

## Fourth Supplement to Memorandum 88-64

Subject: Study H-111 - Commercial Lease Law (Assignment and Sublease--  
use restrictions)

If a lease of commercial real property for specified purposes precludes a change in use by the tenant without the landlord's consent, does the landlord have absolute discretion to grant or withhold consent or may the landlord refuse consent only if there is a commercially reasonable excuse? This, and other issues parallel to the ones we've been dealing with in connection with transfer restrictions, is the subject of the attached study by our consultant Professor Coskran, titled "Use Restrictions in Leases: Relationship to Restrictions Against Assignment and Sublease."

Briefly, Professor Coskran finds many of the same policies and concepts applicable to change in use as are applicable to transfer, and in fact a proposed change in use may be one of the more significant reasons for the landlord to deny permission to transfer. Although the *Kendall* case deals only with a lease clause that requires the landlord's consent for a transfer, the principles involved, other than the policy against restraints on alienation, could apply as well to a lease clause that requires the landlord's consent for a change in use.

Should we attempt to resolve the lurking issues in this area of law by legislation before the courts are forced to struggle with them? In favor of doing this are that it would be fairly easy to extend our transfer restriction provisions to use restrictions, and that codification could save the substantial amounts of litigation that would be required to work out a case by case exposition of the law in the area. Opposed to codification are that transfer restrictions and use restrictions, while related, are distinct and may require subtle differences in treatment best accomplished by case law, and that parties to a lease can draft around the problems, having been forewarned by *Kendall*.

Respectfully submitted,

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USE RESTRICTIONS IN LEASES: RELATIONSHIP TO RESTRICTIONS  
AGAINST ASSIGNMENT AND SUBLEASE

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JUNE 1988

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CLRC/4

COMMENT DRAFT 6/30/88  
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USE RESTRICTIONS IN LEASES:  
RELATIONSHIP TO  
RESTRICTIONS AGAINST ASSIGNMENT & SUBLEASE

By William G. Coskran

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I. SCOPE OF STUDY.

This study is related to, and supplements, the principal study of restrictions on commercial lease assignments and subleases entitled "Restrictions on Lease Transfers: Validity and Related Remedies Issues" (#H-111).<sup>1</sup> That study deals with the validity of, and consent standard applied to, various types of leasehold transfer restrictions. The principal study also deals with the relationship between transfer restrictions and the "lock-in" remedy<sup>2</sup> which allows the lessor to continue enforcement of the lease after the tenant's breach and abandonment.

This study examines the relationship between a restriction on use of the premises and a restriction on transfer of the leasehold, contained in a commercial lease of real property. It focuses on the specific issue of whether the reasonable consent standard, imposed on some transfer restrictions by the California Supreme Court in the Kendall decision,<sup>3</sup> also applies to use restrictions.<sup>4</sup> For convenience, the word "transfer" is used in this study to refer to either an assignment or a sublease.<sup>5</sup>

Assume that a lessor and tenant enter into a commercial lease of real property. The lease contains a use restriction clause. The clause either absolutely prohibits any use of the premises other than the one specified, or it prohibits other uses unless the lessor consents. As an alternative, the clause may

either absolutely compel a specific use of the premises, or it may compel the use unless the lessor consent. Later, the tenant proposes to change the use. As an alternative, the tenant and a potential transferee may propose the use change in connection with a proposed assignment or sublease. The lessor refuses to allow the change in use and a dispute ensues.

Is the lessor held to an objective standard of commercial reasonableness when he refuses to allow a change in use of the premises?

## II. TYPES OF CLAUSES.

There are a variety of clauses dealing with use of leased premises. The following are brief descriptions of the most common types.

1. Specific Use Only. The clause prohibits use of the premises for anything other than the specified use or uses.<sup>6</sup> It is desirable to use language such as "only" or "solely" to make it clear that the use is limited to the specific use. Otherwise, there is a danger that the clause will be interpreted to mean that the specified use is permitted, but that other uses are also permitted.<sup>7</sup>

2. Specific Use Mandatory. The clause affirmatively requires the premises to be used for the specified use or uses.<sup>8</sup> This type of clause usually compels the operation of a certain type of business, and it may get into details of the business such as hours of operation, quality of merchandise, etc. If a clause does not specifically compel operations, it will generally not be construed to require the tenant to actually use the premises, and the tenant may cease using the premises altogether.<sup>9</sup>

3. Specific Use Prohibited. This type of clause prohibits specific use or uses of the premises.<sup>10</sup>

4. Specific Use Protected. This clause prohibits the lessor from using or permitting the use of the lessor's other property for specific businesses.<sup>11</sup>

The first three types of clauses restrict the tenant's use of the premises. The fourth type of clause protects the tenant's use of the premises, generally against competition.<sup>12</sup> This study concerns the first three types of clauses.<sup>13</sup>

Clauses which restrict the tenant's use of the premises fall into two general categories. The "consent" type provides that the lessor's prior consent is required to any variation from the specific use restrictions.<sup>14</sup> The "absolute" type merely sets forth the restriction as an absolute requirement, and there is no mention of the lessor's consent to any variation.<sup>15</sup>

### III. PURPOSES.

Use restriction clauses serve a variety of purposes. In a percentage rent lease, the rent is based on the revenues produced on or from the premises. Generally, there is a minimum base rent, and the likelihood and amount of percentage rent varies with the circumstances. The agreed percentage set forth in the lease is typically based on the tenant's particular type of business. There is a wide variation among rates, based on the type of business, and a change of use of the premises can significantly affect percentage rental income.<sup>16</sup> For example, a tenant might change the use from a large general merchandise retail sales store to a warehouse used to store goods sold elsewhere.<sup>17</sup>

The lessor may want to preserve the drawing power of a certain type of use in a shopping center. For example, a general merchandise retail sales store, or a grocery store, would be expected to attract a larger volume of people than a warehouse or a racquetball facility. That drawing power brings people to the center and generates profits for other tenants who are paying percentage rentals. The drawing power also helps to maintain the overall economic health of the center and facilitates renting space in the center.

