

## LEASING

### An Overview of Hong Kong Leasing Law and Practice (Commercial Premises)

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#### Introduction

This Memorandum contains an overview of the law relating to leasing in Hong Kong, together with some comments on leasing practice and typical clauses/amendments found in leases in Hong Kong. It is written from the perspective of a tenant of commercial premises.

#### Landlord's land interest

All land in Hong Kong is owned by the state of the People's Republic of China and is managed by the Government of the Hong Kong Special Administrative Region pursuant to the Basic Law of Hong Kong. The landlord will usually hold the land under a lease from the Government (although the grant document itself may have a different name, for example, Conditions of Sale). Government leases are, nowadays, usually granted for a term of 50 years although longer terms used to be granted. For most occupational leases, the length of the Government lease is unlikely to be a problem. This system of land holdings is protected under the Basic Law until 2047.

#### Registration

Land registration in Hong Kong is not a guarantee of title. It is a deeds registry, with registration conferring priority in the order that documents are registered. This is, however, subject to the important caveat that a document will have priority according to its date provided that it is registered within 30 days of its completion. This means that a search will not necessarily show all documents having priority, and there is no concept of a priority search. A search should however be undertaken to ensure, so far as possible, that the purported landlord is the registered owner; that no mortgagee's consent is required; and that there are no other subsisting and competing leasehold interests.

Leases of 3 years or less at a rack rent do not need to be registered in order to have priority over later interests and to bind purchasers of the landlord's interest. However, if such a lease contains an option to renew, the option to renew must be registered in order to bind a purchaser from the landlord and have priority and other interests. This point is often missed and is a common way for options to renew to be rendered unenforceable in the event of a sale of the building.

A lease of more than 3 years does need to be registered to have priority and bind third parties.

The current registration fee is HK\$210, and the cost of registration is usually shared between the landlord and tenant with the landlord's solicitor taking responsibility for registering the lease.

It has become something of a trend for landlords to insert a confidentiality obligation in leases which prevents its registration. This is of particular concern to tenants where the building may be sold or mortgaged in the future (and some buildings are at a greater risk of this than others) for in these circumstances a lease that exceeds three years or contains an option would not be binding on the purchaser or mortgagee.

#### Mortgagee consent

If the land search reveals that the land is subject to a mortgage, the consent of the mortgagee should be obtained to the grant of the lease. If consent is not obtained (and is required under the terms of the mortgage) then the mortgagee will not be bound by the lease and could sell the property free of the lease in the event that it exercised its power of sale following a default by the landlord under the mortgage. The mortgagee would be under no obligation to refund the deposit. Sometimes consents given are generic or vague, and it is

important to ensure that the consent covers the specific transaction.

## Stamp duty

Leases in Hong Kong bear ad valorem stamp duty according to the length of the term. If stamp duty is not paid, substantial penalties will accrue and an unstamped document cannot be relied on in court. The Land Registry will not accept unstamped documents for registration, meaning that priority may be lost.

Payment of stamp duty is commonly shared between the landlord and tenant, with the landlord's solicitor taking responsibility for stamping the document.

Please refer to the Appendix for the current rates of stamp duty.

## Lease negotiations

Generally, leases in Hong Kong tend to be more landlord friendly than might be the case in other jurisdictions, with landlords often being reluctant to negotiate (this does of course vary depending on market conditions, the identity of the landlord and tenant, and the amount of space being taken).

An offer to lease will often be expressed to be binding. A binding offer letter will be specifically enforceable (and any deposit paid subject to forfeiture if the lease is not completed) and so a tenant must be careful to ensure that it does not become unwittingly bound. An offer letter should be expressed to be subject to contract (unless, for example, the tenant expressly wants the parties to be bound in order to secure the premises whereupon the letter should be reviewed to ensure that it is binding).

If a tenant is required to pay a deposit on signature of an offer letter, this should be expressed to be repayable if the parties are unable to reach agreement on the terms of the lease.

Another point to note is that an offer letter will often seek to oblige the tenant to enter into the landlord's standard form lease (often without the landlord providing a copy of it prior to signature of the offer letter). A tenant should not agree to be bound by the standard form until the lease has been reviewed by the tenant's legal team.

Even if the offer letter is not binding, the tenant would be well advised to ensure that all major or non-standard terms have been included (such as options to renew) as it becomes much

more difficult to introduce these during the actual lease negotiations.

Note also that restrictions may often be contained in related documents such as the landlord's fitting out guidelines, and these should also be reviewed.

## Licences and side-letters

It is common for licences and side-letters to be granted collateral to the lease, but there are risks associated with these – see below.

