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PRACTICE PAPER

Enforcement against breaches of crown leases in Hong Kong industrial premises

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Abstract *This practice paper examines the current practice of Hong Kong Lands Department regarding enforcement against breaches of the "user clause" in the Crown (Government) lease. A total of 26 categories of lease drafting approaches regarding user restrictions are identified. It is argued that unless the relevant lease document expressly pins down the limit of ancillary office uses in industrial premises, as in one of the 26 categories identified, no enforcement of such uses shall be instigated.*

Purpose and disclaimer

This practice paper is written particularly for surveyors and planners who work in Hong Kong, though it is of interest to professional people who work within a leasehold land system. The paper analyses the problems of the current lease enforcement practice of Hong Kong's Lands Department regarding ancillary office uses in industrial premises. This objective is achieved with a case study by reference to the wordings of lease conditions as found in a sample of 50 lease documents, relevant law cases, and expert opinion.

This practice note is purely written for academic inquiry and professional discussion. It shall not be relied on for business purpose, investment decision or litigation purposes. There is no claim that the samples of lease documents considered below exhaust all modes of lease drafting. The author accepts no liability for the statements made in this paper. The reader is advised to seek independent legal advice about the statements made in this note if some of the points or facts are considered pertinent for investment or legal purposes.

Background

In accordance with Annex III of the *Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong* (the Sino-British Joint Declaration) and the *Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China* (the Basic law), Hong Kong's land system has remained a leasehold system since 1 July 1997. Under this leasehold

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system, private "land owners", who are in fact lessees, hold lands from the government (previously the Crown) for definite periods of time. Land uses ("user") and building forms or their restrictions are specified in the relevant lease documents, namely the "conditions of sale", "conditions of exchange" or the Crown (now "Government") Leases[1], for such lands (Nissim, 1997). As such documents specify the land use (often expressed in land documents as "user") and building restrictions or even post-development property management responsibilities are accepted voluntarily by the lessees, Lai has described the leasehold system as a system of "planning by contract" (Lai, 1998). While the effectiveness of leasehold land tenure as a "forward planning" and "development control" system is debatable (Yeh, 1994; Lai, 1998), there is no doubt that the lease document is a key component of the land use regulatory mechanism of Hong Kong.

The Lands Department is responsible for, among many other duties, the allocation, execution and enforcement of leases and the negotiation of the terms and premium for the leases. Lease conditions, being contractual, are subject to legislative restrictions. The major restrictions are those imposed by the *Buildings Ordinance* and the *Town Planning Ordinance*. Such legislative restrictions are often imposed unilaterally as post-contractual variation of the conditions specified in the lease documents. The statutory town plans, notably the Outline Zoning Plans (OZPs), prepared under s. 3(1) of the *Town Planning Ordinance*, are particularly important. Most urban lands allocated by government have become subject also to OZPs, which may take away some of the property rights specified or implied in the lease documents.

When a lessee is in breach of the conditions of the lease, the Lands Department is entitled to re-enter the land by exercising either the contractual right specified in the lease document by civil action or the exercise of its statutory powers conferred by relevant ordinances. Before such drastic contractual or statutory rights are exercised, the Lands Department will normally issue a warning letter to the lessee, stating:

- the nature of the alleged breach;
- the time before which the breach must be rectified; and
- the need for the lessee to pay a fine called "forbearance fee".

A debit note demanding payment of forbearance fees to government will follow shortly.

A very common kind of breach is the violation of the user clause of Crown Lease by the occupiers of a unit or units in a flatted factory building. The Lands Department has found many such factory units have been used for "office" purposes. From government's point of view, this amounts to a breach of the terms of the lease in so far as the office use exceeds a percentage of "usable floor space" specified in an internal set of guidelines – the *Lands Administrative Office Instructions* (LIs). This set of guidelines is a restricted government document not available to the public. In the relevant warning letter, Lands

Department often advises the lessee to "rectify" the breach by making a town planning application under s.16 of the *Town Planning Ordinance* within the context of the relevant OZP for the industrial district. Where a planning approval is granted by the Town Planning Board, the lessee needs to follow the matter up with the Lands Department by a payment of a premium for either a permanent lease "modification" or a temporary "waiver" of the lease conditions governing the user.