The variety and balance of tenants is another important consideration to a shopping center lessor. Control over the mix can have an important effect on the degree of economic success of

the center. Also, the lessor wants to avoid violating any exclusive rights or non-competition protection given to other tenants. The protection given one tenant depends on the lessor's control over other tenants. In addition to mix, the lessor may want to maintain a certain image for a center or a building. This involves more than just a control over the general type of business. It can involve factors such as name recognition, quality of goods and services, ethnic character of goods and services, etc.

A different use may increase the burden on the building, the common areas or the requirements for lessor services. For example, the new use may require use of heavy equipment which causes noise and vibrations which disturb other tenants. The change in use may require the operation of a forklift which causes extreme bearing weight on small areas and accelerates deterioration of paving and floors. There may be a substantial increase in use of parking areas, elevators and other common areas and facilities. There may be an increased demand for services furnished by the lessor, such as electricity, water, trash pick-up, etc. Insurance costs and availability may change with a change in use. The new use may involve alterations to the building such as partition walls and signs.

Continuation of a specific use may be necessary to preserve a non-conforming use authorization under zoning or building codes. The costs and risks of liability for hazardous substances

will vary dramatically depending on the particular use. In some cases, control over use may be necessary to prevent the tenant from putting the owner into violation of a deed restriction.

The lessor may own adjoining parcels and the particular use of the leased parcel might complement the lessor's business on the other parcel. The property may have been in the lessor's family and used for certain purposes for generations, and he wants to keep it so. There may be certain tax benefits derived by the lessor in maintaining a particular use. A lessor may just personally like a certain use, or personally fear change.

This is not intended as a catalogue of possible purposes of a use restriction clause. It should, however, show that there are many reasons supporting such a clause.

#### IV. RELATIONSHIP TO TRANSFER RESTRICTIONS.

##### A. General.

There is a basic similarity between restrictions on leasehold transfers and restrictions on premises uses. Absent restriction, the tenant has freedom to transfer<sup>18</sup> or change the use,<sup>19</sup> but the lessor can validly impose a restriction on transfers<sup>20</sup> or changes in use.<sup>21</sup> The freedom to change use, absent an express restriction, is limited to lawful purposes and uses that are "not materially different from that for which the premises are ordinarily used or for which they were constructed or adapted."<sup>22</sup> However, an occasional unauthorized or unlawful use might lead only to remedies of damages and injunction, not a forfeiture.<sup>23</sup> Restrictions on transfer and on use are construed in favor of the tenant.<sup>24</sup>

##### B. Reasonableness Requirement.

There is a close relationship between transfer restrictions and use restrictions when the proposed transfer will involve a change in use of the premises by the transferee. The transferee will be subject to the use restrictions in the lease.<sup>25</sup> If the lessor is subject to a reasonableness standard in giving or

withholding consent to a transfer, a proposed change in use will involve factors to be considered in the reasonableness test. Some of these factors were specifically mentioned by the court in the Kendall decision. They are: legality and suitability of the use; the need for alterations, the nature of the occupancy; the tenant mix in a shopping center; and, the belief that a specialty restaurant would not succeed at the location.<sup>26</sup> Thus, a lessor who wishes to restrict transfer should look carefully to the drafting of a use clause.<sup>27</sup> Absent a restriction on use, a lessor will have a difficult time meeting the reasonableness standard when he objects to a transfer on the basis that the transferee will change the use of the premises.<sup>28</sup> If the tenant can change the use, the lessor has no legally enforceable expectation that the use will remain the same.

Subsequent to Kendall, a court addressed the issue of reasonableness in the context of a transfer involving a change of use that would eliminate percentage rentals. The Hogan case<sup>29</sup> involved a percentage rent lease with a clause which limited use to a women's ready-to-wear shop. The tenant had been operating at a stable profit for several years and producing percentage rentals above the minimum rent. The tenant entered escrow to assign the lease to a third party who proposed to operate an antique store as a hobby. There would not be sufficient revenue to produce percentage rentals, so only the minimum rent would be paid by the third party for the remaining 9 years of the term.

The third party agreed to pay the tenant \$150,000.00 for the assignment. This amount was "equivalent to the difference over the remaining nine years of the lease between the minimum rent and the actual rents the Lessor had historically received."<sup>30</sup>

The court held that the lessor was subject to a reasonableness consent standard. It then made an irrefutable comment in holding, as a matter of law, that the lessor met the reasonableness standard. "Refusing to consent to highway robbery cannot be deemed commercially unjustified."<sup>31</sup> The court made an important distinction. A lessor's refusal to consent in order to increase his return above that provided in the lease is generally considered unreasonable. However, it is reasonable to object to a transfer that would place the lessor in a worse financial position than it bargained for and could expect to continue under a percentage lease.

The Hogan court did not appear to directly deal with the use clause. The clause limited use to a women's ready-to-wear shop. The third party intended to use the premises as an antique shop. Probably the court considered the proposed change of use issue as included in, and overpowered by, the loss of rent issue. There does not seem to be any basis to speculate that the court would have allowed the change in use if there had not been a drop in rent.

