BCLP. Client Intelligent

Insights

CONSTRUCTION OF LEASE IN RELATION TO TENANT'S OBLIGATION TO REINSTATE

May 11, 2021

Disputes often arise about the extent of a tenant's obligations to reinstate the leased premises at the conclusion of the lease. Large sums of money can be involved. Modern commercial leases usually contain a term dealing with the extent of the reinstatement obligations.

As might be expected, the extent of the tenant's obligation to reinstate is a question of construction of the relevant clauses in the lease in each case.

The proper construction of a lease in relation of the tenant's obligations to reinstate is illustrated in a recent Hong Kong Court of First Instance case: *AFH Hong Kong Stores, Ltd v Fulton Corporation Ltd* [2021] HKCFI 873.

Background

The Tenant and the Landlord were parties to the Lease in question. Upon commencement of the Lease, the Tenant carried out structural and fit-out works to the premises, pursuant to the terms of the Lease and with the Landlord's consent.

Later, the Tenant effected an early termination of the Lease under the break clause of the Lease. In the discussions between the parties about the scope of the Tenant's obligation to reinstate, a dispute arose as to the meaning of phrase "bare shell" as used in the Lease. There was no definition of "bare shell" in the Lease or any other contractual document between the parties.

The Landlord argued that the Tenant was obliged to restore the premises to the original layout as identified in the floor plans annexed to the Lease, to the extent permitted by the general building plans approved by the Building Department. The Landlord argued that this was the case whether or not the Landlord had served any written notice upon the Tenant calling for reinstatement; but as a fallback, the Landlord argued that it had in fact given valid notice under the Lease to trigger the Tenant's obligation to reinstate the premises as per the Landlord's requirements.

The Tenant's position was that its obligation to yield up and reinstate was limited to a state that was "unfurnished or undecorated without fixtures, fittings or furniture". The Tenant refused to reinstate the premises as per the Landlord interpretation of "bare shell", and as a result of the

Tenant's refusal, the Landlord withheld the deposit, as well as the rent, rates and management charges that had been overpaid by the Tenant.

The Court ruled in favour of the Tenant.

Key clauses in the Lease

Both clause 3.27 and clause 13 of the third schedule of the Lease related to the tenant's obligations to yield up and reinstate. The Court was of the view, although the wordings of these clauses were slightly different, that both clauses had similar effect.

For ease of presentation and reference, the Court dissected the content of clause 3.27 of the Lease into the following constituent parts:

> "*To yield up the Premises in a 'bare shell' good clean state of repair and condition (fair wear and tear latent inherent structural defects not caused by the act or default of the Tenant excepted) at the expiration or sooner determination of this Agreement in accordance with the stipulations herein contained*
>
> *Provided That the Landlord reserves the right subject to not less than 9 months' prior written notice being given by the Landlord to the Tenant*
>
> *(i) EITHER to require the Tenant to leave all fixtures and fittings or any part thereof which have been affixed to the Premises by or on behalf of the Tenant and which have become part of the Premises (except trade fixtures and fittings which the Tenant may remove subject to making good all damages caused by the removal thereof at the Tenant's own cost) and yield up the Premises together with such alterations fixtures and additions thereto and all additions erections alterations and improvements or any part thereof which the Tenant may have made to the Premises with or without the consent of the Landlord*
>
> *(ii) OR at the discretion of the Landlord, to require the Tenant to reinstate remove or do away with any additions, alterations or improvements to the Premises, including the Staircase, elevators, air-conditioning system and the signages (both inside or outside of the Premises) and make good all damages caused thereby in a proper and workmanlike manner at the Tenant's sole costs and expense before delivering up the Premises to the Landlord.*"

Interpretation of the Lease by the Court

The Court expressed the view that, on the plain language of the Lease, there was no express provision which imposed an obligation on the Tenant to yield up the premises as per the Landlord's interpretation.

