

Insights

THE RIGHT-SIZING OF COMMERCIAL LEASES IN HONG KONG SAR AND MAINLAND CHINA

Apr 10, 2024

SUMMARY

In Hong Kong SAR and in Mainland China, we have observed an increase in the relative bargaining power of office tenants to negotiate their leases. A variety of factors, including a stronger supply of new office buildings and more negative economic sentiment among office tenants, have contributed to the evolution of landlord-tenant dynamics.

BACKGROUND

In Hong Kong SAR and in Mainland China, we have observed an increase in the relative bargaining power of office tenants to negotiate their leases. A variety of factors, including a stronger supply of new office buildings and more negative economic sentiment among office tenants, have contributed to the evolution of landlord-tenant dynamics. While landlords would have been reluctant to allow tenants to terminate their leases prematurely or otherwise right-size the leases in the past, there is now a greater chance for tenants on renewals to successfully negotiate for clauses which would better preserve their flexibility to do so. In this article, we will consider the key clauses and considerations which may be of interest in such lease negotiations. We will also consider how, in practice, tenants may give effect to such right-sizing options or pursue other methods of terminating a lease prematurely.

HONG KONG

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. Larger companies taking significant amounts of space in a building will of course have more leverage and may aim for longer lease periods (eg for up to 10 years). Data centres may have a lease extending up to 20 years.

Historically, lease negotiations have generally been 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 (if permitted under a lease). Parties to a contract are bound by its terms. In leases, 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. Tenants generally have security of tenure for the whole period. Equally, there is limited freedom to move elsewhere or “right-size”.

With recent changes in attitudes to working from home, hot desking, a general downturn in the local rental market and a strong supply of new Grade A buildings in Hong Kong coming on stream over the next two years, it is clear that office tenants in Hong Kong have relatively stronger bargaining power at present. The vacancy rate of Grade A office buildings has been on the rise since 2019 and is currently at an all-time high, primarily due to significant new supply but also partly due to decreased demand from key office tenants such as Chinese firms and, generally, the finance sector.

MAINLAND CHINA

A typical lease term in Mainland China (excluding Hong Kong, Macao and Taiwan for the purpose of this article) (the **PRC**) for office and retail properties will vary from two to five years. Landlords nowadays are being far more flexible in accommodating different lease terms. Similar to Hong Kong, the ample supply and weak demand in several major cities of the PRC have also led to climbing vacancy rates. For instance, recent market research revealed that the vacancy rate for the top tech districts in China rose significantly due to the impact from both the withdrawal of tenancies by tech and internet giants and completion of new projects as a result of Covid-related construction delays in several submarkets, e.g. Zhongguancun in Beijing and Caohejing in Shanghai. Undoubtedly, landlords face increasing pressure while tenants are not short of options upon the expiry or renewal of their lease. An opportunity to relocate or “right-size” arises.

NEGOTIATION OF NEW OR RENEWAL LEASES

BREAK CLAUSE IN HONG KONG

In general, commercial leases do not contain a break clause, i.e. a right for the tenant to terminate the lease before the lease term comes to an end. Landlords and tenants are expected to honour the lease for the full lease term. However, in view of the relatively higher bargaining power of tenants in the current leasing market, tenants may consider negotiating for a break clause.

The clause should clearly state, among others, (i) how the tenant should give notice of its decision to terminate the lease to the landlord and (ii) timing requirements for the tenant to do so.

Landlords are often asking for a right to terminate upon a sale or re-development. A tenant fairly asks for this not to be exercised in the initial period of the lease. Perhaps tenants’ early termination rights could be linked to the same date!

BREAK CLAUSE IN THE PRC

Unlike commercial leases in Hong Kong, it is common to see that a lease in the PRC provides contractual grounds of termination available to the landlord and the tenant before the entire lease period expires. For example, the break clause usually becomes exercisable by either party after three to four years in a five-year lease assuming no material default has taken place by satisfying corresponding notice requirements in the lease. Query whether a tenant can negotiate for this right to be exercised at an earlier stage. Of course, tenure is linked to levels of rent so this will be a matter for negotiation.

KEY CONSIDERATIONS IN BOTH HK AND PRC

Key considerations for incorporating a break clause include the following:

- Notice requirements: parties should carefully consider whether the tenant's obligations to give notice are clearly drafted and practicable. In particular, tenants should note that landlords may reject the exercise of the break clause on the basis of technical breaches of such notice requirements.
- Penalty in lieu of proper notice: to maximise its flexibility to exercise a break option, tenants may also wish to negotiate for an option to make a penalty payment in lieu of satisfying the notice requirements.

ALIENATION CLAUSES IN BOTH HK & PRC

Tenants have a legal right to sublet or assign unless it is expressly prohibited under the lease. However, the default position in most commercial leases is that tenants are prohibited from subletting the premises or assigning its rights under the lease to a third party unless the landlord gives prior written consent.

