilities of the lessee to adhere to the lease terms. Thus, where lessor's consent is required prior to a transfer of a leasehold interest, a lessee must comply with the provision to avoid the possible lessor's defense of "bad faith" by the lessee, thereby opening up the possibility of rendering the transfer void and allowing the lessor the option of terminating the lease.[157] Additionally, both lessors and lessees should be cognizant of the applicable civil code sections affecting the lessors remedies upon a tenant's breach.

In negotiating new leases, the lessee should require explicit lease provisions regarding the applicable remedy should the lessor breach the covenant to not withhold consent unreasonably. Since the lessee's available remedies remain wholly unresolved, special care is

155. Sexton v. Nelson, 228 Cal. App. 2d 248, 258, 39 Cal. Rptr. 407, 413 (1964) (lessee's transfer of lease to wholly owned corporation does not violate an assignment clause); Ser-Bye Corp. v. C. P. & G. Markets, Inc., 78 Cal. App. 2d 915, 920, 179 P.2d 342, 345 (1947) (a corporate lessee's stock may be transferred to avoid assignment prohibitions).

156. *Kendall*, 40 Cal. 3d at 499, 709 P.2d at 843, 220 Cal. Rptr. at 824 (quoting *Cohen*, 147 Cal. App. 3d at 329, 195 Cal. Rptr. at 88).

157. The lease provision determines the lessor's alternatives. However, provisions affording the lessor the right to void the transfer and terminate the lease are not uncommon. *See supra* notes 28 and 57 for lease provisions on this issue.

required both in drafting the lease provision and when negotiating for a transfer, should the lessor refuse consent.

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