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What's inside

Editorial

We feature three articles in this edition.

The first article discusses the court's approach to contractual interpretation. Adopting a purposive approach, the court considers both the language and the context in the contract. Besides express terms, contractual terms may be implied in law (such as statute, common law or custom) or in fact (based on the factual context to give effect to the parties' intention).

The second article outlines the common law principle of repudiation. To constitute repudiation, the failure or refusal to perform must be fundamental to the contract. A repudiation can be an express renunciation of contractual obligations or inferred from the conduct which evinces the intention to abandon the contract.

The third article provides an overview on the main features of Stablecoins Ordinance, Cap. 656 which came into operation on 1 August 2025. The ordinance empowers the Monetary Authority ("MA") to regulate the activities on issuing stablecoins in or outside Hong Kong and the active marketing of such activities to the Hong Kong public. A Stablecoin Review Tribunal is established under the ordinance to review MA's decisions.

There are three case reports in this edition.

The first case discussed whether certain service fees paid by a company to another company, who are members of the same group of companies, are for the sole or dominant purpose of obtaining a tax benefit within the meaning of s.61A and are not tax deductible under ss. 16 and 17 of the Inland Revenue Ordinance, Cap. 112.

In the second case, the Court of Final Appeal confirmed that in finding the mutual intention of parties to restrict the use of money for a specific purpose in order to establish a Quistclose trust, an express stipulation of such intention is not required. Such restrictive intention can be inferred from an objective assessment of the circumstances.

The third case discussed how to determine the "effective rate of interest" under s.24 of the Money Lender Ordinance, Cap. 163. The Court of Appeal considered that the essence is to find an overall rate of accrual of interest in relation to time, and the default interest rate is not to be taken into account in determining the "effective rate of interest".

Boyce Yung

Contractual Interpretation

Introduction

Over the years, courts have moved away from a strict literal interpretation of contracts to a more purposive approach to recognize the underlying commercial objectives of the parties.

The modern approach is laid down by Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society*[1]: "*[i]nterpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.*"

This article gives an overview of the process and key principles of contractual interpretation.

Step 1 – Identifying a contractual term

A contractual term is distinguished from a mere representation.

A representation is a statement made by a party to another party which relates to a matter of fact or present intention.[2] A representation of fact intended to have contractual force will amount to a contractual term, breach of which an action for damages will lie. If not, it is a mere representation. Mere representations are statements intended to induce the other party to enter into a contract, but not imposing liability for breach of contract.[3]

Therefore, the true test would be whether there is evidence of an intention by one or both parties that there should be contractual liability in respect of the accuracy of the statement.[4]
Such intention is to be assessed objectively by deducing from the totality of the evidence[5], including the words and conduct of the parties.

A contractual term can be express or implied.

Step 2 – Principles in interpreting express terms

As stated by Lord Clarke in *Rainy Sky SA v Kookmin Bank*[6], "*[…] the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant.*"

Therefore, courts will consider both the (a) language; and (b) context in which the language was used. The test is objective.

(a) Language

The starting point in construing a contract is that words are to be given their ordinary and natural meaning.[7] This is not necessarily the dictionary meaning of the word, but that in which it is generally understood. If a word is of a technical or scientific character, then its primary meaning is its technical and scientific meaning.[8]

The drift of modern authority is to put greater emphasis on the textual analysis and meaning of words used by the parties.[9] As Lord Clarke observed in *Rainy Sky*[10], "*[w]here the parties have used unambiguous language, the court must apply it.*"

(b) Context

A contract is to be construed with reference to its object and the whole of its terms, and accordingly, the whole context must be considered in endeavouring to interpret it, even though the immediate object of inquiry is the meaning of an isolated word or clause.[11]

Where a term of a contract is open to more than one interpretation, it is generally appropriate to adopt the interpretation which is most consistent with business common sense.[12] The court will consider if such interpretation is how the agreement would be understood by a reasonable person with a knowledge of the commercial purpose and background of the transaction.[13]

Therefore, the context would include, for example: (1) the object, recital, or other relevant terms of the

1 [1998] 1 W.L.R. 896, at 912H.
2 Para. 115.172, Halsbury's Laws of Hong Kong.
3 16-002, Chitty on Contracts, 36th Ed., Vol. 1 ("Chitty").
4 *Ibid*, at 16-003.
5 *Ibid*, at 16-004.
6 [2011] 1 W.L.R. 2900, at [21].
7 Chitty, at 16-065.
8 *Ibid*, at 16-066.
9 *Ibid*, at 16-064.
10 *Rainy Sky*, at [23].
11 Chitty, at 16-071.
12 *Rainy Sky*, at [30].
13 Chitty, at 16-091.

contract; (2) the overall purpose of the term; (3) the commercial purpose and background of the agreement or transaction; and (4) the background knowledge which would reasonably have been available to the parties at time of contract.