Further, the Court was of the view that the structure of clause 3.27 and clause 13 of the third schedule supported the Tenant's interpretation. The Court found that the default position under

those clauses was that the Tenant only was required to return the premises in "a bare shell good clean state of repair and condition", subject to a right reserved to the Landlord to serve a notice requiring the Tenant to do certain things, including to leave in place all or part of the fixtures and fittings affixed by the Tenant (sub-clause (i)), or to reinstate, remove or do away with any additions, alterations or improvements to the premises (sub-clause (ii)).

Further, the Court ruled that the Landlord's interpretation lacked certainty, because there was no specification in the Lease as to the meaning either of the "original layout" or the "general building plans approved by the Building Department", and the floor plans annexed to the Lease were marked "for the purpose of identification only". The Court said that, if it was the parties' intention for the Tenant to reinstate to the "original layout", one would have expected that parties would have agreed expressly upon what was the "original layout" for this purpose. Therefore, the Court ruled that the "original layout" of the premises never featured as part of the operative terms of the Lease.

Commercial sense in interpretation of the Lease

The Landlord argued that its interpretation commercially was more sensible.

The Court pointed out that the consideration of "commercial common sense", while important as an interpretation aid, has its limits in the face of the clear and natural meaning of the contractual provisions concerned. Where the parties have used clear or unambiguous language, the court must give effect to the agreed wording apply it and cannot rewrite the agreement of the parties.

The Court considered it to be important that, where used in the Lease, the phrase "bare shell" always was prefaced by the indefinite article "a". The Court held that the meaning of 'a' bare shell state was not ambiguous. The Court held further that the effect of the Landlord's interpretation was to rewrite the relevant clauses in the Lease as imposing upon the Tenant an obligation to return or yield up the premises in "the" pre-lease bare shell state, i.e. replacing the indefinite article "a" with the definite article "the".

The Court expressed the view that whether the Landlord's interpretation made better commercial common sense would be dependent upon factors including the prevailing market rent at the time of the Lease, and whether the Tenant had paid as part of the package to the Landlord any premium for the right to do the fitting out works without any need of reinstatement to the pre-lease state in the absence of notice. However, the Court pointed out that there simply was no evidence before the Court on either of these matters. The Landlord's argument based on commercial sense therefore was rejected by the Court.

Validity of notice actually given by the Landlord

Sub-clause (ii) of clause 3.27 and clause 13 of the third schedule of the Lease reserved upon the Landlord a right to serve a notice of not less than nine months, requiring the Tenant to reinstate, remove, or do away with any additions, alterations or improvements to the premises. The Landlord

served on the Tenant three letters respectively dated 2 December 2016, 12 December 2016 and 26 January 2017 to require the Tenant to carry out reinstatements works prior to the return of the premises on 11 May 2017, i.e. the date of termination of the Lease. It was obvious that these letters were given with less than the required nine months' notice. However, the Landlord argued that these letters did constitute valid notices under sub-clause (ii), because one should look not to the form of the letters but rather to the "commercial reality" and therefore that a reasonable recipient of these letters should be taken to have understood that the Tenant was required to effect the reinstatement works within nine months from the dates of issue of the letters.

The Court rejected the Landlord's argument, and held that none of the Landlord's letters constituted a valid notice to trigger the Tenant's obligation under sub-clause (ii) to reinstate the premises as per the Landlord's instructions set out in these letters.

Conclusion

This case reminds landlords and tenants that, in respect of the obligation to yield up and reinstate, the very first port of call must be the terms of the lease. Just like any other kind of contract, it is important to ensure the lease accurately reflects the agreement between the parties. Prior to the signing of the lease, legal advice should been taken to ensure that the parties are on the same page and have reflected the intended bargain clearly in the lease they are about to sign.

RELATED CAPABILITIES

- Litigation & Dispute Resolution
- Healthcare & Life Sciences
- International Arbitration
- Real Estate
- Construction Disputes

MEET THE TEAM

Glenn Haley

Co-Author, Hong Kong SAR

glenn.haley@bclplaw.com
+852 3143 8450
