Property Subleases in China: Lessor, Tenant and Sub-tenant

Description

Leases of residential properties are generally not big deals, so we don't deal with them very often despite that frequently we are asked about lease disputes in China. However, if it comes to business premises such as manufacturing factories, it could be big deals but also intricate deals.



Sublease in China

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Yes, I am talking about property leases involving a sub-tenant, or subleases.

I. **Typical Fact Pattern**

A sublease often exists where a tenant/sublessor after leasing industrial or commercial properties from the landlord, in turn leases a part or the entirety of such properties to a sub-tenant.

In real estate businesses, sublease is almost inevitable for many reasons. Many properties managing companies are primarily engaged in such business for a profit. Many small property owners don't really want to bother the hassle of finding, negotiating and dealing with different tenants, and would rather sacrifice a bit of profits for a stable long term lease with a sublessor. Many foreigners owning properties in China often have to enter into such an arrangement when they are outside China, unable to attend to leases with tenants.

So let us make a hypothetical case for easy reference below: a foreign property owner owning a piece of industry manufacturing shop in Guangzhou signed a 10-year lease with a local tenant agreeing that the tenant can sublet the manufacturing premises to sub-tenants. Not long after that, the tenant started to give various excuses for not paying rental in full and in time to landlord, but the sub-tenant has been paying full rental to the tenant without any delay. The unhappy landlord can do nothing but sue the tenant or sublessor for breach of contract. In addition to requesting the tenant to make up for all delayed rentals, the landlord also requested to terminate the lease contract with the tenant and take back the factory.

We are concerned with the wellbeing of the sub-tenant in this difficulty and tricky situation. Let us look at what are the relevant rules under China laws.

II. China Laws on Subleases

The main body of rules governing subleases is set out in Chapter 14 of China Civil Code. There are basically four provisions that are specifically designed to address subleases.

Article 716:

> A lessee may, upon the lessor's consent, sublease the leased object to a third person. The lease contract between the lessee and the lessor shall continue to be valid despite the sublease by the lessee, and if the third person causes loss to the leased object, the lessee shall bear the liability for compensation.
>
> Where a lessee subleases the leased object without the consent of the lessor, the lessor may rescind the contract.
> *Article 717 of China Civil Code on Subleases*

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It is easy to understand this provision. Basically, it says, a tenant shall get the prior consent from the landlord in order to legally sublease the property. Otherwise, the landlord shall have the right to rescind or terminate the lease contract with the tenant. Naturally, when the landlord-tenant lease contract is legally terminated, the tenant shall lose the legal basis to lease the same property to any other person, effectively disabling the sublease that shall have to come to an end.

So head tenants or sublessors generally secure landlord prior consent to sublease in their lease contracts with landlord. However, in one specific circumstance as provided in Article 718 below, in the absence of prior consent from the landlord, the landlord will be deemed as having given consent to subleases:

> Where a lessor knows or should have known of the sublease made by a lessee but fails to raise any objection within six months, the lessor is deemed to have consented to the sublease.
> *Article 718 of China Civil Code*

In the meantime, even though the consent from landlord is secured beforehand, the sublessor shall not sign a sublease with a term longer than the remaining term of its lease contract with the said landlord. The period in excess of the lease contract term shall not be binding on the landlord, unless the landlord and the sublessor has otherwise agreed thereon. This is provided in Article 717 of China Civil Code. Simple, I am not going to quote it here. It shall be noted here that the binding effect in this article on the part of the landlord is correlated only to the length of sublease, not to any other terms and conditions in the sublease contract.

Now if the tenant commits breaches of lease contract with landlord (typically not paying rental in time and in full), what could the subtenant do to make sure it can still use and enjoy the leased object

without being adversely affected by the tenant's breaches? The law has offered remedy for sub-tenant caught in that situation as described in our hypothetical case. Let us look at Article 719:

> Where a lessee defaults on payment of the rent, the sublessee may pay the rent in arrears and the liquidated damages for the lessee, unless the sublease contract is not legally binding on the lessor.
>
> The rent and liquidated damages paid by the sublessee for the lessee may be used to offset the rent payable by the sublessee to the lessee. If the amount of rent and liquidated damages thus paid by the sublessee exceeds the rent, the sublessee has the right to indemnification against the lessee.
> *Article 719 of China Civil Code – Subtenant Right to Rescue Sublease*

In this provision, the sub-tenant is equipped with the right to step forward and deal with the landlord directly by paying the rent to landlord so as to prevent the landlord from exercising the right to terminate the lease contract with the tenant. The law has further made it clear that the amount so paid by subtenant to the landlord can be used to offset the rental payable to the sublessor.

This is a right bestowed on the subtenant, aiming to ensure that subtenant's interests under the sublease won't be damaged by the default of another party. Looking deeper into the trilateral relationship, we shall find that the law protects subtenants thereunder through quashing the landlord's termination right against tenant as provided under Article 716.

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III. What Shall Landlord and Subtenant Do in the Hypothetical Case

With the law and rules related to subleases explicated above, let us look at how landlord and subtenant should act in order to achieve their respective goals.

(1) the Landlord

The landlord is suing to terminate the contract with its tenant. Whatever chance it has of winning the case, it shall make sure the subtenant won't pay to it those delayed rentals and liquidated damages owed by the tenant. As indicated in Article 719, once the subtenant pays such rentals and liquidated damages, the landlord basically loses its legal ground to rescind the lease contract with the tenant.

(2) the Subtenant

On the other hand, the subtenant shall carefully assess the situation and choose its course of actions.

- (i) if it is imperative to keep the manufacturing site, it shall actively intervene and pay rentals to landlord directly so that its sublease will be kept intact amid the dispute between landlord and the sublessor. Of course, the subtenant shall need to find out how much the tenant has owed to the landlord, and whether it has a good chance to get reimbursed or indemnified from the sublessor.

- (ii) if there is a good chance that the landlord will be able to rescind the lease contract with sublessor, and the subtenant doesn't want to pay any money to landlord directly, then what could the subtenant do? For example, the subtenant may run the risk of losing the rental advanced to

sublessor if the sublessor's lease contract is terminated.

So could the subtenant hold on rental due and payable to sublessor till the dispute between landlord and tenant is resolved and clear?

We researched this area of law and found that it is not that clear, though I tend to believe there is a legal basis for holding on such rentals to sublessor as provided in Article 527 of China Civil Code:

> A party obligated to perform the obligation first may suspend his performance if there is definite evidence proving that the other party falls under any of the following situations:
> (1) its operating conditions are seriously deteriorated;
> (2) it transfers property or withdraws capital to evade debts;
> (3) the good will of its business has been lost; or
> (4) ***there's another circumstance under which it has lost or is possible lose its ability to perform the obligation***.
> A party that suspends the performance with no such definite evidence shall bear default liability.
> *Article 527 of China Civil Code*

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As in most lease or sublease contracts, tenants or subtenants are only entitled to use leased properties after paying rentals. In other words, subtenant shall pay rental to sublessor first in order to use the property (though already in its possession), but when the sublessor caught in dispute with landlord, it is possible that it may lose its ability to make available to the subtenant the manufacturing premises. So why not hold on the rentals?

Well, any legal relationship involving three parties may make a legal mind dizzy, and it requires careful analysis of real facts of a case in order to draw and come to the best advice to clients.

Date Created
November 2021
Author
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