Another potential relationship between transfer and use restrictions might exist. In the Kendall case, a clause prohibited the tenant from transferring the leasehold without the

lessor's consent. The clause did not specifically state whether the lessor's consent was governed by a "sole discretion" standard or a "reasonableness" standard. The court imposed a reasonableness standard.<sup>32</sup> The view has been expressed that perhaps the Kendall case might foretell the imposition of a reasonableness standard on a clause restricting use of the premises.<sup>33</sup> This is discussed in Section V below.

C. Public Policies.

The imposition of a reasonableness consent standard on leasehold transfer restrictions by the court in Kendall flowed from two distinct public policies: (1) the policy of property law against restraints on alienation; and, (2) the policy of contract law in favor of good faith and fair dealing.<sup>34</sup>

1. Restraints on Alienation.

The policy against restraints on alienation, applicable to transfer restrictions, is not applicable to use restrictions.<sup>35</sup> This is true even though the use restriction impedes transfer. Even restraints on use of fee estates have been allowed for almost any purpose, whether the restraints be imposed as covenants,<sup>36</sup> or as conditions which provide for forfeiture upon violation.<sup>37</sup> The court in the Mountain Brow Lodge case pointed out that use restrictions "have been upheld by the California courts on numerous occasions even though they hamper, and often completely impede, alienation."<sup>38</sup> That case involved a gratuitous conveyance of a fee simple defeasible to a fraternal lodge. The deed contained a restriction on "sale or transfer" by the lodge, and a restriction requiring "the use and benefit" for the lodge

only. After the grantors died, the lodge brought an action to quiet title against the restrictions. The restraint on alienation was declared void. However, the court upheld the restriction on use, which it interpreted as a limitation to lodge, fraternal and other purposes for which the fraternal lodge was formed. This obviously limited the ability of the lodge to transfer the property. The California Supreme Court denied a hearing. A restriction which limited use of property to the erection and maintenance of a dam, in a conveyance of a fee simple defeasible, has been upheld in California.<sup>39</sup> Although this is only a use restriction, there is a limited market for a dam.

It is generally accepted outside California that use restrictions are allowed even if they impede transfer, and that the policy against restraints on alienation is not applicable to a use restriction.<sup>40</sup>

Most of the cases distinguishing restrictions on use from restrictions on alienation, and upholding the use restrictions, involve a restriction on a fee interest. Since a restriction on use of a fee estate is allowed, a restriction on a smaller estate, the leasehold, is obviously allowed. Comparing a grantor with a lessor, the lessor has a much more substantial interest in the restricted property. Traditionally, the policy against restraints on alienation has been more liberal in allowing restraints on leaseholds than on fees.<sup>41</sup>

2. Good Faith & Fair Dealing.

The covenant of good faith and fair dealing is the other basis for the imposition of a reasonableness consent standard on certain transfer restrictions.<sup>42</sup> It seems that both restrictions on transfer and restrictions on use are subject to the obligation of good faith and fair dealing. However, this does not necessarily mean that good faith and fair dealing mandates a commercially reasonable standard for restrictions on use. This is discussed in Section V.B below.

V. VALIDITY & CONSENT STANDARD.

A. General.

Generally, as discussed in Section IV.C.1 above, restrictions on use are valid. An illegal purpose may, however, invalidate the restriction. Assuming that the use restriction is valid, does the implied covenant of good faith and fair dealing require that the lessor allow a change in use unless he has a commercially reasonable objection?

B. Purpose Invalidity.

The purpose sought to be accomplished by the use restriction may cause it to be unenforceable because of constitutional or statutory violations. An early California decision, Los Angeles Investment Co.,<sup>43</sup> discussed the distinction between a transfer restriction and a use restriction, and upheld a deed restriction against use of the property by anyone but Caucasians. Today, a restriction on use which has a purpose of racial exclusion is recognized as repugnant to the constitution and unenforceable.<sup>44</sup>

Cal. Civ. Code Section 53 provides in part that "every restriction or prohibition as to the use or occupation of real property because of the user's or occupier's sex, race, color,

religion, ancestry, national origin, or blindness or other physical disability is void."<sup>45</sup> The Taormina case involved a community developed for retired members of the Theosophical Society.<sup>46</sup> Although the society was not technically considered a religion, the court held that the broad protections against discrimination in Section 53 invalidated a restriction limiting use of the property to members only.

Exclusive business use protections and non-competition use restrictions, although generally permissible, may at times be so broad as to run afoul of federal or state legislation protecting free trade and competition.<sup>47</sup>

C. Good Faith & Fair Dealing.

1. General.

The covenant of good faith and fair dealing is implied in every contract in California,<sup>48</sup> and a lease is considered to be a contract as well as a conveyance.<sup>49</sup> Good faith and fair dealing permeates the contractual relationship so there is little reason to doubt its application to a use restriction clause. That does not, however, necessarily compel a conclusion that the lessor must show a commercially reasonable objection in order to prevent a change in use by the tenant.

The obligation of good faith and fair dealing is discussed at length in the principal study.<sup>50</sup> Basically, it prevents one party from doing something which deprives the other of benefits contemplated under the contract. It protects the reasonable expectations of the contracting parties against interference by one to the disadvantage of the other. Good faith and fair dealing do not prevent the parties from bargaining and expressly providing for restrictions.

The wording of the use restriction clause can make a significant difference in expressing the reasonable expectations of the parties. As discussed in Section II above, the various types of use restriction clause fall into two general types, the "absolute" type and the "consent" type.

