

Stephenson Harwood COVID-19 insights: commercial leasing in Hong Kong



As Governments around the world continue to announce increasingly restrictive measures in the retail and hospitality sectors to try to slow the spread of COVID-19, landlords and tenants are understandably concerned about the effect of such measures on commercial leases. Most commercial leases in Hong Kong are fixed term.

There are three principal ways in which the situation could be dealt with (a) there is a provision in the contract dealing with the situation (such as force majeure); (b) the parties may renegotiate terms to deal with the situation; (c) a party may be in "fundamental breach" of its obligations; or (d) the lease may be frustrated.

Contractual terms

Some leases may contain terms that anticipate actions such as government restrictions. These may be rent abatement or force majeure clauses.

Rent Abatement

A rent abatement clause may justify non payment of rent by a tenant. The application of such a clause will depend on its wording, however frequently they only apply where the premises have been destroyed or damaged.

Force Majeure

A tenant may also argue that a "force majeure" event has occurred. In Hong Kong force majeure will only apply if there is a force majeure clause in the lease. These are rare. Each clause will turn on its own wording – there is no "one size fits all". It is possible that a Government mandatory closure could comprise a force majeure event depending on the clause wording. The consequences of the force majeure event and the notification are normally set out in the clause, as there is no general legal position. These conditions must be strictly complied with.

Frustration

What is frustration?

Frustration is a legal doctrine which has the effect of discharging (entirely) a contract if something occurs which renders it physically or commercially impossible for the contract to be fulfilled, or which transforms the nature of the contractual rights and/or obligations such that they are not what the parties could reasonably have contemplated at the time of its execution. Frustration is a powerful legal doctrine. Accordingly, it applies only in very narrow circumstances. It must occur without the fault of either of the parties. It cannot be invoked to relieve a party from the consequences of an imprudent bargain or for reasons of economic hardship.

Does this apply to leases during COVID-19?

In Hong Kong, we have case law to guide us. In the 2003 case of *Li Ching Wing v Xuan Yi Xiong*¹ the effect of Government restrictions on the use of property during SARS was considered by the Hong Kong Court. A flat in Block E of Amoy Garden was let for a fixed term of two years. As those familiar with the history of SARS in Hong Kong will know, there was a very serious SARS cluster in Block E of Amoy Gardens. The Hong Kong Department of Health issued an isolation order and the residents of Block E were compulsorily evacuated for a period of 10 days. The tenant moved out of the property and subsequently sought to terminate the tenancy agreement arguing that it had been frustrated by the making of the isolation order.

¹ [2004] 1 HKLRD 754

The Hong Kong Court held that in the context of a two year fixed term lease, the isolation order duration of 10 days was insufficient to frustrate the lease because it did not significantly alter the nature of the outstanding contractual rights or obligations from those that the parties could reasonably have contemplated.

As at the date of this note, we have not seen any Government mandated closures of commercial property in Hong Kong or isolation orders in relation to residential premises. However it is becoming increasingly possible. Whether such action would be sufficient to frustrate a lease would depend on the severity of the action taken and its duration as compared with the duration of the overall term of the lease.

There is no set answer to this question, and each case will depend on its individual facts. However, we can find guidance from a number of English case authorities which deal with frustration in a leasing context. For example, in the case of *National Carriers v Panalpina (Northern) Ltd*² the English House of Lords considered whether the lease of a commercial warehouse was frustrated when a City Council closed the only access street to the warehouse for a year. They decided it was not. Although the closure was for one year, the lease was for 10 and there would have been three years remaining to run after the street re-opened.

Fundamental breach

A “fundamental” or repudiatory breach of a lease would be one where a party demonstrates their intention no longer to be bound by the terms of the lease. For instance a notice by the tenant that they no longer intended to pay rent, or a refusal by the landlord to allow access to the property. The effect of such a breach would allow the innocent party to terminate the lease and claim damages from the other.

Mutual agreement

The fundamental issue here is that to vary the lease there must be an agreement by the parties. In addition leases may contain “no oral modification” clauses. The English courts have recently decided that if a contract contains such a clause then any variation must be in writing. Further, it is important to note that under the general principles of contract law, any variation must be supported by consideration.

Outside of the above, a landlord is very unlikely to be in breach of a commercial lease in a Government mandated closure. This is largely because the closure is not something which is within the landlord’s control.

Next steps

If you are a commercial tenant and are facing the situation where your lease is no longer economically viable, review your agreement before making any final decisions. In particular, consider the following:

- Are there any rent abatement clauses or provisions dealing with force majeure? Can you rely on them? Have any of the listed events in such a clause been triggered?
- Is there a break clause in your lease? Is there a sublet/assignment clause? Are you able to arrange a replacement tenant if it is not economically viable to continue the lease?
- Is a commercial solution possible such that a lease variation can be agreed? Consider rent reduction negotiations, and whether it is possible to re-structure rental payment provisions so that can be deferred or delayed.

The COVID-19 situation is rapidly developing. We will endeavour to keep our clients updated of developments through our insights and regular bulletins.

² [1981] A.C. 675.

Get in touch



Andrew Rigden Green
Partner
T: +852 2533 2761
Email: [Andrew](mailto:Andrew@shlegal.com)



Elizabeth Sloane
Partner
T: +852 3166 6926
Email: [Elizabeth](mailto:Elizabeth@shlegal.com)