In Column 2 of the *Notes* to a typical OZP for an industrial zone, "office other than ancillary office" is a use that requires planning permission under s.16 of the said Ordinance. However, "existing" uses, namely those uses which existed prior to the publication in the gazette of an OZP, and uses under Column 1 of the Notes, need no permission and are tolerated by the OZP. According to the *Town Planning Board Guidelines* for industrial zones, definitions of "industrial" and various categories of "ancillary office" are given. "Ancillary office" uses exceeding a certain percentage, which was once 30 per cent (Town Planning Board, 1990) but is now 50 per cent (Town Planning Board, 1997), shall require planning permission.

While the *Notes* form a part of the OZP as a product of legislation, the said Guidelines are administrative circulars, which are meant to help interpret the provisions of the OZP. Unlike the LIs, such guidelines are available to the public. As far as provision of ancillary offices in industrial buildings is concerned, the definitions of and percentages of land tolerated for various types of industrial and ancillary office uses specified in the relevant LIs are identical to those in the *Town Planning Board Guidelines*.

As the subject under discussion is lease enforcement, one must therefore focus first of all on the wordings of the lease.

An analysis of the wordings of lease conditions for industrial premises

The author has surveyed 50 lease documents obtained from the Land Registry and identified 26 main categories of wordings in respect of user and/or building restriction clauses. These lease documents are those for a sample of land lots drawn from all existing or previous industrial districts in Hong Kong Island, Kowloon and the New Territories of Hong Kong. The sample contains examples from industrial areas developed during the Victorian period; inter world wars; early post-Second World War years, as well as in recent years. They cover locations in the old urban core of Hong Kong Island and Kowloon, New Kowloon; satellite towns; modern new towns and industrial estates. Industrial estates are managed by various Industrial Estate Corporations.

Categories of user restrictions

The general ways of drafting of each of the 26 categories of restrictions are summarised below (with the years of the "signed date" of the lease for first and last sample in square brackets):

Category I: old non-offensive trade clause (typically found in the so-called "999-year unrestricted use") [1864-1968 (6 samples)]

Category II: general industrial purposes + non-domestic building(s) clauses [1910 (2 samples)]

Category III: "similar lots" clause [1924 (1 sample)]

Category IV: specific manufacturing purposes + non-domestic building(s) + old non-offence trade clauses [1935 (1 sample)]

Category V: special manufacturing purposes + non-domestic building(s) clauses [1940 (2 samples)]

Category VI: used for a factory and no domestic building(s) clause [1948 (1 sample)]

Category VII: specific manufacturing purposes + old non-offensive trade clauses [1956 (1 sample)]

Category VIII: general industrial purposes + non-domestic building(s) + old non-offensive trade clauses [1958 (1 sample)]

Category IX: identical volume building + "similar lots" clauses [1959 (1 sample)]

Category X: general industrial/godown(s) purposes + factory building(s) clauses [1961-1985 (16 samples)]

Category XI: non-offensive industrial purposes + factory building(s) clauses [1962 (1 sample)]

Category XII: identical volume/building clause [1963 (1 sample)]

Category XIII: special manufacturing purposes and purposes of factory clauses + old non- offensive trade clause [1966 (2 samples)]

Category XIV: specific industrial purposes and factory building(s) and ancillary offices + old non-offensive trade clauses [1967 (1 sample)]

Category XV: factory building and ancillary offices and general industrial purposes + old non-offensive trade clauses [1968 (1 sample)]

Category XVI: buildings for commercial and ancillary offices and factory/factories and ancillary offices + non-offensive trade purposes + industrial user expressed to include godown, office and research facilities required to support the principal industrial undertaking clauses [1977 (1 sample)]

Category XVII: buildings for general industrial purposes and non-offensive trade purposes clauses [1980 (1 sample)]

Category XVIII: one building comprising godown(s) and ancillary offices + building for godown purpose clauses [1981 (1 sample)]

Category XIX: building(s) for general industrial purposes + non-offensive trade purposes + factory building (s) clauses [1981 (1 sample)]

Category XX: general industrial purposes + non-offensive trade purposes + factory building (s) clauses [1983 (1 sample)]

Category XXI: general industrial purposes + factory building(s) clauses [1986 (1 sample)]

Category XXII: one godown building and ancillary offices clause [1991 (1 sample)]