## 2. Absolute Type Restriction.

The absolute type restriction sets forth the specific use requirements and limitations as unqualified obligations. There is no mention of the possibility of variations with the lessor's consent. For example, a clause might provide that "the tenant shall use the premises only for a retail bookstore, and not for any other purpose whatsoever." It is hard to see how a tenant could later convince a court that this language led him to expect that he could change the use unless the lessor had a commercially reasonable objection. The tooth fairy may exist, but most people look to dental insurance for real expectations. A prominent leasing attorney has commented that if the lessor "simply states that the sole purpose will be as specified in the lease, then arguably there can be no change without an actual amendment of the lease. To argue otherwise would be to say that the tenant could change any lease provision by simply requiring the landlord to be 'reasonable.' Why not, for example, change the rent?"<sup>51</sup> The obligation of good faith and fair dealing does not open every contractual provision to judicial renegotiation.

It should not be necessary for the lessor to justify his insistence that the express terms of the absolute type restriction clause be complied with. There are two code sections which support this conclusion. Cal. Civ. Code Section 1930

states: "When a thing is let for a particular purpose the hirer must not use it for any other purpose; and if he does, he is liable to the letter for all damages resulting from such use, or the letter may treat the contract as thereby rescinded."<sup>52</sup> The related Section 1931(1) provides: "The letter of a thing may terminate the hiring and reclaim the thing before the end of the term agreed upon: 1. When the hirer uses or permits a use of the thing hired in a manner contrary to the agreement of the parties..."<sup>53</sup>

3. Consent Type Restriction.

The consent type use clause sets forth the restrictions and then states that variations are not permitted without the lessor's prior consent. Here, the possibility of a change in use is introduced into the language. The issue now becomes the proper standard to apply to the lessor's consent. Can the lessor withhold consent in his sole discretion, or must he have an objective and commercially reasonable reason to do so?

If the clause expressly states that the lessor's consent is only subject to a sole discretion standard, or that the lessor's consent is not subject to a reasonableness standard, that express provision should be honored. The obligation of good faith and fair dealing does not support an expectation of a reasonableness standard in the face of express contrary language.<sup>54</sup> On the other hand, if the clause expressly imposes a reasonableness standard, for example, a provision that "consent will not be unreasonably withheld," reasonableness is a contractual expectation.

If the standard governing consent is expressed in the clause, that standard becomes part of the agreement concerning use of the premises. Thus, either the express sole discretion or the express reasonableness consent standard is consistent with Cal. Civ. Code Secs. 1930 and 1931(1) quoted above.

The only difficulty in determining expectations occurs when a use clause requires the lessor's consent, but says nothing about the standard to be applied--the "silent consent standard." This is the situation faced by the court in the Kendall case, except that the restriction there was on transfer, not use.<sup>55</sup> The court used both the policy against restraints on alienation and the covenant of good faith and fair dealing to produce the reasonable consent standard for a transfer restraint. Since the policy against restraints on alienation does not apply to restrictions on use, will good faith and fair dealing alone produce a reasonable consent standard for a use restriction? It depends on the reasonable expectations of the parties. Absent an express clause one way or the other, do the parties contemplate that the lessor is to have sole discretion freedom or to have commercially reasonable limitations?

A California practice text gives an example of a silent consent standard clause that requires consent, but does not express a standard. It then comments without qualification that "(u)nder this typical basic use clause the landlord can be arbitrary and unreasonable in refusing to consent to a change in use, and the tenant has no recourse."<sup>56</sup> This statement is appropriate when referring to an absolute type clause where consent is not mentioned, or to a consent type clause which has an express sole discretion standard. However, it seems risky

advice when referring to a silent consent standard clause, especially after the Kendall case. Two authorities are cited: Cal. Civ. Code Sec. 1930, quoted above, and the Isom case.<sup>57</sup>

If a clause expressly requires that a lessor not unreasonably withhold consent to a change in use, the lessor could not unreasonably withhold consent and then take advantage of Section 1930 to seek damages or rescission. If a reasonable consent standard is imposed on the lessor by implication, rather than by express provision, the lessor is in no better position to unreasonably withhold consent and seek relief under Section 1930.

Does Section 1930 prevent an implied reasonableness standard when the lessor's consent is required but no standard is expressed? The section states in part: "When a thing is let for a particular purpose the hirer must not use it for any other purpose..." This language appears to strictly limit the tenant. However, when the lessor agrees to a consent type use restriction, he is leasing the premises either for the particular stated purpose or for an alternative consented purpose. The statute does not appear to preclude an implied reasonableness standard for the alternative purpose. As a practical matter, this statute has not been addressed by the legislature since 1905, and the issue of an appropriate consent standard was probably not considered.

The Isom case was also cited to support the lessor's ability to unreasonably withhold consent under a silent consent standard clause. The case is risky authority for that proposition for

three reasons. First, it does not appear in the decision that a silent consent standard clause was involved. Second, it appears that a significant factor leading to the decision was the fact that the absentee owner was tricked about the intended use of the property. Before the property was leased, and unknown to the owner, the eventual tenant had gone onto the land and determined its potential for oil drilling and extraction. He then sent the lessor a letter requesting a lease for a tenement house. Third, the use which caused the lessor to complain involved a permanent removal of a valuable substance from the land.

It could be argued that since a silent consent standard clause does not expressly provide a reasonableness standard, it is an unambiguous reservation of absolute discretion in the lessor. This argument was specifically rejected by the court in the Kendall case.<sup>58</sup>

It seems that the silent consent standard use restriction requires interpretation to determine the intent and expectations of the parties. The covenant of good faith and fair dealing requires that the lessor not thwart the tenant's expectations. The issue of whether sole discretion or reasonableness as an intended and expected standard can be left to a case by case determination as a question of fact. In the alternative, a standard can be implied based on the most likely expectation, and it would control absent language to the contrary in the clause. For example, as in Kendall, a reasonableness standard could be

implied or presumed. The parties would still be free to negotiate and expressly provide for a sole discretion standard which would displace the implied reasonableness standard.

