The Frustration Doctrine and Leases: Lessons from the Hong Kong COVID-19 Litigation

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Abstract

Despite the immense impact of COVID-19 on the business environment, the Hong Kong (HK) courts did not find room for the operation of the frustration doctrine. While all the reported HK cases involved leases, they offer valuable lessons on the theoretical basis of frustration and how the 'radical change in nature of obligations' test is critically concerned with characterising the nature of the bargain. Beyond their precedential value, the decisions point to the limits of contractual construction and the need to recognise the role of legal policy in exercising what is in effect judicial risk allocation when applying the doctrine of frustration.

Keywords: frustration, COVID-19, contract law, change of circumstances.

1 Introduction

The COVID-19 pandemic was truly an epic event of a lifetime. No corner of the world was spared. Borders were shut in order to contain the virus. As air travel came to a sudden halt, so too business travel and travel for leisure. Governments mandated social distancing to break the virus transmission. Work-from-home arrangements became the new norm. With that came new consumption patterns as usual customers in the central business districts emptied their offices in compliance with the precautionary health measures.

The disruption was tremendous. Events were cancelled. Travel was rendered virtually impossible. Supply lines were disrupted. Hong Kong's quarantine and other health measures to deal with the pandemic were probably one of the most stringent in the world. The common law doctrine of frustration was created precisely to deal with the impact of unforeseen supervening events on contracts. One would have expected that the operation of the doctrine of frustration in these circumstances. While there are about seven judicial decisions dealing with the question whether frustration operated to discharge contractual obligations strongly impacted by COVID-19,[1] the frustration argument failed in all the cases. All the cases involved lease agreements.

This raises interesting questions. If, given the severity of the impact on economic life, courts do not find room for frustration to operate, is the doctrine a sterile one? This article engages with this question and argues that frustration is not a sterile doctrine. A proper understanding of the theoretical basis of the frustration is necessary to discern the circumstances in which the common law is prepared to apply the doctrine. We will see why, while there might be a drastic change in the context of performance, courts might nonetheless find no frustration. 'Justice' is a relevant consideration to the operation of frustration. However, whether 'injustice' is an independent factor, or one intimately connected with the bargain and the risk allocation, makes a difference to how it is worked out. *How* it is relevant is important. This points to the theoretical premises of frustration, which are likely to be different from the doctrines found in the civil law tradition.

The HK cases demonstrate how the frustration doctrine should be properly conceptualised and understood. They offer valuable lessons on the critical importance of contract characterisation, that is, the nature of obligations assumed by the parties – for this is material to whether the supervening event impacts on the nature of the obligations. The article will also discuss the role of values in shaping the exercise of contract interpretation. These are not normally fully articulated in the judgments, but, as we shall see, these are of no small moment. In adopting a particular interpretative position, a judge is implicitly embracing certain policy values. This article argues for a more transparent articulation of these policy values. At heart, the characterisation of the nature of the obligations has embedded within it the question: does the nature of the obligation admit consideration of the circumstances in which they are to be performed? This is a question of the construction of the contract. This leads to the further question whether the obligations amount to absolute liability obligations,

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1 *The Centre (76) Ltd* v. *Victory Serviced Office (HK) Ltd* [2020] HKCFI 2991; *Sunbroad Holdings Ltd* v. *A80 Paris HK Ltd* [2021] HKCFI 1422, on appeal *Sunbroad Hldgs Ltd* v. *A80 Paris HK Ltd* [2022] HKCFI 2251 [2022] 6 HKC 155; *Holdwin* v. *Prince Jewellery & Watch Company Ltd* [2021] HKCFI 2735; *Vember Lord* v. *The Swatch Group* [2022] HKCFI 279, [2022] 2 HKC 349; *The One Property* v. *Swatch Group (Hong Kong) Ltd* [2022] 1 HKLRD 975; *Wharf Realty Limited* v. *Abebi Limited* [2022] HKCFI 2036. Available from https://www.hklii.hk.

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or, if they are strict liability in nature, what are the limits? It is suggested that greater analytical clarity might be achieved to recognise that there might also be a normative dimension to construing the nature of the lease obligations. That is, in interpreting typical lease obligations strictly, they are no longer interpreting the parties' intentions but are attributing risks to be associated with the lease obligations. Materially, there can be legitimate policy reasons which account for the strictness of the interpretation.

A candid consideration of the policy reasons leads to a more satisfying explanation of the outcomes. It provides direction to the risk attribution exercise and provides guidance on how to characterise the legal obligations the parties have assumed. In particular, the extent to which one values the security of the transaction feeds into how strict the obligations are to be interpreted.

2 The test for frustration and its theoretical underpinnings

The origins of the doctrine of frustration at common law may be located in *Taylor* v. *Caldwell*,[2] in which the destruction of the concert venue by an accidental fire was held to discharge the contract between the venue provider and the renter. Consequently, the venue provider could not be sued for failing to provide the promised venue. The notion of frustration has expanded since *Taylor* v. *Caldwell*. Beyond the impossibility of performance, the doctrine has also been applied to subsequent illegality,[3] the failure of the common purpose[4] and where changes in the context of performance discharge the contract.[5]

The theoretical basis for frustration has also evolved over time. The initial justification was premised on implied terms, that is, what the parties would have provided for in the contract had they considered the contingency.[6] The basis is problematic for several reasons. First, there is a logical incoherence in projecting how the parties would have provided for an event which is unforeseeable.[7] Second, if any provision had been made, one is likely to see more nuanced provisions for the contingency rather than the categorical provision for the discharge of all contractual obligations.[8] Other justifications – 'justice'[9] and 'foundation of contract'[10] – have not found much traction.[11] The most commonly cited basis today is the 'radical change in obligations'. However, textbooks typically present *frustration* as an umbrella term covering distinct circumstances in which the common law has been prepared to regard the contract as discharged.[12] This manner of presenting frustration is consistent with the common law tradition of categorising precedents and reasoning by analogy. This downplays the debates over the theoretical basis, but, in doing so, it still does not provide a holistic explanation of what animates the operation of the doctrine of frustration. As we shall see, the HK judicial decisions dealing with COVID-19 and frustration provide material by which to enrich our theoretical conception of frustration.

The 'radical change in obligations' test has long been embraced by the HK courts.[13] The most commonly cited formulation is that provided by Lord Simon in *National Carriers Ltd* v. *Panalpina (Northern) Ltd* ('*Panalpina*'):[14]

> Frustration of a contract takes place when there supervenes an event (without default of either party and for which the contract makes no sufficient provision) which so significantly changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time of its execution that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances; in such case the law declares both parties to be discharged from further performance.

This, in turn, is an elaboration on the earlier dictum of Lord Radcliffe in *Davis Contractors Ltd* v. *Fareham Urban District Council*, from which the test derives its name:[15]

> [F]rustration occurs whenever the law recognises that without default of either party a contractual ob-

2 (1863) 3 B & S 826 (Contract 'subject to an implied condition that the parties should be excused in case … performance becomes impossible from the perishing of the thing': at 833-4).

3 *Fibrosa* v. *Fairbain* [1943] AC 32.

4 *Krell* v. *Henry* [1903] 2 KB 740.

