

"RIGHT-SIZING" HONG KONG COMMERCIAL LEASES. KEY ISSUES TO CONSIDER IN THE CONTEXT OF BUSINESS DISRUPTION & COVID-19.

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BRYAN
CAVE
LEIGHTON
PAISNER 

PREMATURE TERMINATION OF COMMERCIAL LEASES

Summary

Business disruption seems to have become the new norm in Hong Kong in the last 12 months or so. The first quarter of 2019 was dominated by news of a regional slowdown caused by the US/China Trade War. The second half of the year was characterised by frequent protests on the streets, in the malls and railway stations of Hong Kong. The first quarter of 2020 and no doubt for longer will be impacted by COVID-19. Hong Kong is famously resilient and will no doubt bounce back at some stage. In the meantime businesses are being dramatically hit and some landlords are now offering significant rental discounts on existing retail leases. As the C-Suite review their targets for the year, it will not be a surprise if many will be re-assessing their real estate needs in Hong Kong. This article will examine some of the key issues to consider in a COVID-19 world in the context of any evaluation of your commercial leasing portfolio in Hong Kong. We will also end this note with a few comments on whether force majeure provisions will now apply given the impact of Covid-19.

Background

- Most commercial leases in Hong Kong are for a fixed term of two or three years. They may or may not include an option to renew. Parties are free to negotiate the length of the lease depending on their respective bargaining power. This is also dependent on the property type and intended use. For instance, larger companies may be in a better position to negotiate a lease for up to 10 years. Data centres may have a lease extending to 20 years. The position in Hong Kong is generally more pro-landlord. As such, it is important for tenants to be aware of the options available to them, especially when considering early termination of a lease agreement (if permitted under a lease).
- Parties to a contract are bound by its terms. In lease agreements between a landlord and a tenant, it is usually not legally possible to terminate the lease before its expiration unless material terms have been breached or there is mutual agreement to do so. Therefore, commercial tenants and landlords are generally bound to honour the lease until the fixed term is over. Whilst this protects tenants with the security of tenure for the whole period, the flexibility is restricted and there is limited freedom to move elsewhere or "right-size".

OPTIONS TO CONSIDER

1

Look for a break or sublet/assignment clause

2

Get the landlord's consent

3

If the Landlord does not consent

4

Whether or not to walk away

Break Clause

- If a tenant wishes to move out of the premises before the lease period comes to an end, the starting point is to review the lease agreement to identify whether or not there is a break clause. Such a clause will also include the relevant notice period required, when and how service is effected, and whether or not a penalty payment can be made in lieu of this notice.
- The use of a break clause in commercial leases, however, is not a common practice in Hong Kong. If there is such a clause, landlords often try to reject an exercise of the break clause by the tenant relying on slight technical breaches regarding the timing and manner of the written notice.

Sublet/Assignment Clauses

- Tenants have a legal right to sublet or assign unless it is expressly prohibited under the lease agreement. Most commercial leases will contain a standard alienation clause prohibiting the tenant from subletting the premises or assigning its rights under the leases to a third party unless the landlord gives prior written consent. In some negotiated leases the tenant may secure a right to assign or sublet all or part of the premises to group companies of the tenant as named in the lease. This may enable the tenant to down-size its operation, consolidate its business, or assign the whole or part of its interests under the existing lease to such a group company. If the subletting or assignment is to a group company this may only require a notification to the landlord rather than an obligation to obtain the landlord's consent. Please check the relevant provisions carefully to see if you have this right.
- Subletting opportunities are often specifically negotiated between the tenant and the landlord. Even if the tenant is permitted to sublet the premises, tenants should be warned that they remain primarily legally responsible under the lease agreement for any sub-tenants. For example, if the sub-tenant fails to pay rent due, the tenant will still be responsible to cover this cost to the landlord (unless otherwise agreed with the Landlord).