Category XXIII: general industrial/godown purposes + expressed provisions for ancillary offices and research facilities for industrial user + factory or factories building(s) + expressed provisions for only 30 per cent usable floor area of each factory or godown for ancillary office clauses [1994 - 1997 (2 samples)]

Category XXIV: industrial/godown purposes + bank etc. + public lorry park + expressed provision for "offices directly related to an industrial/godown operation" + non-offensive trade clause + planning permission for a "composite Industrial Office Building" [1998 (1 sample)]

Category XXV: industrial/godown purposes + expressed provision for "offices directly related to an industrial/godown operation" + non-offensive trade clause + planning permission for a "composite Office Building" + right to "submit an s.16 application under the revised Guidelines" for Application for Composite Industrial-Office (I-O) Buildings in "Industrial" zone (TPB PG-No. 4A) [1998 (1 sample)]

Category XXVI: industrial or godown + "office ancillary and directly related to an industrial or godown operation" or banks... at the lowest three floors + "offices ancillary and directly related to an industrial or godown operation" + planning permission for an "Industrial-Office building" with ancillary carpark, bank, restaurant, retail shop, fast food shop and showroom at specific floors (including basement) [1998 (1 sample)].

"Ancillary office" is expressed in six categories, XIV, XV, XVI, XXII, XXIII and XXVI.

Practice of lands department

Other than for premises controlled by Category I (i.e. "unrestricted lease") restrictions, Lands Department often instigates lease enforcement procedures for premises governed by most categories of lease documents, notably Categories VI and X. These procedures are triggered when its staff discover in their routine inspection that office activities occupy floor space in premises to

the extent that such activities occupy a total area more than the ceiling of 30 per cent usable floor space specified in the LIs within "one unit". That unit is created by strata-titling. It may have a small "gross area" or "saleable area" of 1,000 sq. feet (100m^2 approx), being one of the ten equal-size units on a floor with a gross area of 10,000 sq. feet (1,000m^2 approx). As mentioned previously, Lands Department will in this situation issue:

(1) a warning letter requiring rectification (i.e. discontinuation of the office uses) and suggesting the avenue of "regularising" the breach by obtaining a planning approval; and

(2) a debit note for forbearance fees payable. It should be noted that the planning approval is "advised" to be sought under s.16 of the Town Planning Ordinance in accordance with the relevant *Town Planning Board Guidelines* (1990, 1997).

It is submitted that only such premises controlled by a lease document under category XXIII, which provides expressly a contractual restriction of the land-take of ancillary offices to a pre-specified percentage of floor space, may attract lease enforcement under two situations. These situations are:

(1) the office use is not ancillary to any real principal or parent industrial or manufacturing activities; and/or

(2) such ancillary office use does not exceed the expressed 30 per cent ceiling specified in the lease documents.

Other than category XXIII, it is submitted that the approach adopted by Lands Department is not reasonable, other than in a situation where the office uses in question, such as a bank or a surveyor firm, are autarkic and not ancillary to any real industrial or manufacturing uses.

The reasons are that:

(1) for genuine ancillary office uses, they are indeed permitted under the terms of the lease;

(2) the provisions or ceilings in the LIs, as internal administrative documents of government, are not law or contractual terms, and hence incapable of narrowing or superseding user restrictions already contained in the lease documents; and

(3) the *Town Planning Board Guidelines* as administrative circulars may help interpret but not restrict, enlarge, add, subtract, remove or alter the items under either column of uses (Column 1 or 2) in the Notes to the OZP.

An application for "ancillary office use" under the Guidelines is arguably *ultra vires*, as that use cannot be found under either column of uses for industrial zones. This practice paper confines itself to the first reason, which is developed on the basis of the decisions of the court in two leading Hong Kong cases in the arena of lease enforcement, which were consistent with the English case of

Simmonds Aerocessories (Western) Limited v. *Pontypridd Area Assessment Committee and Another* [1944] (the *Simmonds Case*). These cases are briefly described below.