5 *Wong Lai-Ying* v. *Chinachem Investment Co Ltd* [1980] HKLR 1, at 10: '[P]erformance radically different from that which he originally undertook'; *Shenyin Wangou-APS Management Pte Ltd* v. *Commerzbank (South-east Asia) Ltd* [2001] 3 SLR(R) 108, applying *Davis* v. *Fareham* – below, n. 10.

6 As articulated by Lord Loreburn in *Tamplin* v. *Anglo-Mexican Petroleum Products Co Ltd* [1916] 2 AC 397, at 403, '[I]f parties made their bargain on the footing that a particular thing or state of things would continue to exist … a term to that effect will be implied.'

7 *Davis Contractors Ltd* v. *Fareham Urban District Council* [1956] AC 696, at 728, *per* Lord Radcliffe.

8 *Denny, Mott & Dickinson* v. *James Fraser* [1944] AC 265, at 275, *per* Lord Wright.

9 Below, n. 20.

10 *Tatem* v. *Gamboa* [1939] 1 KB 132, 138, *per* Goddard J. What amounts to foundation of contract remains a question of construction. For this reason, the House of Lords preferred the construction theory proffered in *Davis* v. *Fareham*: *National Carriers Ltd* v. *Panalpina (Northern) Ltd* [1981] AC 675, at 687-88, *per* Lord Hailsham.

11 *British Movietonews Ltd* v. *London and District Cinemas Ltd* [1952] AC 166.

12 E. Peel *(Treitel) The Law of Contract*, 15th ed. (2020) ch. 19, in particular [19-001]. Cf. *Chitty on Contracts* which presents the categories as susceptible to a general test: *Chitty on Contracts*, 35th ed. (2023), at 27-009-27-017.

13 *Wong Lai-Ying* v. *Chinachem Investment Co Ltd* [1980] HKLR 1, at 7 (Privy Council); *Jan Albert (HK) Ltd* v. *Shu Kong Garment Factory Ltd* [1990] 1 HKLR 317, at 322 and 323 (Court of Appeal); *Ng Chun Kong* v. *First Star Development Ltd* [2007] 3 HKLRD 281, at 32-33 (Court of Appeal).

14 [1981] AC 675, at 700. All the COVID-19-related judicial decisions cited in footnote no. 1 in this article refer to *Panalpina* without qualification.

15 [1956] AC 696, at 729. For an example of how it was applied to find frustration, see *Alliance Concrete Singapore Pte Ltd* v. *Sato Kogyo (S) Pte Ltd* [2014] 3 SLR 857, at 34-35.

> ligation has become incapable of being performed because the circumstances in which performance is called for would render [the contractual obligation] a thing radically different from that which was undertaken by the contract. *Non haec in foedera veni*. It was not this that I promised to do … There must be … such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for. (emphasis added)

Lord Simon's formulation has the advantage of being less abstract. It elaborates on what radically different obligations entail. It involves examining the nature of the contractual obligations contemplated at the time of the execution of the contract and asking whether the performance in the new circumstances involves a radical change from the contracted obligations.

Chitty on Contracts characterises the exercise as one involving the 'construction of the contract'.[16] It proposes that the scope of the contracted obligation depends on 'the court's estimate of what performance would have required in time, labour, money and materials'.[17] This is then compared with the obligation in the new circumstances to determine whether the new obligation is involves a 'radical' or 'fundamental' change from what was contracted.

Materially, the inquiry is not whether the supervening event has rendered it unfair to insist on performance. It is important to avoid such a misdirected inquiry. Such an inquiry is effectively an inquiry into whether the more onerous circumstances of performance have rendered it unfair to insist on performance. Under such a conception, the focus is on the impact of the supervening event on the burden of performance. This may be the intuition underlying the notion that a supervening event having significant impact on the context of performance should lead to performance being excused. But that is not the inquiry under the frustration doctrine. Instead, the focus must necessarily be on the nature of the bargain the parties have made. While the test involves considering the impact of the changed circumstances, the inquiry is whether performance under the changed circumstances would be a performance of a bargain different from what they had concluded. The inquiry turns on whether the court would be enforcing 'a different bargain'.

Underlying frustration is necessarily the prevention of injustice.[18] This must necessarily be the reference point against which a decision is to be measured.[19] However, the 'injustice' that Lord Simon referred to in *Panalpina* is not a freestanding consideration. Indeed, such a notion has been repeatedly rejected.[20] Instead, it is the injustice of holding a party to a contract which performance under the changed circumstances would involve enforcing a different bargain from what was agreed. In *The Sea Angel*, Rix LJ cautioned that there is a risk that allowing frustration to operate might reverse the contractual allocation of risk; one needs to be conscious that doing so in such a circumstance would be *against* the interest of justice.[21] Hence, the risk allocation critically impacts on the injustice of holding the parties to the contract.

3 Diving deeper into 'radical change in obligations'

The 'radical change in obligation' test is not an intuitive one. The nature of obligation, as we shall see, involves a characterisation exercise. The radical change examination is, at its core, an inquiry into whether requiring performance in the new circumstances would amount to enforcing a different bargain from what the parties contracted. If a more intuitive label is preferred, the radical change in obligation test might also be referred to as 'a different bargain' test.

Discerning the 'nature of the obligations' requires the adjudicator to pick out the material features of the bargain. 'To pay $X in rent per month' and 'to pay $X in rent per month (given foreseeable risks)' are different characterisations and can yield different outcomes under the frustration doctrine. The first characterisation conceives the payment obligation in absolute terms; it is difficult to see how even a drastic change in the operating circumstances can radically change the nature of the obligation. By contrast, the second characterisation reads in a premise that contract contemplates the assumption of foreseeable risks; frustration is not foreclosed when unforeseeable risks arise.

The nature of an obligation is closely intertwined with the outer limits of the obligation. In a contract for the hire of a performance venue, is the hirer still required to pay if the venue is destroyed by a fire? If one agrees to

16 *Chitty on Contracts*, 35th ed. (2023), at 27-014.

17 *Ibid.*

18 *Eridania SpA* v. *Rudolf A Oetker (The Fjord Wind)* [1999] 1 Lloyd's Rep 307, at 328-9.

19 In the words of Rix LJ in *Edwinton Commercial Corporation* v. *Tsavliris Russ, The Sea Angel* [2007] 2 All ER Comm 634, at 111-12:
'What the "radically different" test, however, does not in itself tell us is that the doctrine is one of justice, as has been repeatedly affirmed on the highest authority. Ultimately the application of the test cannot safely be performed without the consequences of the decision, one way or the other, being measured against the demands of justice. Part of that calculation is the consideration that the frustration of a contract may well mean that the contractual allocation of risk is reversed.... If the provisions of a contract in their literal sense are to make way for the absolving effect of frustration, then that must, in my judgment, be in the interests of justice and not against those interests. Since the purpose of the doctrine is to do justice, then its application cannot be divorced from considerations of justice. Those considerations are among the most important of the factors which a tribunal has to bear in mind.'