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Surrender Agreement

- The next option is to negotiate with the landlord. Query if you wish to surrender all or part. The landlord may more readily consent to a partial surrender rather than a full early termination. If so, the parties can agree to partially surrender the lease via a partial surrender agreement or a full surrender agreement if the landlord accepts this approach. Depending on market situations, landlords may be more willing to accept a full or partial surrender on payment of a settlement sum by way of compensation.

- It is always prudent to execute a surrender agreement to clearly set out the terms and conditions of the early termination. This will normally state that the tenant agrees to surrender the premises in accordance with the requirements of the surrender agreement and that the landlord agrees to accept the premises from the tenant and terminate the lease before the stated expiration date.
- A surrender agreement by mutual consent is the preferred method for early termination of a commercial lease agreement. It is the least intrusive to the business continuity of the tenant and provides clarity to the flow of rental income to the landlord.



Replacement Tenant

- If the landlord does not consent to a surrender agreement, the landlord may agree to release the tenant from the agreement if a replacement tenant is secured, although this is not always feasible especially in challenging markets and if there is a short timeframe available to settle such arrangements. Upon the tenant giving back possession, the premises can either be fully fitted or returned with vacant possession. This is a mitigation method which will reduce the landlord's loss of rent if a replacement tenant is able to take over the remainder of the term of the lease.
- If no consent is obtained from the landlord, tenants should still attempt to find a replacement tenant. This is because the landlord has a legal obligation to mitigate losses before claiming loss and damages from the tenant. Therefore, it is beneficial to both parties to actively and reasonably find a replacement tenant.
- The obvious benefit of this approach is that it will be easier to go back to the landlord to negotiate a surrender agreement. In addition, the tenant will also be able to reduce the losses that can be claimed by the landlord.



- If all of the above alternatives are exhausted, some tenants may elect simply to leave the keys behind and walk away. This is generally not advisable and should only be used as a method of last resort where no mutual agreement can be reached between the parties. This may result in the landlord claiming an order for possession of the property in court. Commencing a possession action will incur costs and may be damaging to the parties' reputations.
- If the tenant walks away during a rent free period, the tenant may have to pay all rent (with interest) payable during the term as if no such rent free period was granted.
- When leaving, the tenant is advised to keep proper records of the premises' condition and the handover of keys in order to protect its own interests. Tenants should take photos of the premises to evidence its condition and meter levels "as is" on the leaving date. It is also advised that an acknowledgement is sent to the landlord's registered address.

Heads of Claims

- **Outstanding rent:** Even if the lease is terminated, the landlord is still entitled to claim losses e.g. the rental difference due to the inability to find a replacement tenant for the remainder of the lease term. The tenant may be liable to compensate the landlord for outstanding rent (with interest) until the earlier of either the end of the lease period or when a replacement tenant takes over the lease.
- **Forfeit of the security deposit:** The security deposit paid, commonly the amount equivalent to two months' rent, will usually be forfeited by the tenant, although this may be offset when calculating loss and damages suffered by the landlord.
- **Costs relating to the new lease:** If the tenant does not return vacant possession, the landlord may also claim furniture removal fees. Other costs include estate agent fees for promotion and advertising related costs. The tenant may also be responsible for paying the landlord's portion of the stamp duty fees in relation to the new lease.
- **Other fees:** All legal fees and fees attached to the stamping and adjudication incurred by the landlord will also be payable by the tenant, and if necessary, reinstatement costs.
- Tenants are therefore not advised to walk away and are encouraged to negotiate a surrender agreement with the landlord if possible.

IMPACT OF THE COVID-19 (NOVEL CORONAVIRUS) OUTBREAK

- The World Health Organisation recently declared the COVID-19 outbreak a public health emergency of international concern on 30 January 2020. As a result of the COVID-19 outbreak in Hong Kong, it is expected that there will be an increased focus on force majeure clauses contained in lease agreements.
- Both tenants and landlords should look into whether or not the current circumstances will affect their rights under any lease agreements and the impact of COVID-19 on its obligations arising from such agreements.