One of the leading Hong Kong cases is *Mexx Consolidated (Far East)* v. *Attorney-General* (*High Court Miscellaneous Proceedings*, No. 2421, of 1986) HKLR 1210-1220 (the *Mexx Case*). It involves the interpretation of a user covenant in the deed of variation for a site in Kowloon (Kowloon Inland Lot No. 6053). It restricted the use of the premises involved to industrial and godown purposes. The plaintiff set up and operated 11 different departments in the suit premises, which departments were responsible for the design, research, and testing of samples and also the making or patterns for the manufacturing of clothing. The Crown demanded a forbearance fee for an alleged breach of covenant: the real nature of the activities was commercial and not industrial, the primary use of the premises was a research and design office and the limited manufacturing and packing activities were subsidiary to that primary use. Deciding in favour of the plaintiff, Judge Cruden held that a broad approach to interpreting industrial activities is necessary. "All of the plaintiff's activities within the suit premises must be considered as a whole. Where it is technically possible to break down those activities into separate elements, it is still their cumulative effect and not their individual characteristics, which is more important. When this broader approach is adopted, it is clear that the research, design and testing functions are merely successive stages in one continuous industrial process, resulting in the creation of manufactured garments. . ." (Author's underlining).

In short, it was held in the *Mexx Case* that:

(1) The primary user of the premises must be industrial before compliance with the user covenant can be achieved and the cumulative effect of all the plaintiff's activities on the premises must be taken into account.

(2) The primary use of the majority of the plaintiff's departments was industrial and the remaining departments necessarily and reasonably incidental to the major departments.

The other key Hong Kong case is *Cavendish Property Development Ltd* v. *Attorney-General* [1987] (the *Cavendish Case*). The case involves the interpretation of the "type of building to be erected" per Special condition (9)(a) and the "user" per Special condition (8)(a) of an Aberdeen lot. It was held that "industrial purposes" involves a manufacturing process. The main test for considering whether the building was an industrial building was whether there was any process carried on therein for or incidental to the making of any article or part of an article. It was ruled that the test in the *Mexx Case*, referred to above, applied. If the same test in *Cavendish* is to apply to interpret the nature of a premises as to whether it is "a building" or "factory", it is argued that it should be regarded as "industrial" where the premises are used for the carrying out of industrial processes. This is still to be the case where such processes are

aided by computers or other office equipment, for or incidental to the making of manufacturing or industrial products. Examples that the author has come across include air-conditioners, watches and jewellery.

In the *Simmonds Case*, the issue was whether a canteen serving a factory is industrial or not. It was ruled that it is, because the canteen is primarily occupied and used for the purpose of a factory or workshop. In the light of this case, offices within a factory serving an industrial undertaking within the factory should also be regarded as industrial, if not "ancillary office".

In pp. 341-53 of Malcolm Merry's *Hong Kong Tenancy Law* (3rd edition) (Merry, 1997), an example of a lease clause for a factory is given:

> Clause 2(g) of the example reads: "Not to use or permit or suffer to be used the Premises or any part thereof for any purposes other than that of a factory only and not to use or permit ... parking cars."

Merry is of the opinion that this clause will "restrict the floors to factory use only. The essence of factory use is manufacturing, although any type of industrial use is probably allowed by the covenant. A limited amount of office or other commercial use may be consistent with the covenant." Note that Merry is of the opinion that "*office or other commercial use*" may be consistent with a lease term that expressly restricts uses to "factory uses". Obviously, Merry's opinion is consistent with any of the three cases cited above.

Finally, in the most recent Hong Kong Case, *Raider Ltd* v. *Secretary for Justice* [1999] (The *Raider Case*), the Court of First Instance (previously the High Court) ruled in favour of an occupant who operates a paging service in a multi-storey building controlled by an industrial lease. The service manufactured pagers and provided paging services. The Lands Department alleged that the paging activities is "office" use in breach of the lease conditions and took enforcement action, initially against "non-conforming commercial uses" and later "non-industrial use". Mr Justice Findlay granted the occupant a declaration that the occupant had not breached the terms of the lease. It was held that the term "industry" has a wide meaning, "covering a whole range of human activities aimed at making money" and is not restricted to "manufacturing"; that the term "factory" in leases refers to building control and should not be equated to "manufacturing"; and that the making of pagers was a "primary use" and the paging service an ancillary use or at least, "an ancillary office". While the ratios of this case are consistent with what is advanced in this paper, it must be noted that this decision is pending appeal to the Court of Appeal.