20 *Notcutt* v. *Universal Equipment Co (London) Ltd* [1986] 1 WLR 641 (CA), at 647, *per* Dillon LJ ('justice' is not a further factor). *Eridania SpA* v. *Rudolf A Oetker (The Fjord Wind)* [1999] 1 Lloyd's Rep 307, at 328-9, *per* Moore-Bick J (the 'demands of justice' should not be taken to suggest a more liberal approach than would be indicated by Lord Radcliffe's speech. This is consistent with the House of Lords' rejection of the invitation to interpret contractual obligations narrowly to do what is 'just and reasonable' in the circumstances: *British Movietonews Ltd* v. *London and District Cinemas Ltd* [1952] AC 166, 185.

21 *Eridania SpA* v. *Rudolf A Oetker (The Fjord Wind)*, above, n. 18.

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pay for the right to watch a parade from a specific location, does the obligation to pay persist if the parade is cancelled? The question relating to the nature of the obligation forms the overarching inquiry under which to consider the multiple factors articulated in *The Sea Angel* for determining whether there is frustration:[22]

- 'the terms of the contract itself, its matrix or context'
- 'the parties' knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of the contract, at any rate so far as these can be ascribed mutually and objectively'
- 'the nature of the supervening event' and
- 'the parties' reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances'.

These are all matters which are relevant to how the risks should be distributed in a contract. Parties have assumptions about the usual circumstances in which they expect to perform their undertakings. The risks which impact on the burden can range from the more immediately foreseeable to the more remote. The parties may have made express provision on the allocation of the risks. Alternatively, one may be able to infer the allocation of risks through the technique of implied terms. However, risk allocation and assumption go beyond the parties' contractual provision. It extends to the more amorphous 'parties' knowledge, expectations, assumptions and contemplations … as at the time of the contract … so far as these can be ascribed mutually and objectively'. Rix LJ's dictum is nuanced on the nature of the exercise that the adjudicator is engaging in:[23]

> [C]ontracts are about the allocation of risk, and since the allocation and assumption of risk is not simply a matter of express or implied provision but may also depend on less easily defined matters such as 'the contemplation of the parties' … the test of 'radically different' is important: it tells us that the doctrine is not to be lightly invoked; that mere incidence of expense or delay or onerousness is not sufficient; and that there has to be as it were *a break in identity between the contract as provided for and contemplated and its performance in the new circumstances*.

Frustration involves a value judgment by the adjudicator on the proper risk allocation and when the contract should no longer be binding, taking into account first, the parties' provisions, and, second, the nature of the contract and the circumstances in which it was concluded. There are policy values at stake, as revealed by the caution against lightly invoking the doctrine and the insufficiency of 'mere incidence of expense or delay or onerousness'. These point to an inclination to uphold the continued applicability of the contract. For frustration to be found, what is required is a determination that requiring performance in the changed circumstances would in effect be enforcing a different bargain.

22 *Ibid.*, at [111], *per* Rix LJ.

23 *Ibid.*

4 A contrast with the Civil Law (of the People's Republic of China)

It is apposite at this juncture to make a comparison between frustration and the equivalent civil law doctrines under the law of the China, the country to which Hong Kong belongs. The exercise serves to accentuate what the frustration is not and does not do. Even as there are superficial similarities between HK law and Chinese law, the comparison demonstrates how, despite the possibility of similar outcomes, one should not expect congruency in outcomes.

At first impression, the scenarios covered by the frustration doctrine are also covered by PRC Civil Code. Article 590 (*force majeure*) applies where there is inability to perform due to '*force majeure*', which is defined as 'objective conditions which are unforeseeable, unavoidable and insurmountable'.[24] The result is the discharge of civil liability.[25] In both scope and effect, this broadly maps the instances of frustration like *Taylor* v. *Caldwell* where the subject matter is destroyed and performance is rendered impossible.[26] However, whereas frustration pertains to the discharge of a contract, *force majeure* under Article 590 permits the discharge of the affected obligations without necessarily discharging the whole contract.

Where *force majeure* impacts on the purpose and renders it unachievable, Article 563(1) applies. An affected party has an option to terminate the contract; the consequence is therefore somewhat different from an application of frustration. Article 563(1) covers a case like *Krell* v. *Henry*,[27] which incidentally has almost always been distinguished rather than applied.[28]

Article 533 sets out the 'change-of-circumstances' doctrine.[29] Article 533 operates where 'a fundamental con-

24 PRC Civil Code, Art. 180. The PRC Civil Code (English version), as provided by the State Council of the People's Republic of China. Available from https://www.trans-lex.org/601705/_/civil-code-of-the-peoples-republic-of-china-/.

25 Art. 590.

26 *Fibrosa* v. *Fairbain*, above, n. 3.

27 [1903] 2 KB 740 (contract to rent in Pall Mall to watch the coronation parade of Edward VII frustrated when the parade was postponed due to the King's ill health).

28 Distinguished almost immediately in *Herne Bay Steam Boat* v. *Hutton* [1903] 2 KB 683. There has been little inclination to applying the notion of frustration of purpose. See, for example, *Maritime National Fish Ltd* v. *Ocean Trawlers Ltd* [1935] AC 524, at 529; *Amalgamated Investment Property* v. *John Walker & Sons Ltd* [1977] 1 WLR 164, at 176; *North Shore Ventures Ltd* v. *Anstead Holdings Inc* [2010] EWHC 1485 (Ch), at 307-12]; and more recently, *Canary Wharf (BP4) T1 Ltd* v. *European Medicines Agency* [2019] EWHC 335 (Ch). In the context of COVID-19 litigation, it is no surprise that HK courts found grounds not to apply frustration: *The One Property* v. *Swatch Group (Hong Kong) Ltd* [2022] 1 HKLRD 975.

29 The codification of the change-of-circumstances doctrine took place with the enactment of the PRC Civil Code on 28 May 2020. (Commencement

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dition upon which the contract is concluded is significantly changed' and insistence on the original terms will be 'obviously unfair'. This echoes Article 313 of the German Civil Code ('circumstances which became the basis of the contract have significantly changed…').[30] Article 533 stipulates that the change must be 'unforeseeable' and must not be one of the 'commercial risks'. If Article 533 applies, the adversely affected party may seek renegotiation. If no agreement is reached, the court is empowered to rectify or rescind the contract. The key to the operation of the change-of-circumstances doctrine lies in discerning what constitutes a fundamental condition of the contract. Like the 'radical change in obligations' test, it involves a construction of the contract. However, the inquiry is somewhat different in its nature. The above discussion shows that while there may be some similar facets– for example, in the need to interpret the contract and the risks involved – it cannot be assumed that they operate similarly. Significantly, the effect of the supervening event varies according to the applicable doctrine under PRC law. Whereas *force majeure* results in relief from civil liability, the change-of-circumstances doctrine sets the threshold for the court's power to adjust the contract. By contrast, the consequence of frustration operating is a discharge of the contract, which operates automatically from the time of the supervening event. The consequence is consistent with the concluded bargain having reached the outer limits and no longer having effect. The terrain covered by frustration broadly maps onto at least three provisions in the PRC Civil Code, each with distinctive elements and consequences. While some similar outcomes may be observed, one would not necessarily expect the common law's 'radically change in obligation' test to yield similar outcomes from applying the above doctrines under the PRC Civil Code.[31]