Key considerations for incorporating alienation clauses include the following:

- Alienation to group companies: tenants are more likely to find success in negotiating for a right to assign or sublet premises to its "group companies" (as opposed to any third party). The term "group companies" will need to be clearly defined.
- Notice requirements: it will be most beneficial to the tenant if it is only required to give notice reasonably promptly after the assignment or subletting has been made; however, the landlord will usually require advance notice.
- Continuing obligations of tenant: the tenant should be aware that if it sublets the premises, it is liable for the breaches of the sub-tenant; on the other hand, if it assigns the premises, it is generally not liable for the breaches of the assignee (to the extent that such breaches relate to tenant obligations in respect of use of land). On balance, subject to the business and

operational needs of the tenant, it may be more worthwhile to ensure that the tenant has a right to assign rather than a right to sublet (if the landlord is reluctant to grant both).

REINSTATEMENT

At the expiry of a lease, a tenant is usually required to reinstate the premises (usually to “bare shell” condition) and remove all installations made. While a landlord will typically reserve a right to retain installations by the tenant, this remains a matter of discretion of the landlord.

Reinstatement of premises is potentially costly and time-consuming for tenants. A tenant should therefore carefully consider its reinstatement obligations ahead of the expiry of the lease term, or in the case of premature termination, before the tenant exercises its option to terminate the lease. On the other hand, in the current market, tenants may consider negotiating for more favourable reinstatement requirements in any new leases or renewal. For example, tenants may consider proposing the following:

- Reinstatement to “original condition”: if the premises are handed over to the tenant in a non-bare shell condition (i.e. with existing fit-out and installations), the tenant can consider proposing that it should reinstate the premises back to such condition only, rather than stripping out all installations, at the expiry or termination of the lease. The “original condition” of the premises should be carefully set out in a schedule of conditions to the lease.
- It should be noted that this option is more suitable for a tenant who does not intend to make extensive installations to the premises handed over to it. If the tenant, instead, intends to fit out the premises extensively, then the usual position is to reinstate to bare shell condition. This is no longer acceptable to many tenants. See our further comments below.
- No reinstatement if suitable replacement tenant is found: a tenant may propose adding a proviso to its reinstatement obligations to the effect that, if a replacement tenant that adopts substantially all of the existing fit-out of the premises is found, the tenant should be relieved of its reinstatement obligations. While such clause is unusual in the local market, it can be potentially mutually beneficial to the landlord and the tenant, as the tenant may have an incentive to help identify replacement tenants that will take on the premises as-is. This proviso can also help reduce unnecessary waste and labour costs arising from removal of installations and reinstatement works.

Dilapidations payments

Another alternative is to agree a “dilapidations payment” which is a compromise between “reinstatement” and waiting to see if the landlord secures a replacement tenant.

Reinstatement period: if the landlord insists upon a full reinstatement clause, then the time required for reinstatement should form an extra rent-free period after the original expiry date. Otherwise, this

is “dead time” and a double cost to the tenant due to (a) non-use of the premises while reinstatement activities are carried out; and (b) the cost of reinstatement.

EXTENSION OF EXISTING LEASES IN THE PRC

PRC statutes do **not** give a tenant a legal right to automatically renew the lease upon expiry.

Interestingly, the Civil Code of the PRC (**Civil Code**), which came into effect on 1st January 2021, grants the tenant a priority right to renew the lease on equivalent terms. However, it is not a sweeping change. Before such right was passed as a national law, a similar right has long existed in several regional regulations, e.g. in Guangdong province, Beijing and Shanghai. Now the Civil Code provides a clear national legal basis for a tenant to enjoy this priority right to a renewal even without any express stipulation in the lease (which also cannot be excluded even by mutual agreement).

Key considerations to exercise the tenant’s priority right to lease renewal (even though there is no express contractual right to renew) on “equivalent terms”:

- The priority right to lease renewal is only exercisable when the entire lease term expires. That is to say, in the event of premature termination of a lease, such priority right would not be available to the tenant.
- Another prerequisite to exercise the right is the landlord’s intention to re-let the premises. For example, the priority right is not applicable when the landlord states unequivocally that it will no longer let the premises (e.g. taking back the premises for rezoning or renovation). Given the general policy-wise trend to be pro-tenant in the PRC, courts tend to hold the position that a landlord who claims not to continue re-letting needs to show just cause (e.g. use for self-occupied property, expropriation by the government, improper use of the premises by the tenant during the lease term).

Renewal on “equivalent terms”

1. Needless to say, the rental still needs to be on market competitive terms so priority is still subject to a market rental being agreed. For instance, if the rental offered by the existing tenant is lower than other potential tenants, a court is not in a position to hold in favour of the original tenant.
2. Other equivalent terms to be considered on renewal are usually the rent payment schedule, lease term, usage purpose and tenants’ capabilities to perform the lease.

PREMATURE TERMINATION OF EXISTING LEASES

In view of market uncertainty, we note that it has become increasingly common for commercial tenants to consider its leasing portfolio both in Hong Kong and the PRC and look for ways to right-

size or terminate the lease. We have set out below a number of key considerations for a tenant seeking to pursue such options.