The implication of a commercial reasonableness standard for a clause mentioning consent, as was done in Kendall, should not be done indiscriminately. There is a danger in turning the word "consent" into a litigable issue of reasonableness wherever it is encountered in a lease. Sometimes it may be used as a careless shorthand to indicate the obvious proposition that the parties can modify their agreement and change the deal if they are both willing. For example, consider a clause which states "This lease may not be amended without the written consent of the parties." Surely this should not mean that if one party wants to later change the agreement, the other party must submit to potential litigation over a commercially reasonable modification. The danger of turning courts into forums for an exercise in "let's make a deal" must be recognized.

D. "Satisfaction" Condition.

There are contract rules relating to "satisfaction" as a condition precedent to one's duty to perform. Suppose that party A does not have to perform the contract unless A is "satisfied" with party B's performance or with some other factor. What standard governs A's satisfaction? There are similarities between these cases and the consent issue. However, there is a major distinction between the two.

The common approaches taken to satisfaction conditions can be summarized as follows:<sup>59</sup>

1. The parties are free to expressly provide for a sole discretion standard governing satisfaction.

2. Absent an express standard, if the satisfaction involves fancy, taste or judgment, the sole discretion standard applies.

3. Absent an express standard, if the satisfaction involves mechanical fitness or utility, the reasonableness standard applies.

4. When the sole discretion standard applies, the party need not be reasonable in expressing dissatisfaction. However, the party is still bound by a duty of good faith. In other words, if the party is truly satisfied, he cannot lie and deny that satisfaction.

There is a major distinction between the cases involving satisfaction as a condition to perform a contract, and a potential case involving the lessor's consent as a requirement to modification of the contract provision restricting use. If A's promise to perform the contract is conditioned upon A's satisfaction, is A's promise consideration for the promise or performance of B, or is A's promise illusory? Satisfaction condition cases typically involve this issue of contract formation. As a result, they focus on imposing some base level minimum obligation on A to avoid an illusory promise. When the sole discretion standard is applied to a party's satisfaction, this is particularly a problem. As a result, there is a focus on a minimum duty to act in good faith, if not reasonably.

In the case of a use restriction, the contract is formed and the use restriction is part of the terms of the contract. Thus, in evaluating the lessor's consent requirement, it is not necessary to find some basic duty of the lessor in order to have a contract. The lessor's consent is more in the nature of a modification of the tenant's contract duty to observe the use restriction. It is in the nature of consent to modification, rather than a condition to performance. Thus, it is not necessary to seek a base level duty to uphold the contract. You can still have a binding contract even though there is no limitation on a party's refusal to later change its terms. The issue can be addressed as a question of intent and expectations.

Satisfaction condition cases are not directly analogous to consent cases. However, the two situations where a satisfaction standard is implied (2 & 3 above) seem to conform to reasonable expectations. It might be of assistance to look at the possible application of these rules for adopting a satisfaction standard when none is expressed, to the adoption of a consent standard when none is expressed. For example, it might be said that:

1. Absent an express standard, if the consent to a change in use involves subjective factors such as fancy, taste or judgment, the sole discretion standard applies.<sup>60</sup>

2. Absent an express standard, if the consent to a change in use involves objective factors such as mechanical fitness or utility, the reasonableness standard applies.

If this test is applied, it seems that in a typical commercial lease, objective business factors are involved, leading to an implied reasonableness standard. See Section III above regarding purposes for use restrictions. There are still obvious problems in predicting what will be considered subjective or objective factors in all situations. It is just as obvious that the selection of a particular standard governing consent is best left to bargaining and express provision. However, if that was always done, this study would not be necessary.

VI. RELATIONSHIP TO REMEDIES LEGISLATION.

A. Remedies Statutes in General.

The major remedies provided to the lessor for a tenant's breach are contained in Cal. Civ. Code Secs. 1951.2 and 1951.4.<sup>61</sup> The basic plan of Section 1951.2 is to have an immediate termination of the lease and an immediate cause of action for damages, including prospective rental loss damages. The contract rule of mitigation of damages is built in by allowing the tenant to prove post-termination rental loss that could have been reasonably avoided by the lessor. The termination of the lease is triggered by either of two situations: (1) the tenant breaches and abandons the premises; or, (2) the tenant breaches and the lessor terminates the tenant's right to possession of the premises.

The tenant can unilaterally terminate the lease, pursuant to Section 1951.2, by a breach and abandonment. The lessor is given the opportunity to prevent this unilateral termination and provide for a "lock-in" remedy by Section 1951.4. If the lease specifically provides for the remedy, and this section is complied with, the lessor can keep the lease in effect and continue to enforce its provisions. Relief is provided to the locked-in tenant by requiring that the lease permit the tenant to

assign or sublet (or both), subject only to reasonable restrictions. The relationship of the lock-in remedy to restrictions on leasehold transfer restrictions is covered in the principal study.<sup>62</sup>

B. Damages Per C.C. 1951.2.

When the lease is terminated due to the tenant's breach, the lessor is entitled to damages pursuant to Section 1951.2. The major component of damages is "the amount by which the unpaid rent which would have been earned...exceeds the amount of such rental loss that the lessee proves could be reasonably avoided."<sup>63</sup>

Suppose that there will be a deficiency and damages if the lessor relets for the use specified in the terminated lease. Suppose further, that the lessor could get more rent by leasing for a different use. How does the use restriction in the terminated lease affect the tenant's offset for reasonably avoidable rental loss?

There are two basic situations based on what the tenant could have done under the terms of the lease if it had not been terminated for breach

1. The tenant could have changed the use without the lessor's consent, or limited only by a requirement for the lessor's reasonable consent. In this situation, it seems that the tenant is entitled to have a possible reasonable change in use considered as one of the factors in determining the reasonably avoidable rental loss.