5 Frustration by operation of law

Frustration is a doctrine by operation of law.[32] Frustration goes beyond the parties' actual and presumed intentions. The law prescribes the principles by which to determine the scope of frustration, including: what amounts to self-induced frustration which will bar the operation of the doctrine[33] and whether foreseeability should be a bar to frustration. These speak not only to the limits of the doctrine but also to its theoretical premises. As to whether foreseeability should operate as a bar, there are numerous judicial dicta supporting the notion that frustration cannot apply where the event is foreseen or a foreseeable event.[34] The authorities are not, however, uniform. In *W J Tatem LTD* v. *Gamboa*,[35] the onset of the Spanish Civil War was held to frustrate the thirty-day charter of a vessel hired for the purpose of evacuating the civilian population from North Spain. The principal holding in the case was: it was not foreseeable that the vessel would be detained way past the thirty-day period of the charter. Nonetheless, Lord Goddard went further to say that as the subject matter of the contract was destroyed, frustration followed 'whether or not the event causing it was contemplated by the parties'.[36] In *The Eugenia*, Lord Denning MR also doubted the existence of any such bar: 'The only thing that is essential is that [parties] should have made no provision for it in the contract.'[37]

Much as a bright-line rule will enhance the certainty of the law, the best that can be said is that the more foreseeable an event, the more unlikely that frustration will be found.[38] Indeed, a bright-line rule was never possible. In *Taylor* v. *Caldwell*, the supervening event was the accidental fire which destroyed the concert venue. Accidental fires have been with mankind even before the dawn of civilisation. They are inherent risks in any built-up environment. Yet, it was not an issue in *Taylor* v. *Caldwell*.

What it comes down to is whether the law is prepared to allow for the operation of frustration when an event is foreseeable. It may be that in certain situations, the law applies an approach akin to a penalty default rule;[39]

date was 1 January 2021.) The codification followed a process of judicial development of over twenty years which culminated in Art. 26 of the Judicial Interpretation II Concerning the Application of the Contract Law of the Supreme People's Court. For a discussion of the prior jurisprudence, see Chen and Wang, 'Demystifying the doctrine of change of circumstances under Chinese Law – a comparative perspective from Singapore and the English common law' [2021] JBL 475.

30 The German Civil Code (English version), as provided by German Federal Ministry of Justice and Consumer Protection. Available from www.juris.de. For a comparative account of the change of circumstances, see R.A. Momberg Uribe, *The Effect of a Change of Circumstances on the Binding Force of Contracts: Comparative Perspective* (Intersentia, 2011).

31 One notable feature found among the Chinese commentators and judges is the emphasis on the balance of the bargain. See, for example, ZHU Guangli, 'Systematic Thinking on the System of Change of Circumstances' (2) *Law Science Magazine*法学杂志) 3-8, at 1 (2022); (Judge) ZHOU Hengyu, 'Important problems relating the Change of Circumstances' (关于《民法典》情势变更制度的若干重要问题) (6) Zhongguo Yingyong Faxue (中国应用法学) 201-2, at 194 (2022).

32 *Davis* v. *Fareham*, above, n. 10, at 723.

33 *Maritime National Fish Ltd* v. *Ocean Trawlers Ltd* [1935] AC 524; *J Lauritzen AS* v. *Wijsmuller BV (The Super Servant Two)* [1990] 1 Lloyd's Rep 1.

34 *Tamplin* v. *Anglo-Mexican Petroleum Products Co Ltd* [1916] 2 AC 397, at 424; *Davis* v. *Fareham* [1956] AC 696, at 731; *The Hannah Blumenthal* [1983] 1 AC 854, at 909; *Gamerco SA* v. *ICM* [1995] 1 WLR 1226, at 1231.

35 *Tatem* v. *Gamboa*, above n. 10.

36 *Ibid*., at 138.

37 [1964] 2 QB 226, at 234.

38 In the words of Marcus Smith J in *Canary Wharf* v. *European Medicines Agency* [2019] EWHC 335, at 211, foreseeability is a factor which 'informs the parties' knowledge, expectations, assumptions and contemplations, in particular as to risks'.

39 I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules', 99 *Yale LJ* 8 (1989). The authors' conception of penalty default rule involves either rules which do not align with the parties' expectations or create an undesirable outcome unless they are

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namely, the parties are expected to make provision for the foreseeable event which has unpleasant consequences. Failure to do so will mean the risk will lie where it falls. The penalty default approach works well when a risk is salient and should have been provided for, but was not. Where the risk is a more remote one, parties may reasonably determine that the bargaining costs are not worthwhile. Parties are in effect leaving to the law to determine how the risk which has occasioned should be fairly dealt with. A categorical approach precluding frustration whenever the supervening event was foreseeable would involve the adoption of a default penalty even where parties would rationally save on the time and expense; there is a risk of injustice insofar as the holding the contract nonetheless binding in the changed circumstances might involve enforcing a different bargain from what they had agreed. Embedded in the issue whether a foreseeable event should prevent the operation of frustration is a value judgment. A similar value judgment operates when the actualised risk in question is beyond the parties' actual and presumed intention – the law performs the task of allocating the risk, whether the risk is within or beyond the scope of the contract.

This implicates the underlying policy reason or value which underpins the legal principle and which provides direction to how the legal principle is applied – what might be termed 'legal policy'. It is contended that a more transparent recognition of legal policy will better explain the HK decisions dealing the impact of COVID-19 on leases.

6 The frustration doctrine in the COVID-19-related litigation in Hong Kong

In the three-year period between 2020 and 2022, there are seven judicial decisions in the HK case database which considered the operation of the frustration doctrine in relation to the impact of COVID-19.[40] A notable feature of the COVID-19-related litigation in Hong Kong is that all of these judicial decisions involved leases.[41] Insofar as a lease involves both contract law and property law, it was at one time thought that the transfer of a legal estate poses an obstacle to the operation of the frustration doctrine.[42] In *Panalpina*,[43] the House of Lords determined that no such obstacle exists and that it is possible for leases to be frustrated.

Given the tremendous impact of the COVID-19 pandemic and the regulatory measures put in place to contain the pandemic, it is at first sight surprising that the HK courts consistently held that there was no frustration. The common thread in the reasoning is that the nature of the tenant's obligation is to pay the rent and observe the terms and conditions of the agreement; given this characterisation, the pandemic does not change the nature of the obligations.[44]

Wharf Realty Limited v. *Abebi Limited*[45] is instructive for it has arguably the most sophisticated reasoning on how the nature of the obligation is characterised. The case also saliently highlights first the impact of the pandemic on the commercial spaces, and, second, the impact of the prior widespread social unrests associated with the Extradition Bill in 2019. Importantly, it explains why, despite the severe impact, there was no radical change in the obligations. The defendants in *Wharf Realty* were two tenants of distinct shop units in Ocean Terminal (Harbour City), a high-end mall popular with Mainland visitors and located on the waterfront in the shopping district of Tsim Sha Tsui. Both leases were for three years. The first lease, signed on 17 November 2017, was for the period of 14 November 2017 to 13 November 2020. The second lease, signed on 10 January 2018, was for the period of 10 March 2018 to 28 February 2021. Hence, both leases were signed before the onset of the Extradition Bill protests which began in March 2019, and certainly before the COVID-19 pandemic and the first border restrictions on 5 February 2020. The defendants started defaulting on rents from December 2019. In June 2020, the plaintiffs began to claim for unpaid rents. The decision involved an application by the plaintiffs for summary judgment. One of the questions raised was whether the defendants had an arguable defence against the plaintiffs' claim.