Problems of the lease enforcement practice of Lands Department regarding ancillary office uses in industrial premises

While there is no doubt that the leasehold land system is an effective land use control system, there are apparently, from the author's practice, four problems to which the government should pay attention and address satisfactorily before lease enforcement actions could be clearly justified. These problems are summarised and discussed below.

Contract construction: interpretation of lease terms
There is an asymmetry in power between Government and the lessee in that the former decides what is and what is not permissible under the lease. It is argued that Government should not have taken lease enforcement measures against the industrial and ancillary office uses in those premises which, on the basis of a proper construction of the relevant lease conditions in the light of expert opinion as found in the literature, leading court cases and where a careful interpretation of the industrial lease is drafted as surveyed, are in fact "industrial" and "ancillary offices", unless:

(1) the lease terms expressly restrict the percentages of the latter; and

(2) the use of the premises really exceeds those percentages. In case of ambiguity of lease terms, the benefit of doubt should be given to the lessee under the doctrine of *contra proferentem* for contract construction, given the greater power of the Government over the lessee[2].

Reasonable use of industrial premises by ancillary offices
Government lease enforcement actions often follow a restrictive approach. They may sometimes ignore the intention of legislature as expressed in statutory town plans. It is argued that no enforcement action shall be taken or continued, even where the lease contains expressed or implied terms that do not permit ancillary offices, if the actual area of ancillary office use is below the limits imposed by the Town Planning Board Guidelines. These guidelines help interpret the statutory town plans.

Lease enforcement surveys
Government lease enforcement surveys actions may sometimes appear to have departed from the approach in the *Mexx Case*. It is argued that these surveys shall be conducted in the light of the "broader approach" recommended by Judge Cruden in the *Mexx Case*. This approach suggests that enforcement inspections shall go beyond an "eye-ball judgement" of the "office appearance" of the premises inspected. It shall instead find out whether individual units surveyed in fact belong to one single user. If that is the case, then the survey shall take into account the "cumulative effect" of factory units as well as the industrial organisation and functional relationships of these units and the rest of the industrial establishment before the conclusion that the lease has been breached is made.

Conclusion
This practice paper advances the argument that there is a need to re-examine the current Lands Department's practice regarding enforcement against alleged breach of the user due to the presence of ancillary offices in certain industrial premises. The argument is backed by a case study by reference to the wordings of the user restriction terms, as found from a sample of 50 lease

documents for industrial lots and the relevant case law. It is considered that, unless the lease documents expressly pin down the amount of ancillary office uses in terms of the usable floor area, no enforcement of such uses shall be instigated or sustained.

Two important messages follow if the arguments advanced in this paper are correct:

(1) valuation of industrial lots subject to less restrictive user clauses shall make more generous allowances for the scope of ancillary office uses; and

(2) lessees wrongly enforced may wish to apply for a refund of forbearance fees because there was no "consideration" from government when it required the lessee to pay "forbearance fees".

Finally, it should be added that, in practice, a lessee subject to lease enforcement actions is entitled to discuss and clarify matters with the Lands Department. Provided that accurate and frank disclosure of information relating to the industrial and ancillary uses is provided, the Lands Department may stay or waive further action when it is satisfied that, on the facts of measurement of actual uses, the ceilings stipulated in the LIs are not exceeded; and/or the lease conditions do permit the office activities. It is therefore advisable for the lessee who is using part of their industrial premises for truly ancillary purposes, to contact and explain to the Lands Department as soon as a warning letter is received. He may also wish to retain the relevant professional people as soon as possible. The professional fees paid are often much less than the forbearance fees demanded, not to mention the costs of re-entry by Government.

Notes

1. A Crown or Government Lease is a deed. Conditions of sale are part of the contract to sell government land which, upon fulfilment of all its positive conditions, is deemed statutorily to be a Crown or Government lease, under the *Conveyancing and Property Ordinance*.
2. At common law, this doctrine or rule is reversed in favour of Crown grantor, as in *Feather* v. *R*. (1865) 6 B&S 257 and Viscountess Rhondda's Claims (1922) 2 AC 339. However, the author subscribes to the view of Lewison (1997) that it is questionable whether there is any justification of this bias towards the Crown in an ordinary commercial contract to which the Crown happens to be a party. In the case of land leasing in Hong Kong, land is generally allocated to lessees at full premium and it is doubtful whether the government after 1 July 1997 can be regarded as having the same capacity as the Crown before.

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