2. The tenant could not have changed the use because the terminated lease contained an absolute restriction on use or a sole discretion consent standard. It is a policy decision whether the mitigation concept embodied in section 1951.2 allows the tenant to establish a reasonable alternate use for damage purposes. However, it seems that the lessor should not be required to give up a bargained benefit in order to reduce the damages to a breaching tenant. If the tenant is allowed to base offsets on modifications of the lease terms, which could not have been made absent a breach, what would limit the modifications to the use clause?

C. Lock-In Per C.C. 1951.4.

Section 1951.4 allows the lessor to keep the lease in effect and enforce its terms against a tenant who has breached and abandoned. The remedy is available only if the tenant is permitted to either assign or sublet, subject only to reasonable restrictions.

Does the lessor's exercise of this lock-in remedy change the effect of a use restriction when the tenant seeks to assign or sublet?

The essence of the lock-in remedy is to keep the lease in effect. Section 1951.4 provides that "the lease continues in effect" and "the lessor may enforce all his rights and remedies under the lease."<sup>64</sup> The use clause is an integral part of the continuing lease, and it remains enforceable against the tenant and transferees according to its terms. If it allows the tenant to change the use without restriction or with the lessor's reasonable consent, the transferee would have the same freedom and limitations. If the clause absolutely prohibits change, or gives the lessor sole discretion to prevent change, the tenant and transferee have to conform to those restrictions.

**VI. SUMMARY OF CONCLUSIONS.**

**A. General Relationships.**

1. Restrictions on the tenant's use of the premises, contained in a commercial lease of real property, have some characteristics in common with restrictions on the tenant's transfer of the leasehold. Absent express restriction, a change in use (with some limitations) or a transfer of the leasehold is permitted. Restrictions on use or transfer are allowed, but construed in favor of the tenant.

2. Although restrictions are valid in general, those which have an illegal purpose are not enforceable.

3. Use restrictions and transfer restrictions are related when a prospective transferee proposes to change the use of the premises. If the lessor is subject to a reasonableness consent standard in connection with the transfer restriction, the proposed use of the premises is a factor which can be taken into consideration in testing the reasonableness of the lessor's objection to the transfer. The transferee is subject to the use restriction in the lease. If there is no use restriction in the lease, it is less likely that the lessor can use the proposed change in use as a basis for reasonable objection.

**B. Policies Involved.**

1. The Kendall case involved a clause which restricted transfer without the lessor's consent, but which failed to express a standard governing consent. The court used two public policies as the bases for imposing a reasonableness standard on the lessor: the policy against restraints on alienation; and, the policy in favor of good faith and fair dealing.

2. The policy of property law against restraints on alienation does not apply to a use restriction.

3. The policy of contract law imposing an obligation of good faith and fair dealing applies to use restrictions, but this does not necessarily mean that a lessor must have a commercially reasonable objection to a change in use.

**C. Application of Good Faith & Fair Dealing.**

1. The obligation of good faith and fair dealing prevents one party from doing something which deprives the other of benefits contemplated under the contract. It protects the reasonable expectations of one party against interference by the other party.

2. Good faith and fair dealing do not prevent clearly expressed restrictions on use of the premises.

3. An absolute type restriction states requirements and limitations as unqualified obligations of the tenant, and does not mention the possibility of a variation with the lessor's consent. This type of clause does not create a reasonable expectation that the lessor must have a reasonable objection to prevent a change in use. Good faith and fair dealing do not require such a standard.

4. A consent type restriction states requirements and limitations, and provides that they cannot be changed without the lessor's consent. The provision for consent introduces the possibility of a change in use. This type of clause may contain an express reasonableness standard or an express sole discretion standard, or it may not contain any express standard.

5. If the consent type restriction contains an express sole discretion standard for the lessor's consent, it should be enforceable according to its terms. This type of clause does not create a reasonable expectation that the lessor must have a reasonable objection to prevent a change in use. Good faith and fair dealing do not require such a standard.

6. A consent type restriction that does not contain an express standard raises the issue of the intended and expected standard governing consent: sole discretion or reasonableness. The issue can be left to case by case factual determinations, or it can be resolved by establishing an implied standard to govern in the absence of an express contrary provision. This is the

issue which the Kendall case resolved by establishing a reasonable consent standard with respect to a transfer restriction.

7. If a consent standard is implied into a clause that restricts use without the lessor's consent, but that does not contain an express standard, it seems that a reasonableness standard is most consistent with the reasonable expectations of the tenant. The lessor is free to avoid an implied reasonableness standard by bargaining and expressly providing for an absolute restriction or a sole discretion consent standard.

8. There is a danger in extending a reasonableness standard indiscriminately to every clause in a lease which mentions the possibility of consent to a variation. Sometimes the parties may merely intend the consent phrase to express the proposition that the agreement can be modified if both parties are willing. For example, the application of a reasonableness standard to a clause which provides that the lease may not be amended without written consent of the parties would subject the entire contract to judicial renegotiation.

9. The issues raised in this study can be substantially avoided by careful drafting: avoiding consent provisions or expressly stating the intended and expected standard when using them.

D. Relationship To Remedies Legislation.

1. If the lease is terminated due to the tenant's breach, pursuant to Cal. Civ. Code Sec. 1951.2, the tenant's ability to consider a change of use in connection with proving an offset against damages for reasonably avoidable rental loss depends on what the tenant could have done under the lease if it had not been terminated for breach. There are two basic situations:

A. The tenant could have changed the use without the lessor's consent, or limited only by a requirement for the lessor's reasonable consent. In this situation, it seems that the tenant is entitled to have a possible reasonable change in use considered as one of the factors in determining the reasonably avoidable rental loss.