Summary judgment will be denied if there is an arguable defence. To assess whether there is an arguable defence, the judge proceeds on the assumption that the factual

departed from. The theory has a normative dimension – given that information sharing is necessary to negotiate around the undesirable outcome, penalty default rules serve to 'encourage parties to reveal information to each other or to third parties', at 19.

40 Above, n. 1.

41 The exception (which is not included in the present count) is *Atelier Engrg Ltd* v. *Hong Kong Interior Design & Engrg Company Ltd* [2021] HKCFI 1526. The dispute involved a renovation agreement. The frustration argument was not a serious one and was dismissed without substantive discussion. For this reason, the case does not count as a considered decision.

42 *Cricklewood Property & Investment Trust Ltd* v. *Leighton's Investment Trust Ltd* [1945] AC 221 (Lord Russell and Lord Goddard were of the view that the transfer of the legal estate rendered the operation of frustration impossible, while Viscount Simon and Lord Wright were prepared to consider the possibility). For a comparison between the English law position and the Scots law position, see Styles, 'Contracts and Coronavirus Part 2' [2020] SLT 109, at 111.

43 Above, n. 14. For a recent discussion on frustration of leases under English law, see Tanney, 'Leases and the Doctrine of Frustration' [2021] *L & T Review* 59.

44 *The Centre (76) Ltd* v. *Victory Serviced Office (HK) Ltd* [2020] HKCFI 2991, at 39; *Sunbroad Holdings Ltd* v. *A80 Paris HK* Ltd [2021] HKCFI 1422, at 62 (citing *The Centre (76) Ltd*), on appeal *Sunbroad Hldgs Ltd* v. *A80 Paris HK Ltd* [2022] HKCFI 2251 [2022] 6 HKC 155, at 36-53 (agreeing with prior decided cases); *Holdwin* v. *Prince Jewellery & Watch Company Ltd* [2021] HKCFI 2735; *Vember Lord* v. *The Swatch Group* [2022] HKCFI 279, [2022] 2 HKC 349, at 81, and agreeing with prior decided cases, at 75; *The One Property* v. *Swatch Group (Hong Kong) Ltd* [2022] 1 HKLRD 975, at 22 (citing *Vember Lord*); *Wharf Realty Limited* v. *Abebi Limited* [2022] HKCFI 2036, at 114.

45 *Wharf Realty Limited* v. *Abebi Limited*, above n. 44.

allegations made by the defendant are true. The impact on the commercial spaces is amply illustrated by two key statistical indicators. First, the decline in visitor numbers. Between February 2020 and November 2020, the decline in footfall was 91.8% while the decline in overnight Mainland visitors was 90.4%. Second, the decline in business. For the impact upon the business done, the comparisons were made against the equivalent period in the previous year. This approach takes into account the seasonal variations in the course of the calendar year. For the period August 2019 to January 2020 – the pre-pandemic period affected by the social unrest arising from the Extradition Bill – the decline in business was 61.6%. For the period between February 2020 and November 2020 – which reflects the business disruption caused by the pandemic – the decline in business was 90.7%!

The hearing for the summary judgment application was on 2 September 2021, when travel restrictions imposed by the HK government were still very much in place. By this time, both leases had expired. There was therefore no question whether there was any remaining period of the lease that was unaffected by the pandemic. Indeed, at the date of judgment – 15 July 2022 – Hong Kong had still not yet lifted its quarantine requirements for inbound travellers.[46]

Despite the significant impact on the operation of the commercial space, the judge held that defendants did not have an arguable defence in frustration and gave summary judgment for the plaintiffs.[47] To ascertain whether the parties' obligations had been radically transformed, the judge engaged in a characterisation of what these involved:

> [114] … the primary obligation of the plaintiff was to let the Premises and the primary obligation of the defendants was to operate high end children clothing shops there and pay rent and other charges.

A similar characterisation was earlier made in *The Center (76) Limited* v. *Victory Service Office (HK) Limited*,[48] where the singular focus was on the obligations that comprised the contract. There was no discussion of the context in which the obligations were to be performed or the foreseeable risk associated with the contract. The characterisation of the nature of the tenant's obligation – 'to pay rents and observe the covenants terms and conditions of the Tenancy Agreement'[49] – meant that the change in circumstances could not change the nature of the obligations.

Wharf Realty Limited is somewhat more sophisticated in its reasoning. *Wharf Realty Limited* engages with the context in which the contract was to be performed and its relation with the risks associated with the contract. The reasoning proceeded as follows. In a tenancy agreement for a retail space with a fixed rent, the tenant takes the risk of an economic downturn. Even if the rents were negotiated with common expectations over what the likely footfall and revenue were likely to be, they remain merely background expectations. They do not affect the legal obligations that have been assumed.[50] In other words, changes in the economic conditions do not impact on the nature of the legal obligations.

In the nature of a fixed rent for a retail space, it is fair to infer that the usual economic risks do lie with the tenant. This works well for the usual economic risks that one would associate with a business enterprise, for example: inflation and interest rate changes, and the ebb and flow of customer turnover. Such risks are implicitly assumed under the agreement. However, when it comes to unusual economic risks – say, a global pandemic resulting in a 90% decline in footfall in a retail space – it is more difficult to posit that the parties intended the unqualified words to be taken to their linguistic limits. All that the judge can point to in the contract is first, the payment obligation, and, second, the absence of a contractual term providing for relief. The absence of a term providing for the unforeseen circumstance may precisely be due to the parties not having provided for it. The resulting contest is between an 'interpretation' which determines that the contract subsists as long as continued performance is physically possible and not illegal and one which recognises that a contract always has a context and is prepared to admit the possibility that unforeseeable supervening event fundamentally undermines the reasons for the contract.

In the circumstance of an unforeseen event, to determine that the payment obligation subsists in the radically changed scenario is less about discerning what risks the parties have undertaken and more about judicial attribution of risks associated with that particular type of contract. One should be careful not to ascribe an interpretation of risk allocation to parties' intentions when the more accurate characterisation is judicial attribution of risk based on the type of contract made by the parties.

A good example of an interpretation of risk allocation based on parties' intentions can be found in *Salam Air SAOC* v. *LATAM Airlines Group plc*.[51] The claimant, which operated a low-cost airline based in Oman, had entered into aircraft leases for the duration of seventy-two months with the defendant airline. In the wake of the COVID-19 pandemic, the Omani authorities issued regulations initially restricting the passengers to returning

46 The relevant measures were lifted on 23 September 2022. See https://www.info.gov.hk/gia/general/202209/24/P2022092400048.htm (last visited 4 March 2024).