BREAK, SUBLETTING OR ASSIGNMENT OPTIONS IN THE LEASE

If a lease entitles the tenant to a break option (as considered in 2.1 and 2.2 above) or subletting or assigning the lease (as considered in 2.4 above), the tenant should carefully consider the formality requirements in such clause(s), in particular any notice requirements to the landlord, and exercise its rights accordingly.

NEGOTIATION WITH LANDLORD

In the absence of any express break or alienation clauses in the lease, the next option is to negotiate an agreed early termination 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.

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 the parties have reached an agreement in respect of the surrender of the lease, 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. It is the least intrusive to the business continuity of the tenant and provides clarity to the flow of rental income to the landlord.

WALKAWAY

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 and recovery of rent for the balance of the lease period. Defending such court proceedings will incur costs and may be damaging to the parties' reputations.

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.

In Hong Kong, 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.

In the PRC, it is worth noting that some potential legal consequences may follow when tenants elect to walk away without mutual agreement, e.g. a legal representative of the tenant company is likely to be subject to certain civil restrictions. As elaborated above, simply walking away may result in legal action against the tenant, where the legal representative of the tenant company may be restricted from certain high-value/luxury-type activities after the tenant company is regarded as a dishonest judgment debtor by courts due to its failure to satisfy a court or arbitration award when still solvent.

HEADS OF CLAIMS

Hong Kong

- **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.
- **Forfeiture of the security deposit:** The security deposit, commonly the amount equivalent to two months' rent, will usually be forfeited by the landlord, 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 stamp duty (if any) 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.

PRC

- Outstanding rent, property management fees, any overdue charges and interest: In the event of early termination, the landlord is entitled to claim such due payments (with interest if applicable) as of the early termination date.
- Occupancy fees: For the duration from early termination to actual possession of the property by the landlord, the landlord is entitled to occupancy fees (on top of the rental) at a daily rate as agreed in the lease, usually the applicable rental from the date of early termination.
- Forfeiture of the security deposit: Usually the landlord is allowed to claim the security deposit when the tenant early terminates the lease without cause. However, courts generally consider the security deposit as partial liquidated damages when calculating the total compensation payable to the landlord. This is relevant when the landlord claims both the security deposit and liquidated damages.
- Loss for rent-free period and/or lease incentives granted: The landlord is entitled to claim a loss for the rent-free period and/or any incentives granted to the tenant as stated in the lease, e.g. the typical calculation in practice is based on the unamortised costs for the past rent-free period and any paid tenant incentives. However, in the absence of express agreement in the lease, this claim-back amount will be determined on a case-by-case basis.
- Liquidated damages: Courts usually determine the amount of liquidated damages based on the lease clause or, if none, the actual loss due to the tenant's early termination. When the agreed liquidated damages are significantly greater than the actual incurred loss, courts may apply an appropriate reduction at the request of the tenant. In practice, courts may consider the landlord's potential vacancy loss, any mitigation measures taken, brokerage commissions paid to find a replacement tenant and other key elements together.
- Other fees: Other fees may also apply as agreed or in practice. For instance, if the tenant fails to return the property in the agreed condition, reinstatement costs may be incurred and payable

by the tenant, e.g., cost in relation to the removal of accession and cleaning.

Notably, if a tenant is unwilling to continue performance of the lease whether insolvent or not, the nature of the tenant's obligations (i.e., obligations above pure monetary payment) may preclude enforcement of continuing performance under PRC laws. Therefore, the courts are less likely to uphold a landlord's claim to continue the lease when the tenant insists on early termination. However, the landlord should still have an entitlement to the claims set out above.

RECOMMENDATIONS

1. Tenants seeking to enter into a new lease or renew its lease should take advantage of its relatively strong bargaining power in the current market to include clauses which would facilitate right-sizing of the lease on future occasions. However, the drafting of such provisions will need to be specifically negotiated between the parties. In particular, the formality requirements in such clauses (e.g. notice requirements for early termination) should be carefully considered in view of the commercial needs and concerns of the tenant.
2. Tenants that are already bound by existing leases have limited options for right-sizing a lease, unless express provisions for early termination or alienation have been expressly included. Nevertheless, in some situations (e.g. with the ready supply of a replacement tenant), landlords may be open to varying the lease and entering into a surrender agreement with tenants. Walking away from the lease is the least preferred option and might expose the tenant to the risk of court action and reputational damage.
3. Finally, don't forget to be "green" - see the following links: ["Adoption of Green Leases in Hong Kong SAR – Part 1"](#) and ["Adoption of Green Leases in Hong Kong SAR – Part 2"](#). Perhaps a tenant may also seek to secure some special "green" provisions in any future tenancy agreements. We will be issuing a further note on these aspects shortly.

RELATED PRACTICE AREAS

- Commercial Real Estate

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