B. The tenant could not have changed the use because the terminated lease contained an absolute restriction on use or a sole discretion consent standard. It is a policy decision whether the mitigation concept embodied in section 1951.2 allows the tenant to establish a reasonable alternate use for damage purposes. However, it seems that the lessor should not be required to give up a bargained benefit in order to reduce the damages to a breaching tenant. If the tenant is allowed to base

offsets on modifications of the lease terms, which could not have been made absent a breach, what would limit the modifications to the use clause?

2. If the lessor uses the lock-in remedy provided in Cal. Civ. Code Sec. 1951.4 upon a breach and abandonment by the tenant, the right of the tenant or the tenant's transferee to change the use of the premises in connection with a transfer of the leasehold depends upon the terms of the lease. The use restriction in the lease should be enforceable according to its terms.

- 1 This study is also related to separate studies on assignment and sublease topics entitled: *Tenant Remedies For Wrongful Enforcement of Assignment & Sublease Restrictions*; *Lessor Remedies For Breach Of Assignment & Sublease Restrictions*; *Involuntary Leasehold Transfers: Effect of Restrictions Against Assignment & Sublease*; and, *Enforcement of Leasehold Transfer Restriction Against Tenant's Successor: Should Dumpor's Be Dumped*.
- 2 Cal. Civ. Code Sec. 1951.4 (West 1985).
- 3 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 220 Cal. Rptr. 818, 709 P.2d 837 (1985).
- 4 See the principal study for a discussion of the Kendall case and its ramifications. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 5 An assignment is a transfer of the entire leasehold, whereas a sublease is a transfer of only an interest in the leasehold. The distinctions between an assignment and a sublease, although significant, are not important for the purposes of this study. For a discussion of the distinctions, see Sec. III of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 6 For example, see *Commercial Real Property Lease Practice*, Sec. 3.58 (Cal CEB, 1975).
- 7 Miller & Starr, 4 *Current Law of California Real Estate*, Sec. 27:73, p. 351 (1977); Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.02, p. 6-6 (1987).
- 8 For example, see *Commercial Real Property Lease Practice*, Sec. 3.60 (Cal CEB, 1975).
- 9 Miller & Starr, 4 *Current Law of California Real Estate*, Sec. 27:92 at p. 416-417 (1977). For a discussion of the requirements necessary for an implied covenant to operate, see: *Lippman v. Sears, Roebuck & Co.*, 44 Cal. 2d 136, 142-143, 280 P.2d 775 (1955); *First American Bank v. Safeway Stores, Inc.*, 151 Ariz. 584, 729 P.2d 938 (1986); *Walgreen Arizona Drug Co. v. Plaza Center Corp.*, 132 Ariz. 512, 647 P.2d 643 (1982)
- 10 It may also prohibit certain general types of activities. For example, see: Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.05 (7) (1987); *Commercial Real Property Lease Practice*, Sec. 3.59 (Cal CEB, 1975)
- 11 Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.05 (12) & (13) (1987).
- 12 For a general discussion of lease competition clauses, see Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.04 (1987).
- 13 For a recent application of the covenant of good faith and fair dealing to the fourth type of clause, see *Edmond's of Fresno v. MacDonald Group, Ltd.*, 171 Cal. App. 3d, 217 Cal. Rptr. 375 (1985).

- 14 For example, see *Commercial Real Property Lease Practice*, Sec. 3.58, (Cal CEB, 1975).
- 15 Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.05 (5) (1987).
- 16 *1987 Percentage Lease Rates*, The Mortgage and Real Estate Executives Report, Vol. 20, No. 1, p. 8 (March 1, 1987).
- 17 *Lippman v. Sears, Roebuck & Co.*, 44 Cal. 2d 136, 280 P.2d 775 (1955).
- 18 See Secs. II & VII of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 19 Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.02, p. 6-6 (1987).
- 20 See Secs. II & VII of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 21 Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.02 (1987); Restatement Second Property (*Landlord and Tenant*) Sec. 15.1, comment e., p. 88 (1977)..
- 22 Miller & Starr, 4 *Current Law of California Real Estate*, Sec. 27:25 at p. 265 & 27.73 at p. 350 (1977).
- 23 *Keating v. Preston*, 42 Cal. App. 2d 110, 108 P.2d 479 (1940). The tenant of a lease for a restaurant in a hotel occasionally accomodated the desire of customers to wager. This was before California made it exceptionally easy to legally satisfy this desire.
- 24 Regarding transfer restrictions, see Section VII.A of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111. Regarding use restrictions, see: Miller & Starr, 4 *Current Law of California Real Estate*, Sec. 27.73, p. 351 (1977); and Rohan, 7 *Current Leasing Law & Techniques*, Sec. 6.02, p. 6-6 (1987).
- 25 Restatement Second Property (*Landlord and Tenant*) Sec. 15.1, comment e., p. 188 (1977); 49 Am. Jur. 2d, *Landlord and Tenant*, Secs. 449 & 508 (1970)..
- 26 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 501-502, 220 Cal. Rptr. 818, 826-827, 709 P.2d 837 (1985).
- 27 This is particularly true in a percentage rent lease.
- 28 See e.g. *Roundup Tavern, Inc. v. Pardini*, 68 Wash. 2d 513, 413 P.2d 820 (1966).
- 29 *John Hogan Enterprises, Inc. v. Kellogg*, 187 Cal. App. 3d 589, 231 Cal. Rptr. 711 (1986).
- 30 *John Hogan Enterprises, Inc. v. Kellogg*, 187 Cal. App. 3d 589, fn. 2 at 592, 231 Cal. Rptr. 711, fn. 2 at 713 (1986).
- 31 *John Hogan Enterprises, Inc. v. Kellogg*, 187 Cal. App. 3d 589, 594, 231 Cal. Rptr. 711, 714 (1986).