47 That the leases have expired means that it has become clear that the uses for which the lease was entered into could not be realised. It therefore presents the stark scenario of the lessee's being liable for the rent despite the commercial purpose of the lease being undermined by the coronavirus epidemic. Cf. *Panalpina*, above, n. 14 (the interruption of about a year out of a ten-year lease with about three years remaining after the interruption); *Cricklewood Property and Investment Trust Ltd* v. *Leightons Investment Trust Ltd* [1945] AC 221 (99-year lease with unexpired term of more than 90 years).

48 [2020] HKCFI 2881, at [39] (lease for a flexible workspace business).

49 *Ibid.*

50 *Ibid.*, at 118.

51 [2020] EWHC 2414. See a case comment, see Morgan, 'Frustration and the pandemic' (2021) 137 LQR 563.

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Omanis. A week later, all passenger flights were effectively prohibited. The claimant sought an injunction to restrain the defendant from making demands on three standby letters of credit in relation to the underlying leases of the three aircrafts. The claimant proceeded on the basis that the contracts had been frustrated by reason of the regulations issued by the Omani Public Authority of Civil Aviation, which led to a substantial decrease in demand for flying. Foxton J held that, whilst the travel industry had become 'challenging', it was not a sufficient basis for frustration, as it did not prevent either party from performing its contractual obligation. The judge took careful note of the terms of the agreement.[52] Materially, the agreement made it clear that the obligation to pay rent was expressed to be 'absolute and unconditional irrespective of any contingency whatever', including 'the ineligibility of the airport for particular use or trade',[53] and even if the aircraft became a Total Constructive Loss.[54] The lease expressly placed on the lessee 'the full risk of any … occurrence of whatever kind which shall deprive [the claimant] of the use, possession and enjoyment thereof'.[55] Given how the agreement allocated the risk between the parties, the judge held that the frustration did not operate where the lessee was prevented from employing the aircraft profitably by reason of the pandemic. The many contractual provisions dealing with how the risks were allocated between the parties provided a sound basis to rule that frustration could not operate.

The same cannot be said of the HK cases, of which *Wharf Realty Limited* is representative. The HK courts' construction of the nature of the lease obligations bear echoes of the literalism that characterises the old approach to contract interpretation.[56] Given that this has given way to the modern approach which emphasises the common sense understanding of terms and allows for a contextual understanding of the contractual language,[57] a better explanation is needed.

7 Legal policy in the construction of contract

The notion that policy motivations might explain how certain kinds of contracts are construed should not be alien. Indeed, recognising that such policy motivations exist better explains the determinations under the guise of true construction of contract. A prime example is the *contra proferentem* rule in the construction of exemption clauses.[58] This rule involves the court construing exemption clauses strictly against the *proferens*, that is, the party who drafted the exemption clause. While there may be issues concerning the operation of the rule, the pertinent observation is that a policy motivation for the rule stems from the desire of the common law to check on unfair terms that arise from exploiting one's superior bargaining position.[59] The candid dictum of Lord Denning MR from *George Mitchell (Chesterhall) Ltd* v. *Finney Lock Seeds Ltd* is apposite:[60]

> Faced with this abuse of power – by the strong against the weak – by the use of the small print of the conditions – the judges did what they could to put a curb upon it. They still had before them the idol, 'freedom of contract'. They still knelt down and worshipped it, but they concealed under their cloaks a secret weapon. They used it to stab the idol in the back. This weapon was called 'the true construction of the contract'. They used it with great skill and ingenuity. They used it so as to depart from the natural meaning of the words of the exemption clause and to put upon them a strained and unnatural construction. In case after case, they said that the words were not strong enough to give the big concern exemption from liability: or that in the circumstances the big concern was not entitled to rely on the exemption clause.… In short, whenever the wide words – in their natural meaning – would give rise to an unreasonable result, the judges either rejected them as repugnant to the main purpose of the contract, or else cut them down to size in order to produce a reasonable result.

In the United Kingdom, the enactment of the Unfair Contract Terms Act 1977[61] equipped courts with the statutory tools to check on the use of exemption clauses, especially in consumer contracts and standard-form contracts. The statute greatly diminished the need for courts to have recourse to the *contra proferentem* rule.[62] Despite dicta suggesting that the rule is losing its au-

52 *Ibid.*, at 51.
53 Clause 8.2.
54 Clause 21.3.
55 *Ibid.*, at 51.
56 *Lovell & Christmas Ltd* v. *Wall* (1911) 104 LT 85, 88.
57 *Prenn* v. *Simmonds* [1971] 1 WLR 138; *Investors Compensation Scheme Ltd* v. *West Bromwich Building Society (ICS)* [1998] 1 WLR 896.
58 The rule can be traced back to Roman law: *Oxonica Energy Ltd* v. *Neuftec Ltd* [2008] EWHC 2127 (Pat), at 90.
59 The stronghold that the freedom of contract had on the common law meant that there were few meaningful checks on the stronger party that sought to impose its will on the weaker party. Alongside the *contra proferentem* rule, the common law also required that reasonable notice be given of clauses sought to be incorporated by notice: *Parker* v. *South Eastern Railway* (1877) 2 CPD 416. This carried the implication that onerous clauses were not incorporated unless special effort was employed to bring them to the attention of the counter party: *Interfoto Picture Library Ltd* v. *Stiletto Visual Programmes Ltd* [1989] QB 433. However, this requirement of reasonable notice did not extend to clauses incorporated by signature: *L'estrange* v. *F Graucob Ltd* [1934] 2 KB 394. (Cf. Ontario, Canada: *Tilden Rent-A-Car Co* v. *Clendinning* (1978) 83 DLR (3d) 400 (onerous provisions in standard-form contract not binding on counterparty 'in the absence of … reasonable measures to draw such terms to the attention of the other party').
60 *George Mitchell (Chesterhall) Ltd* v. *Finney Lock Seeds Ltd* [1983] QB 284, 296-301.
61 c. 50. The HK equivalent is the *Control of Exemption Clauses Ordinance* (Cap. 71), which was enacted in 1990.
62 *George Mitchell (Chesterhall) Ltd* v. *Finney Lock Seeds Ltd* [1983] QB 284, 296-301; *Photo Production Ltd* v. *Securicor Transport Ltd* [1980] AC 827, at 843; *Bank of Credit and Commerce International SA* v. *Ali* [2001] UKHL 8 [2002] 1 AC 251, at 57-60 (Lord Hoffmann); *Triple Point Technology, Inc* v. *PTT Public Company Ltd* [2021] UKSC 29, at 107.

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thority, its existence is a historical fact.[63] Indeed, more recently Briggs LJ in *Nobahar-Cookson* v. *The Hut Group* reiterated the point that *contra proferentem* interpretation is not confined to exemption clauses and continues to have a role where it is difficult to resolve the ambiguity in the contractual language.[64] Importantly, the *contra proferentem* rule demonstrates the instantiation of legal policy. While there is some tension on how the *contra proferentem* rule operates alongside the modern approach to interpretation,[65] it minimally retains its utility in resolving ambiguity which subsists despite application of the modern approach to interpretation.[66]

The *contra proferentem* rule has been recast as a 'clear word rule' by Lord Leggatt in *Triple Point Technology, Inc v. PTT Public Company Ltd*: the courts will require clear words before coming to the conclusion that a party has agreed to give up a valuable right.[67] Embedded within the recast 'rule' is a legal policy leaning against a finding that a person has given up their valuable right.[68] This demonstrates how the rule was reshaped as the underlying legal policy was reconsidered. What is pertinent is how the policy rationale underpinned the *contra proferentem* rule and how the new policy rationale accounts for the clear word rule.

