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Insights

FRUSTRATION AND RENT ABATEMENT IN COMMERCIAL LEASES – HONG KONG COURT RULES ON THE IMPACTS OF COVID-19 PANDEMIC

Mar 09, 2022

More than two years into the COVID-19 pandemic, anecdotal reports are that there have been many disputes between landlords and tenants about how the pandemic might affect the tenant's payment obligations. Tenants reportedly have sought to take refuge in arguments such as (a) alleged frustration of the tenancy agreement and (b) triggering of the rent abatement clause.

A recent Hong Kong SAR decision *The One Property Limited v The Swatch Group (Hong Kong) Limited* (HCA 268/2021) and *Silvercord Limited v The Swatch Group (Hong Kong) Limited* (HCA 269/2021) ([2022] HKCFI 362, 8 February 2022, heard together) considered some of these defences but the defences were rejected by the Court.

BRIEF FACTS

The Tenant (as Defendant) had entered into two separate tenancy agreements with respective Landlords (as Plaintiff) for Premises in large shopping arcades. The Tenant defaulted on payments of rent under both tenancy agreements. Both Landlords accepted the Tenant's breach and terminated the tenancy agreements.

The Landlords applied against the Tenant for summary judgment in respect of the claims for rent arrears and loss of rent.

The Tenant raised the following defences and argued that its payment obligations were discharged and/or suspended:-

a. Frustration of the tenancy agreements as a result of the 2019 Social Unrest and the COVID-19 Pandemic;

b. Rent abatement based on the rent abatement clauses in the tenancy agreements; and/or

c. The Landlord's failure to mitigate its losses.

(A) FRUSTRATION

The Tenant's case on frustration

The Tenant argued that the Social Unrest and the Pandemic were events that "*so radically and fundamentally changed the nature of the outstanding rights and/or obligations … that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances*".

The Tenant alleged that the common purpose between the parties of both tenancy agreements was "*the Premises would be operated as luxury watch retail stores*". The bases for this alleged common purpose as asserted by the Tenant were (a) the restriction of user clauses which provided the Premises should only be used as a first class shop for the display and retail sales of watches and accessories and (b) other clauses which required the Premises to be fitted out to the standard of a first class shopping and commercial centre.

The Tenant argued that the alleged common purpose had been frustrated by the Social Unrest and Pandemic, both being extraordinary circumstances.

The Court's decision on frustration

The Court said there was no suggestion that the Premises could not be used to display and sell luxury watches as a store. Instead, the real complaint was that the Premises were no longer commercially viable to so operate. Therefore, in determining the minimum scope of the common purpose in order for the Tenant successfully to claim frustration, the Court added "*commercially viably*" to the Tenant's formulation of the common purpose, i.e. "*the premises would be commercially viably operated as luxury watch retail stores*".

The Court said "*[t]o say that commercial viability of the business on the Premises is part of the common purpose of the tenancy agreements is another way of saying that both parties agreed to take risks over the lack thereof*". Given the Landlords had no control whatsoever over the Tenant's business, the Court said it was difficult to see how the Landlord could be taken to have agreed to bear such risks. As a matter of contractual risk allocation, the risk regarding lack of commercial viability of business had been placed entirely on the Tenant (not the Landlord).

To support its argument that the Landlords did have an interest in the business venture on the Premises, and thus, the viability of the Tenant's business was the Landlords' concern, the Tenant pointed to the fact that the rent was a minimum basic rent, plus an uplift based on turnover. The Court disagreed that such an inference could be drawn. In fact, the minimum basic rent arrangement indicated that the risk was placed squarely on the Tenant in case its business failed. Further, the Court was unaware of any legal doctrine in this context which suggested that, insofar as the landlord is to take the benefit of an upside (i.e. to participate in profits if the business flourishes), the landlord correspondingly must bear the detriment of the downside.

Based on the above analysis, the Court ruled that it was not able to say that there was, as alleged, a relevant common purpose in the tenancy agreements, i.e. "*the Premises would be commercially*

viably operated as luxury watch retail stores". The Court held that the Tenant's defence of frustration on the doctrine of failure of common purpose failed.

(B) RENT ABATEMENT CLAUSES

The rent abatement clauses

The rent abatement clauses in the tenancy agreements read as follows:-

a. The ONE tenancy agreement

> "*If the Premises or any part thereof are rendered* ***unusable or inaccessible*** *by closure order or building order issued by the Government, fire lightning explosion storm tempest flood earthquake bursting or overflowing of water tanks apparatus and pipes impact aircraft and articles dropped therefrom riot civil commotion labour disturbances and malicious damage and* ***such other events beyond the control of the Landlord and as may be determined by the Landlord*** *the Rent and Service Charges or a part thereof proportionate to the extent to which the Premises shall have been so rendered unusable or inaccessible shall abate and ceased to be payable from the month following the happening of the events mentioned hereinabove until the Premises shall have been again rendered* ***fit for use and accessible****…*" (emphasis added)

b. Silvercord tenancy agreement

> "*If the Premises or any part thereof are rendered* ***unusable*** *by an Insured Risk the Rent reserved hereby and Service Charges or a part thereof proportionate to the extent to which the Premises shall have been so rendered* ***unusable or inaccessible*** *shall abate and cease to be payable until the same shall have been again rendered fit for use and accessible…*"
>
> "*[The Tenant covenants:] To keep the Portions of the Building insured…against loss or damage by fire, lightning, explosion, storm, tempest, flood, earthquake, bursting or overflowing of water tanks apparatus and pipes impact aircraft and articles dropped therefrom riot, civil commotion, labour disturbances and malicious damage and* ***such other risks as may be determined by the Landlord*** *(each of which risks being referred to in this agreement as "****an Insured Risk****")…*" (emphasis added)

The Tenant's case on rent abatement

The Tenant argued that the Pandemic fell under the catch-all phrases in these rent abatement clauses, namely:-

a. The ONE tenancy agreement: "*such other events beyond the control of the Landlord*"; and

b. Silvercord tenancy agreement: "*such other risks*".

