

Client Alert

16 March 2020

Economic Fluctuations and Reduction of Rent in connection with COVID-19

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Economic Fluctuations and Reduction of Rent in connection with COVID-19 (coronavirus disease 2019)

Issues

As the number of areas affected and of patients infected by COVID-19 keep growing, not only human safety is threatened, but economic activities are also slowing down. We understand that the number of companies facing a drop-off in sales due to COVID-19 is by no means small, especially for those in the hospitality industry, such as hotels, restaurants and event-related businesses. Many of these companies lease premises from owners and pay rents on a monthly basis, and there may be cases where the amount of the rent payable is higher than the sales revenue generated from the business conducted at the leased premises. It is anticipated that discussions between lessors and lessees regarding rent reduction may increase going forward.

This client alert explains the relevant provisions under the Act on Land and Building Leases and judicial precedents with respect to rent revision so that future discussions between lessor and lessee may go smoothly.

Article 32 of the Act on Land and Building Leases (Right of Request to Increase or Reduce the Rent)

When leasing a building, both the Civil Code and the Act on Land and Building Leases (the "Act") will apply. Article 32.1 of the Act prescribes a right for lessors to request an increase of the rent, and also a right for lessees to request a reduction of the rent as follows:

When the building rent becomes unreasonable, as a result of the increase or decrease in tax and other liabilities relating to the land or the buildings, as a result of the rise or fall of land or building prices or fluctuations in other economic circumstances, or in comparison to the rents on similar buildings in the vicinity, the parties may, notwithstanding the contract conditions, request future increases or decreases in the amount of the building rent; provided, however, when special provisions exist to the effect that building rent shall not be increased for a fixed period, those provisions shall apply.

In relation to the lessees' right to request a reduction of the rent, Article 32 of the Act is a mandatory provision, and as such this right may not be waived even if the lessee agrees to such waiver. Therefore, notwithstanding the provisions of the lease agreement, the lessee will always have a right to request a reduction of the rent, except for certain fixed-term lease agreements as described below.

The issue is, whether a lessee may exercise its rights under Article 32 of the Act in case of economic fluctuations caused by COVID-19.



The purpose of Article 32 of the Act is to provide for a party's right to request the revision of the rent to a reasonable amount from a fairness perspective, when the current rent becomes unreasonable due to changes in certain circumstances. Article 32 of the Act specifies the following factors to determine whether the current rent has become "unreasonable" or not:

- increase or decrease in tax and other liabilities relating to the land or the buildings;
- rise or fall of land or building prices or fluctuations in other economic circumstances; and
- in comparison to the rents on similar buildings in the vicinity,

Note that these are just examples and other factors that are not described in Article 32 of the Act may be considered when determining the unreasonableness of the current rent. Also, the mere presence of these factors does not necessarily imply that the aforementioned rights under Article 32 of the Act may be exercised. Judicial precedents state that the existence of a right to request a reduction of the rent, and the amount of rent deemed reasonable should be comprehensively determined referring to the factors described in Article 32 of the Act as well as the factors that the parties took into account when they determined the amount of the current rent.

If a long period of time elapsed since the current rent has been agreed, such fact could be one of the factors to determine the unreasonableness of the current rent. However, if there is a material and sudden change in economic circumstances, the request for a reduction of the rent could be approved even if only a short period of time elapsed since the current rent has been agreed between the parties.

When the current rent becomes relatively high compared to the average market rent applicable in the vicinity of the premises, such fact could also be one of the factors to determine the unreasonableness of the current rent, but the existence of this factor is not always required. If the current rent becomes unreasonable due to other factors, the request for a reduction of the rent could also be approved.

Article 32 of the Act will also apply to subleases, i.e. when a lessee (the "main lessee") leases premises from the owner (the "main lessor") for the purposes of subleasing all or a part of the premises to a third party (the "sublessee"). However, in most sublease cases, the main lessor expects the main lessee (also acting as sublessor) to be able to guarantee the lease, as the main lessee expects to receive a certain amount of rent from the sublessee for a long period of time, and such main lessor and main lessee usually consider that the risks arising from economic fluctuations shall be borne by the main lessee. Therefore, the unreasonableness of the current rent would not be easily admitted if such economic fluctuations were expected or foreseeable for the parties at the time they executed the lease agreement.

It could be said that the level of economic fluctuations caused by COVID-19 is material, unexpected and sudden. However, the extent to which each company is adversely affected is different, and the background for the determination of the current rent is also different, thus every situation must be



considered on a case-by-case basis. Furthermore, if the rent consists of a fixed and a variable rent, the unreasonableness of the rent needs to be determined with care. Indeed, certain economic fluctuations are usually already taken into account by the parties when determining the current variable rent as long as the degree of these economic fluctuations was either expected or foreseeable for the parties. Please refer to the provisions of Article 32 of the Act and the approach taken by the judicial precedents described above when considering a reduction of the rent.

Fixed-Term Building Lease

Article 32 of the Act also applies to fixed-term building leases¹, however, in this case the parties may agree to the non-application of Article 32 (Article 38.7 of the Act). Even if the parties to a fixed-term building lease agree not to apply Article 32 of the Act, this does not mean that they exclude more generally applicable provisions set forth by the Civil Code. Therefore, when significant economic fluctuations occur that were unforeseeable at the time of the execution of the lease agreement, the request of reduction of the rent may be approved by applying the doctrine of changing circumstances or the principle of good faith under the Civil Code. A ruling issued by the Tokyo District Court on June 9, 2014 states that Article 32 of the Act will not be eliminated in every and all cases pursuant to Article 38.7 of the Act and a party may request to reduce the rent if an event that was unforeseeable at the time of the execution of such fixed-term building lease agreement occurs due to significant economic fluctuations and if fairness can be restored by reducing the rent.

Conclusion

As mentioned above, both the factors described in Article 32 of the Act and those that the parties took into account when they determined the current rent must be comprehensively considered in relation to the reduction of the rent. Besides, whether the economic fluctuations caused by COVID-19 make the current rent "unreasonable" or not must be analyzed and considered in each individual case. Even if the parties agree to reduce the rent, they need to think about the amount of such rent reduction, and whether to limit the period during which the lessee shall pay the reduced rent to the lessor. Seeking advice from lawyers and real estate agents may lead to smooth discussion between the parties.

We sincerely hope that this client alert will be useful for lessors and lessees alike, and also help slow, to some extent, the worsening of the economic situation.

¹ A "fixed-term lease" means a lease agreement where (i) the lease term is fixed, (ii) there is no renewal of the lease, and (iii) certain formalities, such as execution in writing, are met pursuant to Article 38. A lease agreement with a fixed-term alone does not necessarily fall within the definition of a "fixed-term lease."