8 Legal policy in frustration

The HK judicial decisions demonstrate a very strong inclination to upholding the lease agreement and avoiding its discharge. There must surely be limits to the lessee's obligation to pay rent. If an earthquake destroys the mall or a change in the law renders the lease illegal, frustration is not inconceivable. The courts were in effect confronted with construing the lessee's obligation in the face of economic risks, between the obligation 'to pay $X in rent per month (regardless of economic risks)' and 'to pay $X in rent per month (given foreseeable economic risks)'. The former construction was preferred.

One is no longer dealing with risks consciously assumed by the parties. We are in the realm of risk allocation as attributed by the law to a particular type of contract. Materially, it is a risk attribution which might stem from legal policy.[69] This, it is suggested, is a better explanation of the outcomes in the HK courts. The unmistakable undercurrent in the HK cases is this: in a lease of premises simpliciter, the subsistence of the lease is not defeated by the tenant's cash-flow considerations. This finds expression in the risk allocation attributed to simple lease agreements and can be justified by considerations of legal policy. Absent provision for contingencies, the unqualified nature of the tenant's obligations will be regarded as such. Such an interpretation expresses the premium placed on the security of the lease transaction. It will also avoid the unpredictable and probably widespread knock-on effects that attend the unravelling of a category of transactions that fundamentally underpin the state of the local economy. It is a justifiable interpretation, harsh as it may be for the lessee.

One of the metrics to evaluating the state of an economy is the property price index and, related to that, the rental value of properties. Indeed, decline in the real estate market often precedes economic crisis and even recessions.[70] This accounts for the attention showered on the house-price index.[71] Property prices and rental values are intimately tied to the likely trajectory of an economy. Hong Kong is no exception.[72] The concern with property prices extends to changes in commercial property value, which can impact on investment behaviour.[73]

A determination that an event amounts to frustration and that it discharges the lease agreement can have widespread ripple effects. Many commercial spaces in malls have been repackaged as assets which comprise a

63 *Triple Point Technology, Inc* v. *PTT Public Company Ltd* [2021] UKSC 29, at 111, *per* Lord Leggatt. For a defence of the *contra proferentem* rule, see E. Peel, 'Whither *Contra Proferentem*', in A. Burrows and E. Peel (eds.), *Contract Terms* (2007) at 53.

64 *Nobahar-Cookson* v. *The Hut Group* [2016] EWCA Civ 128, at 16-19, *per* Briggs LJ. The key point is about ambiguity, and extends to the person seeking to rely on it, who does not necessarily need to have drafted the clause:
[14] … It was a rule designed to resolve ambiguities against the party who prepared the document in which the clause appeared, or prepared the particular clause, or against the person for whose benefit the clause operates (citing K. Lewison, *The Interpretation of Contracts* (5th ed., 2011), at 7.08).

65 As put succinctly by Lord Hodge in *Impact Funding Solutions Ltd* v. *AIG Europe Insurance Ltd* [2016] UKSC 57, at 6: '[Under the modern approach, the] court looks to the meaning of the relevant words in their documentary, factual and commercial context': *Rainy Sky SA* v. *Kookmin Bank* [2011] 1 WLR 2900, at 21, *per* Lord Clarke of Stone-cum-Ebony.

66 *Morris* v. *Blackpool Borough Council* [2014] EWCA Civ 1384, at 53; *Impact Funding Solutions Ltd* v. *AIG Europe Insurance Ltd* [2016] UKSC 57, at 6. *Contra*. *Burnett* v. *International Insurance Company of Hanover Ltd* [2014] CSIH 9, 2019 SLT 483 (*Contra proferentem* rule applies regardless of ambiguity. Lewison rightly doubts the correctness of this decision: K. Lewison, *The Interpretation of Contracts*, 7th ed. (2022), at 7.91).

67 *Triple Point Technology, Inc* v. *PTT Public Company Ltd* [2021] UKSC 29, at 111, *per* Lord Leggatt.

68 Another iteration of this approach is to lean against the interpretation that the risk allocation clauses fully prescribe how losses are to be borne, irrespective of the precise of scope of the parties' obligations: *Seadrill Management Services Ltd & Anor* v. *OAO Gazprom* [2010] EWCA Civ 691, at 18, *per* Moore-Bick LJ (implied duty of care and skill exists and the interpretation of the risk allocation clause must take that into account).

69 The suggestion here runs parallel to Elisabeth Peden's arguments concerning implied terms in law: Peden, 'Policy Concerns behind Implication of Terms in Law' (2001) 117 *LQR* 459.

70 E.E. Leamer, 'Housing IS the Business Cycle', in Housing, Housing Finance and Monetary Policy, A Symposium Sponsored by the Federal Reserve of Kansas City, August 2007, Jackson Hole, 2007; R.J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It* (2008); C.M. Reinhart and K.S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2009); O. Jordà, M. Schularick & A.M. Taylor, 'The Great Mortgaging: Housing Finance, Crises and Business Cycles', 31(85) *Economic Policy* 107-52 (2016).

71 See, for example, the *Economist*'s house-price indices: https://www.economist.com/.

72 'The Property Market and the Macro-Economy', *Hong Kong Monetary Authority Quarterly Bulletin* 5/2001, p. 40. Available from https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb200105/fa02.pdf.

73 T. Chaney, D. Sraer & D. Thesmar, 'The Collateral Channel: How Real Estate Shocks Affect Corporate Investment', 102(6) *American Economic Review* 2381-2409 (2012).

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Real Estate Investment Trust (REIT). The income-generating potential of the assets critically affects the creditworthiness of the bonds which the REIT has issued. The leases would be based on a common template. A determination that the pandemic frustrates a particular lease holds precedential value for other leases. This is especially so if they are short leases which remaining tenure lay within the period covered by the pandemic. By the judicial ruling, the income stream of the REIT will be dramatically reduced; more seriously, it will result in the REIT going into default.

For standalone properties, the follow-up question when the lease is discharged is: what rent can the property fetch in the current market? This leads to the further question of property revaluation. A revaluation of the property is of no small moment. If it is collateral for a loan and the collateral has fallen in value, the lender may require the borrower either to top up the collateral or to reduce the borrowing. If a borrower is unable to do so, the lender may then exercise its right to call a default.

The ruling carries precedential value for other leases. Tenants of leases covering similar periods will take the position that the lease is frustrated. Potentially, this can result in a supply surge of uncertain degree, with consequential impact on the market rentals. Tenants holding leases ending later than that found in the judicial precedent may insist on litigating the issue; at the minimum, they have some legal basis to bargain for a reduction in rental.