In arguing for the application of the rent abatement clauses, the Tenant had to deal with previous case law, which tended towards the view that matters such as the Social Unrest and the Pandemic not falling within such clauses. A number of the earlier cases had dealt with rent abatement clauses that contained the phrase "destroy or damage", which only applied where there was physical damage. In addition, there was a recent Hong Kong decision of *Vember Lord v The Swatch Group (Hong Kong) Limited* [2022] HKCFI 279, which the tenant needed to try to distinguish.

In the recent case of *Vember Lord*, although the rent abatement clause did not contain the phrase "*destroy or damage*", but the Pandemic still was ruled as falling outside the rent abatement clause. The Court's reasoning was:-

a. That rent abatement clause provided that the extent of abatement was to be determined by the landlord.

b. If that rent abatement clause was intended to apply to pure economic loss, it would be difficult to see how the landlord, which is not privy and has no access to (sensitive and confidential) financial information of the tenant's business conducted at the premises, would be in a position to determine extent of abatement.

c. Therefore, the Court held that that rent abatement clause did not cover pure economic loss.

The Tenant attempted to distinguish the present case from *Vember Lord* by alleging that the rent abatement clauses in the present case did not provide that it was for the landlord to determine the extent of abatement.

The Court's decision on rent abatement

Insofar as the The ONE tenancy agreement was concerned, the Court's view was that the Pandemic was an event beyond the control of both parties, not only of the Landlord, and therefore the Pandemic was not the kind of event which was contemplated by the rent abatement clause, which as noted above referred to "*such other events beyond the control of the Landlord*".

Further, the Court referred to DHCJ Le Pichon's dicta in *Vember Lord* that, although a rent abatement clause may not refer expressly to "destroy" or "damage", "*a common thread running the entire provision is that the triggering event is something that affects the premises themselves, impinging on their use and/or accessibility*".

The Court was of the view that the expressly listed events in the rent abatement clause all related to inaccessibility or destruction or damage of the premises. Applying the *ejusdem generis* (of the same kind) principle, the Court held that the catch-all phrases (a) "*such other events beyond the control of the Landlord*" and (b) "*such other risks*" were limited to the types of events or risks which were "*tied in with*" the inaccessibility, destruction or damage of the premises. In contradistinction, it would not

include "*pure economic risks divorced from*" inaccessibility, destruction or damage of the premises, such as the Pandemic.

The Court agreed with the Tenant's point that the rent abatement clauses in the present case did not provide that if the clause applied then it was for the Landlords to determine the extent of abatement. However, the Court ruled that this difference did not assist the Tenant. The rent abatement clauses in the present case and *Vember Lord* all provided that the extent of abatement would depend on "*the extent to which the Premises shall have been so rendered unusable or inaccessible*". Such drafting militated against the application of the rent abatement clause to pure economic loss. The Court said that construing the rent abatement clauses as covering pure economic loss would depart from issues affecting the Premises, render an exponential increase of uncertainties of the assessment of the abatement, and thus, be "*inherently unattractive*".

Based on the above reasons, the Court held that the Pandemic was not a relevant event and/or risk which fell within the rent abatement clauses.

The Court's disposition on the Landlord's application for summary judgment on liability

Since the Tenant's defences of frustration and the rent abatement clause had not been established, the Court granted summary judgment on liability against the Tenant.

(C) THE LANDLORDS' ALLEGED FAILURE TO MITIGATE

It was common ground that a significant portion of the sum claimed by the Landlords against the tenant related to damages in relation to (a) the loss of rent after the Premises had been delivered up, and (b) the Landlords claiming that they had been unable to rent out the Premises despite efforts.

The Court said the issue of mitigation in this case was not clear cut. On the one hand, the Landlords' claims for loss of rent covered a period of up to ten months, which, in the Court's view, could not be described as "normal" for prime retail premises. On the other hand, as indicated in the Tenant's defence of frustration, the relevant very unsettled period in the retail industry could not be described as "normal".

Wing Siu v Goldquest International Ltd (No.2) [2002] 4 HKC 420 is authority for the view that whether or not in the circumstances a plaintiff had acted reasonably, is not something that is easily decided on a summary basis. Reasonableness is a matter of degree and in the absence of cross-examination or full discovery, this often is not capable of determination at the application for summary judgment stage.

Therefore, in the present case, the Court refused to give summary judgment on quantum insofar as they related to unliquidated damages, including loss of rent and fees payable. The Court granted

summary judgment only on the liquidated sums claimed with interest, with unliquidated damages to be assessed.

BCLP COMMENTS

For commercial landlords and tenants affected by the Pandemic, the first step is to review the terms of the tenancy agreement and to consider whether there are any available remedies or relief under the contractual provisions and common law doctrines.

Each tenancy agreement is different and legal advice should be sought. However, in general, the landlords and the tenants should consider the following before alleging frustration of the tenancy agreement and or the triggering of the rent abatement clauses:-

a. Does the tenancy agreement provide for a common purpose between the parties? If yes, has that common purpose been frustrated by the extraordinary circumstances?

b. Does the tenancy agreement provide for rent abatement? If yes, have the events listed in the rent abatement clauses been triggered?

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