Licences are usually granted for two reasons:

- To disguise the true market rent in order to create favourable comparables within the landlord's portfolio - the landlord may want to grant part of a rent free period or other incentives by means of a licence of the premises for a period prior to the term commencement date.
- To grant rights over areas such as roofs, lifts and car parks, the intent here being for the landlord to retain control of the areas in question. The same result could be achieved by way of an easement granted in the lease itself but landlords in Hong Kong are reluctant to consider this and prefer to proceed by way of a licence.

Whether or not a licence is really a licence or a lease is a matter of fact (and does not turn on the name given to the document) and depends largely on whether or not exclusive occupation has been given of the space in question. If the document is a true licence, there are various consequences of which the tenant should be aware and for which the tenant's legal advisors should draft appropriately:

- A licence does not bind third parties, as it is a contractual right and not an interest in land. Therefore any successor in title to the landlord's interest will not be bound by it. A tenant should include in the licence an obligation on the landlord to ensure that any successor in title gives a direct covenant to the tenant to be bound by the licence. If a direct covenant is not given and the successor terminated the licence granted, the tenant would be left with a contractual claim in damages against the previous landlord (which might not be worth much) and no right to use the space in question.
- A licence does not enjoy rights of relief against forfeiture. If there is a breach, the licensor will usually be able to terminate the licence and the licensee will have no right to have the licence reinstated. The licence should therefore contain an express right to be notified of

the breach and an opportunity to remedy the breach within a defined time-frame.

- The existence of a licence means that care must be taken with any rent review (usually in the context of a renewal). Works are often only disregarded from a valuation perspective if they are carried out during the term of the lease. Where the works are carried out under a pre-occupation licence, care needs to be taken to ensure that they are not inadvertently rentalised on review.
- Whether the terms of a licence are to be taken into account on a rent review should also be especially considered.

A side-letter may be entered into where the lease is registrable and the landlord is prepared to agree a concession to one tenant which it does not want to become public knowledge. Rights granted by way of side-letter may be very important, but an unregistered side-letter would not bind the landlord's successors in title. See above for steps which can be taken to partially mitigate this risk.

### Premises under construction

Landlords are often very reluctant to commit to premises being available by a particular date, and will often provide that the tenant is obliged to take up the lease upon being given a limited number of days' notice. This may not be enough time for the tenant to line up its fit out contractors to enable it to make the most of its rent free period.

Provisions relating to the standard and quality of the works are often limited, as are the tenant's remedies. The landlord will usually reserve to itself extensive rights to change the layout of the building, which may impact on matters such as footfall.

If the tenant is taking premises in a building which is under construction, the documentation should be reviewed carefully.

### Term, security of tenure and options to renew

Leases of retail premises in Hong Kong are usually quite short, often being for no more than 3 years (with an option to renew for a further 3 years). There is no security of tenure, meaning that a lease may only be renewed if there is a contractual option to renew contained within the lease. See above regarding registration of the option.

The option to renew is therefore important. In addition to registration, other points to watch out for include the following:

- Landlords will often try to restrict the period within which the option can be exercised (e.g. not more than 7 months and not less than 6 months prior to the lease expiry date). A tenant should try to amend this because time is of the essence when it comes to serving an option notice – if the notice is served outside the relevant period the option will not have been validly exercised.
- A landlord will also try to make the exercise of the option dependent on the tenant not being in breach of the covenants in the lease as at the expiry of the term. Even the smallest breach could frustrate the exercise of the option. A tenant should always look as a minimum to provide for "material" or "substantial" breach.
- The rent payable under the renewal lease will usually be expressed to be the open market rent. If the parties are unable to agree the rent, the matter may be referred for expert determination or occasionally arbitration. There are a number of issues to consider in any rent review, and the rent review clause should be carefully reviewed by the tenant's legal advisors in the context of the particular transaction (see below).

### Payments under the lease (excluding management fee)

Rent is usually payable monthly in advance without the tenant being entitled to make any set off or deduction, including in respect of any breach of the lease by the landlord.

For a retail lease, a turnover rent will often be payable over and above a basic rent.

Rent reviews usually occur at the end of the first 3 years of the term.

The tenant is usually responsible for the payment of rates. Rates are levied quarterly at 5% of the rateable value of the property. Rateable value is an estimate of the annual rental value of the property at a designated valuation reference date, and upon a statutory hypothesis which includes the assumption that the property was then vacant and to let.

Government rent is usually paid by the Landlord, who should also be responsible for outgoings of a capital or non-recurring nature.

Interest is usually charged on late payments.

VAT or GST is not applicable in Hong Kong.

## Rent Review

Particular care should be taken with regard to the rent review clause, for the impact of agreeing to a rent review on the wrong valuation basis can be significant.

