CAN COVID-19 BE AN ESCAPE DOOR FOR A COMMERCIAL LEASE? RISK ALLOCATION IN TIMES OF UNCERTAINTY.

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Risk is integral to running a business. The recent decision in Sunbroad Holdings Ltd v A80 Paris HK Ltd and Another reaffirms the significance of risk allocation under a commercial lease, in the context of the unprecedented outbreak of COVID-19 in Hong Kong since 2020.

The dispute arose out of the early termination of the lease of a ground floor store situated in Causeway Bay, in the vicinity of one of the busiest shopping districts in Hong Kong. The landlord of the store commenced two actions to recover rent in arrears over different but consecutive periods from the first defendant, the tenant, and the second, a guarantor of the tenant. The tenant belongs to an established group in the business of retail of beauty and hair products, possessing over 80 physical stores covering key locations in Hong Kong, Singapore and Macau, renting the retail store for selling beauty and hair products.

The landlord and the tenant entered into the lease in August 2019, where the store was let for a fixed term of three years. The lease contained no break clause for the tenant to terminate it. There was also an express term in the lease that the landlord was entitled to elect not to terminate the lease in the event of the tenant's default.

The outbreak of COVID-19 resulted in the implementation of social distancing measures and, from February 2020, the tenant defaulted on the rent, ceased to operate the store and communicated to the landlord that it could not perform its obligations under the lease in the prevailing circumstances. After rounds of failed negotiations, the landlord commenced HCA 735/2020 on 21 May 2020 for inter alia arrears of rent from 1 February 2020 until 20 May 2020 in a total sum of around HK$1 million. The landlord then applied for

summary judgment or alternatively interim payment of 50% of the amount claimed. The master granted the defendants an unconditional leave to defend and ordered the defendants to make an interim payment, though both parties appealed.

In July 2021, the tenant returned the keys to the store, but the landlord stated that it did not accept the tenant's repudiation and that the lease was still valid and binding. The following month, the landlord commenced HCA 1174/2021, claiming inter alia further arrears of rent from 21 May 2020 until 31 July 2021 in a total sum of around HK$4.5 million, and applied once more for summary judgement in HCA 1174/2021.

In November 2021, some 20 months after the tenant's exit from the store, the landlord informed the defendants that the lease was terminated as a result of the latter's ongoing repudiation and abandonment of the store which the landlord accepted.

The appeals in HCA 735/2020 and the summary judgment application in HCA 1174/2021 were heard together, where the court allowed the appeal by the landlord in HCA 735/2020 and granted summary judgment in favour of the landlord in both actions. The central issue is whether the impact of the pandemic constitutes frustration of the lease (the frustration ground) and, as an alternative defence, whether it is reasonable for the landlord to refuse to accept the tenant's early termination of the lease such that the landlord was not obliged to mitigate its loss upon the tenant's repudiation (the mitigation ground).

For the frustration ground, the court, applying National Carriers v Panalpina (Northern) Limited, endorsed the trite common law principles on frustration of contracts. It held that frustration takes place only when there supervenes an event which so significantly changes the nature of the outstanding contractual rights or obligations from what the parties could reasonably have contemplated at the time of its execution so that it would be unjust to hold them to the literal sense of the stipulations in the new circumstances. Frustration cannot be lightly invoked to relieve the contracting parties of normal consequences of (imprudent) commercial bargain or commercial risk unless a common purpose could be said to have been frustrated by the most extraordinary circumstances which render the performance of a contract impossible.

The court went on to rule that COVID-19 has not fundamentally or radically changed the nature of the lease (i.e. letting and possession of the store) that exceeded the parties' reasonable contemplation at the time of entering into it. Putting the tenant's case to the highest, the impact of the pandemic would at most lead to a reduction of the profitability of the business of the tenant, which does not suffice in frustrating the lease.

In addition, it has been within the tenant's knowledge at the time of signing the lease that there was no escape clause. The court pointed out that the tenant's commercial standing should allow the making of a considered decision to choose the store suitable for its purpose and also to commit itself to a fixed-term lease without a break clause.

In the same vein, the court disagreed that force majeure would assist the tenant's case. The crux of force majeure is whether the premises is unfit for use as a result of destruction or damage for causes beyond the control of the landlord and not attributable to the act or default of the tenant. In other words, unless a certain event renders the performance of the contractual obligations of the parties impossible, a mere lack

of commercial viability or profitability is plainly distinguished from force majeure.

Turning to the mitigation ground, the court upheld the position that an action for rent in arrears is one for an agreed sum as a debt, and that the landlord does not have a duty of mitigation. This is subject to the restrictions where the innocent party requires the defaulting party's cooperation to perform, or the innocent party has no legitimate interest in performing the contract, rather than claiming damages in which the court would decline to grant the remedy of an agreed sum (White & Carter v McGregor).

The court, applying Reichman v Beveridge, observed that instances of a court denying an innocent party's entitlement to maintain the contract in force and to sue for the contract price are limited. They would be where an election to keep the contract alive would be wholly unreasonable and where damages would be an adequate remedy. The burden of proving that it was wholly unreasonable for a landlord to hold onto the lease is on the defaulting tenant. This heavy burden is not discharged merely by showing that the benefit to the innocent landlord is small compared to the loss to the defaulting tenant.

The court would readily find the commercial parties to have made an informed commercial decision in entering into the lease, and emphasised the cardinal principle that the innocent party is not bound to accept repudiation of a contract, especially when such right is clearly spelt out in the contract itself. On the evidence, it is not wholly unreasonable for the landlord not to terminate the lease given the lukewarm retail market brought about by the pandemic. Should the landlord elect to terminate the lease, there is a likelihood that it has to commit to a potentially lower rent than that under the lease for a substantial term with any replacement tenant. If the court were to accept that the landlord had the duty to accept early termination of the lease, this would have unjustifiably reversed the allocation of the risk in the commercial decision in committing to the lease term and the terms of the lease from the tenant to the landlord.

What can we learn from the circumstances and potential outcomes of these examples? That contracts are all about risk allocation. Hong Kong courts have consistently held parties liable for what had been agreed at the contract stage. So, commercial parties, in the course of contractual negotiation, should make it clear as to who bears the risk in times of unforeseen situations.

In the absence of a break clause for a tenant in a lease, a landlord is generally entitled to affirm the contract and to sue for an agreed sum of arrears of rent in the event of the tenant's default of rent. Practically, unless the tenant can show that the landlord engaged in conduct such as deliberately turning down an existing replacement tenant who was ready and willing to enter into a lease for at least the remainder of the term of the lease at a comparable level of rent, it appears that argument on the "unreasonableness" on the part of the landlord in affirming the lease in the event of the tenant's default is rather insurmountable.

Francis Chung acted for the defendants in this case. The CFI's judgement can be accessed here.