The potential unravelling of many leases within a short time might trigger a slide towards property devaluation in the local economy and exacerbate the already dire economic conditions arising from the much-diminished economic activity. To be sure, the slide is not inevitable, and confidence-building measures can avoid dire consequences. Nonetheless, the prospect that the judicial determination might be the trigger for an economic crisis will surely give pause to the adjudicator.

If upholding the lease agreements and avoiding their unravelling are important, this can explain the seemingly unsympathetic attitude towards the tenants – and this despite an undeniably drastic change in the circumstances in which the contract is to be performed. The lease obligations are attributed the nature of strict obligations. In commercial properties, the obligations continue despite the change in the economic conditions which might very significantly affect the income-earning capacity of the property. *A fortiori*, this applies to a residential property where the income-generating capacity of the property is not a salient feature of the contract. In the absence of features of the contract which suggest that the tenant's revenue or income stream impacts on the continued operation of the lease, the associated economic risks are borne by the tenant.

Recognising that judicial risk attribution is involved helps explain why – despite the ex facie common purpose being undermined by the pandemic in *The One Property* v. *Swatch Group (Hong Kong) Ltd*. ('*Swatch Group*')[74] – the court nonetheless found that there was no frustration. The additional feature in this lease was the stipulation that the premises were only to be operated as a luxury watch retail stores. The lessee argued that this was the common purpose of the lease; as the pandemic undermined the common purpose of the lease, the lease was frustrated. The court rejected the argument. The court held that in order for the tenant to succeed in the frustration argument, it had to establish that the minimum scope of the common purpose was that 'the Premises would be commercially viably operated as luxury watch retail stores.'[75] It reasoned that it was still possible to display and sell watches and that

> [t]he real complaint is that it is no longer commercially viable.[76] The adjudicator found that the lack of commercial viability was a risk borne by the tenant, and not a risk which was shared.[77] In doing so, it agreed with the approach taken in *Holdwin Ltd* v. *Prince Jewellery and Watch Co Ltd*, where the judge held that 'financial viability of the … business was not the purpose of the Lease.'[78]

Swatch Group and *Holdwin* have precedential value for how we approach leases with specified use, as well as a plain lease for premises. Lessors do not concern themselves with the income stream, which sustains the rental payment. The risk of commercial viability falls entirely on the lessee. This applies no matter how extreme and unexpected the economic circumstances. It matters not that the space was only to be used to sell luxury watches and that the specification achieves the landlord's purpose of a high-end mall with an ideal tenant mix.

This is no mere interpretation of what the leases in question involve. There is a strong prescriptive element: all economic risks are borne by the lessee. The normative component is suggestive of an implied term in law, that is, a term implied into particular types of contract. In common law, an implied term in law is 'based on wider considerations, [the search is] for such a term as the nature of the contract might call for, or as a legal incident of this kind of contract.'[79] While the formal test is one of 'necessity',[80] 'wider considerations' point to the policy concerns which give impetus to the implied term.[81] The concerns with unravelling lease agreements

74 [2022] 1 HKLRD 975.
75 *Ibid*., at 17 and 18.
76 *Ibid*., at 19. The finding that the operations were still possible distinguishes the case from *Lachman's Emporium Pte Ltd* [2022] SGHC 19, where the common purpose argument succeeded before the Singapore High Court. The tenancy was for premises to be used as 'pub/bar/cabaret/night club/discotheque/karaoke lounge only', the tenure to run for two years from 1 January 2020 to 31 December 2021. On the premise that COVID-19 measures rendered the premises 'no longer capable for its intended purpose', the court held that there was a triable issue whether the intended use was a commonly held purpose shared by both parties: at 11. If it was, there was the possibility for the operation of frustration. The application for summary judgment was dismissed.
77 *Ibid*., at 20.
78 [2021] HKCFI 2735, at 35.
79 *Liverpool City Council* v. *Irwin* [1976] AC 239, at 255.
80 *Ibid*., at 256.
81 Peden, above n. 69.

comport with one category of 'motivating issues' for implied terms in law identified by Elisabeth Peden – 'effect on society'.[82] Implied terms in law tend to strike a balance in the rigour of the obligation by incorporating notions of reasonableness. The HK cases could have – but did not – take a nuanced position when it came to economic risks affecting leases. It could, for example, have taken the view that the lessee assumes all foreseeable economic risks. That all the economic risks were attributed to the lessee is suggestive of the premium given to upholding the lease agreement.

Chitty on Contracts posits that in construing the nature of the obligations, the court estimates what is required in terms of 'time, labour, money and materials'.[83] The HK judicial decisions demonstrate that this exercise is context dependent. If it is an implied term in leases – that all economic risks lie with the lessee and the nature of the lessee's obligation is simply to pay rent and observe the terms of the agreement – then, the conditions which generate the revenue to pay the rent are irrelevant. Similarly, the nature of the contract determines the relevance of the different factors articulated in *The Sea Angel*. Given the aforesaid characterisation of the nature of the bargain in a lease, whether a simple lease or one with permitted activities strictly delineated, the parties' 'knowledge, expectations, assumptions and contemplations at the time of contract' will be rendered largely irrelevant by the characterisation. Given the characterisation of the contract as essentially one of rent-for-premises, 'the parties' reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances' is largely irrelevant insofar as they concern the parties' calculations as to the possibility of generating the income by which to pay the rent.

9 Conclusion

The HK litigations over the impact of COVID-19 on leases offer valuable lessons on the operation of frustration. As precedents, they inform how the common law characterises the nature of obligations in leases.[84] This characterisation determines the room for considering the new circumstances in which the obligations are to be performed. In a simple lease essentially involving rent for premises, the income-earning capacity of the premises is not the lessor's concern. The same applies for leases of commercial properties. Accordingly, the impact of COVID-19 on the footfall and business volume does not radically transform the nature of the obligations assumed.

That COVID-19 was tumultuous but did not amount to an event of frustration for leases can only be understood by a proper understanding of the theoretical underpinnings of the frustration doctrine. The focus of the doctrine on 'nature of the obligations' requires attention to the nature of the bargain. The issue is not whether the balance of the bargain has been radically altered. Rather, a radical change to the nature of the obligations requires a determination that performance in the new circumstances involves enforcing a different bargain from what the parties entered into. Doing 'justice' by frustration involves a fine-grained appreciation of the risk allocation in a contract; it is not a free-floating consideration.

The 'nature of the obligations' hints at the role of legal policy in attributing risks to the bargain entered into. This is in effect what the HK courts were engaging in, if under the guise of interpretation. This better explains cases like *The One Property* v. *Swatch Group (Hong Kong) Ltd*. Viewed as an iteration of the premise in simple commercial leases – that the lessor is not concerned with the income-generating capacity of the premises which they rented out – the result is understandable. Legal policy can have a legitimate role in interpretation, but, as with any exercise in legal reasoning, the rationalisation needs to be satisfactorily defended to be persuasive. Explicit recognition that legal policy is involved will open the way to more satisfying analysis.

82 *Ibid*., at 475.

83 Above, n. 16.

84 The precedential value of characterisation adopted does not affect the fact that 'each case is decided on its own facts': *Sunbroad Hldgs Ltd* v. *A80 Paris HK Ltd* [2022] HKCFI 2251; [2022] 6 HKC 155, at 43.

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