Rent will invariably be reviewed on the basis of a hypothetical letting between a hypothetical landlord and tenant on the review date. Unless there is an express provision to the contrary, the hypothetical lease will be deemed to be on the same terms of the actual lease and the premises will be deemed to be in their condition as at the review date. This may have unforeseen consequences and it is therefore usual for certain matters to be assumed or disregarded.

Particular attention should be paid to the deemed condition of the premises, the deemed terms of the hypothetical lease, the effect of the tenant's occupation of any part of the building and inducements and concessions available in the market.

Generally rent review clauses in Hong Kong are both upwards and downwards.

## Management fee, services and exclusions of landlord's liability

The tenant will be expected to pay a management fee and an air-conditioning fee (the air-conditioning fee may be a separate amount or may be included in the management fee). The initial amount of the fee will be specified in the lease, but the landlord will reserve the right to increase the fee – this is often expressed to be in the landlord's discretion, and a tenant should look to try to achieve at least some limitations on the landlord's right to increase. Landlords often agree that the service charge shall be applied at the same rate for all tenants in the building.

If services or air-conditioning are required out of hours, there will be an additional charge.

There is often a lack of transparency regarding the management fee and there is no right for the tenant to receive copies of the management accounts.

Leases in Hong Kong also do not ordinarily contain a detailed list of services which the landlord is obliged to provide (and may not even oblige the landlord to keep the building in repair) and to the extent that there are any obligations on the landlord there are often also wide-ranging carve outs and exclusions of

liability. Although it may be possible to negotiate some obligations (e.g. relating to repair), a tenant should not expect to negotiate a substantial list of services. Tenants often take comfort from the identity of the landlord and the fact that a building is well managed, but it should be remembered that this may not always be the case as the landlord may sell the building in the future.

## Obligation to fit out, alterations and reinstatement

The tenant will usually be under an obligation to fit out the premises.

Many of the rules relating to fit-out will often be contained within the landlord's fit out guidelines, and these should always be asked for and examined by the tenant prior to signature of the lease in order to ensure that the tenant can comply with the requirements. The lease should always be stated to prevail in the event of any inconsistency.

The tenant will usually be obliged to use the landlord's nominated contractors when carrying out works which connect into the building services. Such contractors are likely to charge a price which is above market and a tenant should build this into its costings. The tenant should seek to ensure that any electrical, air-conditioning or telecommunication works carried out solely within its own premises and also its general building works can be carried out by its own contractors.

As a matter of Hong Kong law, the landlord is under no obligation to act reasonably when considering any application made under the lease. It is therefore important to try to build the concept of reasonableness into the lease in all cases where the landlord's approval is required. Although landlords may be prepared to agree to this in certain cases, they will not usually be willing to provide reasons for any refusal.

The tenant will usually not be entitled to make alterations and if structural works are envisaged this should be expressly provided for.

The reinstatement clause should be looked at carefully in the context of the works being carried out by the tenant. In particular, the landlord often has the option to retain tenant's fixtures and fittings and a tenant will usually want to ensure that the tenant has the right to remove such items.

Depending on the nature of the works being carried out, other consents may be required, for example, from the Buildings Authority.

## Signage

The tenant will usually have the right to have signage on the directory board of the building.

Any other required signage rights should be clearly set out in the lease, and the landlord will usually expect to be able to approve (with no obligation to act reasonably) the location, size and form of the tenant's signage. Any changes to the signage would also require the landlord's consent. Again, a requirement for the landlord to act reasonably should be built in. Some landlords may also be prepared to agree to permit changes to signage in line with the tenant's corporate signage from time to time.

If the tenant is to be granted signage rights on the exterior of the building, the tenant's legal team should check that ownership of the exterior wall is vested in the landlord (this may not be the case in some multi-owned buildings). The treatment of such signage rights on rent review should also be considered

## Alienation

Alienation (including assignment and subletting) is generally prohibited, although it is usually possible to negotiate group sharing provisions.

In addition, the lease will usually prohibit change of control. If this is likely to be an issue for a tenant, it may be possible to agree some amendments with the landlord.

The clause may also prohibit a change of business name. Landlords may be prepared to negotiate around this to lessen the restriction.

## User clause

The lease will invariably contain a restrictive user clause with no ability to change the use. In addition to the lease, restrictions on use may also be found in the Government lease, any Deed of Mutual Covenant of the building, the Occupation Permit and the Outline Zoning Plan. The Landlord will not give any warranty that the building can be used for the permitted use, and so these matters should be checked by the tenant's legal team.

## Keep open/trade

In the case of retail premises, the lease will usually oblige the tenant to keep open and trade between specified hours. The landlord may reserve to itself the right to change those hours in its absolute discretion.