- 32 See Sec. X.B of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 33 DiSciullo, Momentum for a Reasonableness Standard in Lease Transfer Clauses, VI Probate & Property 32, 34 (No. 3, May-June, 1987); Gurwitsch and Fleisher, Kendall v. Ernest Pestana, Inc.: The Doctrines of Good Faith and Commercial Reasonableness in Commercial Leases, 9 CEB Cal. Real Prop. L. Rep. 61, 67 (April, 1986).
- 34 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 498, 220 Cal. Rptr. 818, 824, 709 P.2d 837 (1985); See Secs. X.B & XII of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 35 *Los Angeles Investment Co. v. Gary*, 181 Cal. 680, 186 P. 596 (1919); *Taormina Theosophical Community v. Silver*, 140 Cal. App. 3d 974, 190 Cal. Rptr. 38 (1983) (Hrg. den.); *Mountain Brow Lodge No. 82, Independent Order of Odd Fellows v. Toscano*, 257 Cal. App. 2d 22, 64 Cal. Rptr. 816 (1967); Restatement Second Property, (Donative Transfers) Sec. 3.4 (1983).
- 36 MacEllven, *Land Use Control Through Covenants*, 13 Hastings L.J. 310 (1962).
- 37 Simes, *Restricting Land Use in California by Rights of Entry and Possibilities of Reverter*, 13 Hastings L.J. 293, 297 (1962).
- 38 *Mountain Brow Lodge No. 82, Independent Order of Odd Fellows v. Toscano*, 257 Cal. App. 2d 22, 26, 64 Cal. Rptr. 816 (1967) (Hrg. den.).
- 39 *Johnston v. City of Los Angeles*, 176 Cal. 479, 168 P. 1047 (1917).
- 40 *Mountain Brow Lodge No. 82, Independent Order of Odd Fellows v. Toscano*, 257 Cal. App. 2d 22, 26-27, 64 Cal. Rptr. 816 (1967) (Hrg. den.).
- 41 See Sec. XII.A.1 of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 42 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 500, 220 Cal. Rptr. 818, 825, 709 P.2d 837 (1985).
- 43 *Los Angeles Investment Co. v. Gary*, 181 Cal. 680, 186 P. 596 (1919).
- 44 *Shelley v. Kraemer*, 334 U.S. 1, 68 S.Ct. 836, 92 L.Ed. 1161 (1948); *Barrows v. Jackson*, 346 U.S. 249, 73 S.Ct. 1031, 97 L.Ed. 1586 (1953).
- 45 Cal. Civ. Code Sec. 53(b) (West Supp. 1988).
- 46 *Taormina Theosophical Community v. Silver*, 140 Cal. App. 3d 974, 190 Cal. Rptr. 38 (1983) (Hrg. den.).
- 47 *Boughton v. Socony Mobil Oil Co.*, 231 Cal. App. 2d 188, 41 Cal. Rptr. 714 (1964); *Doo v. Packwood*, 265 Cal. App. 2d 752, 71 Cal. Rptr. 477 (1968); *Commercial Real Property Lease Practice*, Sec. 2.13 (Cal CEB, 1975 & Supp. 1988).
- 48 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 500, 220 Cal. Rptr. 818, 825, 709 P.2d 837 (1985). See also: *Seaman's Direct Buying Services, Inc. v. Standard Oil Co.*, 36 Cal. 3d 752, 206 Cal. Rptr. 354 (1984); and, Restatement Second Contracts, Sec. 205

- (1982).
- 49 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 498, 220 Cal. Rptr. 818, 824, 709 P.2d 837 (1985); Cal. Civ. Code Sec. 1925 (West 1985).
- 50 See discussion in Section XII.B of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 51 Zankel, Commercial Lease Assignments and the Age of Reason: Cohen v. Ratinoff, 7 CEB Real Prop. L. Rep. 29, 36 (1984).
- 52 Cal. Civ. Code Sec. 1930 (West, 1985).
- 53 Cal. Civ. Code Sec. 1931(1) (West, 1985).
- 54 See the related discussion regarding transfer restrictions in Section XII.B of the principal study. Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 55 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, fn. 5, p. 494, 220 Cal. Rptr. 818, fn. 5, p. 821, 709 P.2d 837 (1985).
- 56 *Commercial Real Property Lease Practice*, Sec. 3.58, p. 104 (Cal CEB, 1975).
- 57 *Isom v Rex Crude Oil Co.*, 147 Cal. 659, 82 P. 317 (1905).
- 58 *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 502-503, 220 Cal. Rptr. 818, 827-828, 709 P.2d 837 (1985).
- 59 For a general discussion, see: Witkin, *Summary of California Law, Contracts*, Secs. 729-735 (9th ed., 1987); Restatement Second of Contracts, *Contractual Obligations*, Sec. 228 (1982).
- 60 The court in the *Kendall* case state that it was not commercially reasonable to deny consent on the basis of "personal taste, convenience or sensibility." *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 501, 220 Cal. Rptr. 818, 826, 709 P.2d 837 (1985).
- 61 (West 1985).
- 62 See Section XV of Coskran, *Restrictions on Lease Transfers: Validity & Related Remedies Issues*, Study H-111.
- 63 Cal. Civ. Code Sec. 1951.2 (a) (2) & (3) (West 1985). Note that the amount specified is subject to modification to determine the "worth at the time of the award" in accordance with subsection (b) of 1951.2.
- 64 Cal. Civ. Code Sec. 1951.4 (a) (West 1985).