Force Majeure

- Under common law, a contract may provide that a party may be excused from performance on account of a radical, unforeseeable intervening event that is expressly set out in the contract. Whether or not the COVID-19 outbreak amounts to a force majeure event will be heavily dependent on the facts of each individual case and the drafting of its force majeure clause.
- There is no generally accepted definition of "force majeure" and it is open to the parties to agree on the definition and scope of events which constitute force majeure under the contract. Common examples of force majeure events include war, strikes and natural disasters etc.
- A party relying on a force majeure clause must prove that (i) one of the events referred to in the clause occurred and that the party was prevented, hindered or delayed from performing its contractual obligations as a result of that event; (ii) its non-performance was due to circumstances beyond its control; and (iii) there were no reasonable steps that it could have taken to avoid or mitigate the event or its subsequent consequences.
- The impact of invoking a force majeure clause in the context of lease agreements may include the right to terminate the lease or an extension of time for performance of obligations such as payment of rent.

Frustration

- In the absence of a force majeure clause, it may be possible to rely on the law of frustration if it can be demonstrated that the outbreak of COVID-19 frustrated the purpose of the contract. If successful, the contract can be set aside in its entirety since the contractual obligations have been rendered impossible to perform and/or its underlying purpose has radically changed.
- However, this is also a matter of interpretation for the court and is dependent on the specific set of facts of each case. The threshold to prove frustration is high. For example, a contract which has become more difficult or expensive to carry out is insufficient to give rise to frustration.
- In the 2003 SARS epidemic related case of *Li Ching Wing v Xuan Yi Xiong* [2004] 1 HKLRD 754, a tenant argued that the lease agreement was frustrated due to a Department of Health isolation order against the premises under which it was uninhabitable for 10 days. The tenant's arguments for the application of the doctrine of frustration were rejected and it was held that in the circumstances, 10 days out of a 24 month lease (of which the tenant was 13 months into) was a short duration and therefore insignificant. The courts considered that although the outbreak of SARS was arguably an unforeseeable event, it did not go as far as to significantly change the nature of the rights and obligations arising from the contract.

Recommendations

- As it currently stands and unless the situation worsens dramatically, it remains to be seen whether or not the COVID-19 outbreak will constitute a force majeure event. Agreements should therefore be reviewed to see whether or not there is an express force majeure clause, and if so, its scope as well as the prescribed form of notice required to benefit from such a clause and the applicable time limitations.
- Since COVID-19 is affecting all parties in all businesses, it may be possible to start a dialogue for negotiation whether for rent reductions, an adjustment to the size of the premises or a surrender. Those entering into new contracts should consider the drafting of the relevant force majeure clause carefully and comprehensively.

BCLP IS HERE FOR YOU

- If you need assistance in reviewing your real estate agreements for force majeure clauses, BCLP can help across your portfolio. As part of our Corporate Real Estate Solution programme, we design targeted force majeure review projects across multiple jurisdictions with the purpose of creating a clear action plan in the event that force majeure events affect a client's real estate portfolio offering you a pragmatic solution. While most force majeure events are unforeseeable, the need for a plan on how to handle them when they affect your real estate portfolio is foreseeable.

This article provides a general summary and is for information/educational purposes only. It is not intended to be comprehensive, nor does it constitute legal advice. Specific legal advice should always be sought before taking or refraining from taking any action.

Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

Hong Kong

25th Floor, Dorset House, Taikoo Place
979 King's Road, Quarry Bay, Hong Kong

Andrew MacGeoch
Partner, Hong Kong
Head of Asia Real Estate and Infrastructure
Global Co-Head of Hospitality and Leisure Group
Tel: +852 3143 8402
andrew.macgeoch@bclplaw.com

Ann Ho
Of Counsel, Hong Kong
Tel: +852 3143 8453
ann.ho@bclplaw.com