## Landlord's right to alter the common parts

The landlord will often reserve to itself wide-ranging rights to alter or redevelop the common parts with no payment of compensation to the tenant. This may be particularly relevant for a retail tenant where changes to the common parts may impact the footfall past the premises.

## Landlord's sale and redevelopment clause

Leases in Hong Kong will often contain a clause entitling the landlord to terminate the lease on giving 6 months' notice (without payment of any compensation to the tenant) in the event that the landlord sells or resolves to redevelop the building.

It may be possible to negotiate an exclusion of this clause (and this is best discussed at heads of terms stage), or at least to provide that it cannot be exercised within a certain period.

If it is not possible to exclude the clause, the tenant's legal advisors should carefully review the clause to make it as limited as possible, e.g. to exclude the landlord being able to trigger the clause by selling the property to a related group company.

## Termination for breach and relief from forfeiture

Leases in Hong Kong typically contain rights for the landlord to forfeit the lease for non-payment of rent, breach of covenant and certain events of insolvency. Section 58 of the Conveyancing and Property Ordinance (Cap.219) sets out some of the procedures relating to forfeiture, and provides a right for the tenant to apply to the court for relief against forfeiture other than in the case of non-payment of rent. Such relief may be granted or withheld in the court's discretion, having regard to all the facts and circumstances. If the breach has been remedied, it is likely that relief would be granted although relief is generally only granted once.

## Deposits and guarantees

It is usual for the tenant to pay a deposit equal to 2-3 months' rent, rates and management fee (and sometimes more in the context of retail premises). In the event of an insolvency of the landlord, the tenant will be an unsecured creditor in the landlord's liquidation. Where there is a large deposit, a tenant may wish to negotiate the provision of a rent guarantee

instead of a deposit. Provision of a rental guarantee instead of a deposit should always be discussed at the heads of terms stage as it is not that common.

The landlord's standard form lease will often provide that on a sale the landlord may transfer the deposit to its successor in title. It has been held as a matter of law that the obligation to repay a deposit is a personal covenant which does not run with the land. Therefore if the landlord sells the building, there is no obligation on the landlord's successor in title to repay the deposit and (if it does not do so) the tenant is left with a claim against the previous landlord who might be difficult to locate or not have the money. As such, the tenant should ensure that there is an obligation on the landlord to procure (prior to any transfer of the deposit) that a direct covenant is provided by the incoming purchaser to hold and repay the deposit in accordance with the terms of the lease.

## Indemnities

The lease will usually contain extensive indemnities requiring the tenant to indemnify the landlord against loss or damage (whether property damage or third party claims) deriving from:

- the tenant's act or default;
- any part of the premises which the tenant is obliged to repair;
- machinery, plant, fixtures, fittings, wiring and piping which the tenant is obliged to repair; or
- fire, smoke, fumes or water coming from the premises (even if not originating there).

Where there is an indemnity in relation to a contractual breach, the landlord does not need to rely on the law of damages in order to claim against the tenant. Landlords may sometimes be prepared to agree some limitations to the indemnity language to bring it more in line with the law of damages.

## Conclusions

Leases in Hong Kong tend to be more landlord friendly than might be the case in other jurisdictions. The extent to which it is possible to negotiate the points referred to above depends on the state of the market and also the identity of the landlord, with some landlords being more reasonable than others. A tenant is advised to take a pragmatic approach, but it is

worthwhile negotiating key points. A properly drafted heads of terms can be very helpful.

Corporate real estate and leasing advice forms one of the core elements of Cordells' practice. For full details of these services please see our website: [www.cordells.com.hk](http://www.cordells.com.hk)

### Legal Notices

This Note does not constitute legal advice and you should not take, or refrain from taking, any action as a result of it. No responsibility can be taken for losses arising out of any such action or inaction. Always seek advice from a solicitor in respect of any legal issue which you may have.

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## Appendix

Stamp duty is calculated at rates which vary with the term of the lease as follows:

Term		Rate
Not defined or is uncertain		0.25% of the yearly or average yearly rent
Exceeds	Does not exceed	
	1 year	0.25% of the total rent payable over the term of the lease
1 year	3 years	0.5% of the yearly or average yearly rent
3 years		1% of the yearly or average yearly rent
Key money, construction fee etc. mentioned in the lease		4.25% of the consideration if rent is also payable under the lease. Otherwise, same duty as for a sale of immovable property
Duplicate or counterpart		\$5 each

Notes:

1. The yearly rent/average yearly rent/total rent has to be rounded-up to the nearest \$100.
2. Where the stamp duty calculated includes a fraction of \$1, round-up the duty to the nearest \$1.