Further, where there is ambiguity or obscurity as to the meaning of the term, a contract shall be construed more strongly against the grantor or maker thereof[14], often known as the *contra proferentum* rule.

Overall, the court will seek to strike a balance between the indications given by the language, and the implications of the competing constructions.[15] The clearer the natural meaning, the more difficult it is to justify departing from it[16], unless the outcome becomes so arbitrary or irrational that words can be dismissed as a mistake.[17]

Step 3 – Principles in interpreting implied terms

In certain cases, parties may argue that that the express terms of a contract do not adequately reflect the intention of the parties at the time the contract was entered into and therefore, certain terms should be implied into the contract. However, courts are reluctant to depart from the express terms where the wording is clear and comprehensive.

There are two broad categories of implied terms: terms implied (a) in law; and (b) in fact.

(a) Terms implied in law

Terms implied in law (including statute, common law, or custom) applies to a class of contractual relationship, such as landlord/tenant, employer/employee, or seller/consumer.[18] Many such terms have become standardized for particular classes of contract. Therefore, unless the implication of such a term would be contrary to the express words of the agreement, courts will imply certain terms into the contract based on a broader range of considerations.

Such relevant considerations would include, for example: (1) relevant provisions under the statute(s); (2) common law principles (such as reasonableness and fairness of the term); (3) custom, usage, or established standard practice in particular trades or areas of industry; (4) prior course of dealings between the parties; and (5) a range of competing policy considerations.

(b) Terms implied in fact

Terms implied in fact applies to any particular contract based on the factual context to give effect to the unexpressed intention of the parties.[19]

A term may be implied into a contract if it is (1) reasonable and equitable; (2) necessary to give business efficacy to the contract[20]; (3) so obvious that it goes without saying[21]; (4) capable of clear expression; and (5) not inconsistent with any express term of the contract.[22]

Conclusion

Certainty of contract forms the bedrock of mutual trust and confidence in commercial dealings, and contractual interpretation seeks to achieve this purpose. It ensures validity and enforceability of contracts by mitigating potential disputes over their interpretation. With this in mind, the principles, rules, or tests above all work together to provide the tools the court need to arrive at the contractual interpretation that best gives effect to the intention of parties in each case.

Ann Cheung

14 *Ibid*, at 16-111.
15 *Ibid*, at 16-094.
16 *Arnold v Britton* [2015] UKSC 36, at [18].
17 *Pink Floyd Music Ltd v EMI Records Ltd* [2010] EWCA Civ 1429, at [20]-[21].
18 Chitty, at 17-005.
19 *Ibid*.
20 *The Moorcock* (1889) 14 P.D. 64, at p.68.
21 *Shirlaw v Southern Foundries* [1939] 2 K.B. 206, at p.227.
22 BP Refinery (Westernport) Pty Ltd v Hastings Shire Council (1977) 52 A.L.J.R. 20.

Repudiation of Contract

Introduction

The right to terminate a contract is a crucial remedy where contractual relationship breaks down irreparably. While this right is most clearly established when a contract contains express termination clauses, many situations fall outside such express clauses. Where an express termination clause is absent or inapplicable, the common law doctrine of repudiation may provide an alternative path to termination.

This article examines the forms of repudiation, the establishment of repudiation, and the critical choices available to the innocent party upon encountering a repudiation.

Forms of Repudiation

Repudiation occurs when a party evinces, through words or conduct, an intention to refuse performance of contract terms or no longer be bound by the terms.[23] However, not every refusal to perform amounts to a repudiation that justifies termination. To constitute repudiation, there must be a refusal to perform obligations which goes to the root of the contract.[24] Repudiation manifests in two distinct forms, namely actual breach and anticipatory breach.

Actual breach occurs when a party fails to perform their contractual obligations at the time fixed for performance, and the nature of this failure is so fundamental that it strikes at the root of the contract.

Anticipatory breach, conversely, arises when a party clearly indicates by words or conduct, before the performance is due, that it will not fulfill its contractual obligations. In such case, the innocent party needs not wait until the performance date to take action but may be entitled to treat the contract as immediately discharged and bring an action for damages.

Breach of contract

Determination of whether a breach of contract is repudiatory sometimes requires analysis of whether the breached term is a condition, a warranty or an innominate (or intermediate) term.

Conditions are terms that go to the substance or foundation of the matter to which the contract relates, breach of which gives the innocent party the right to terminate the contract and claim damages for any loss suffered from the breach.

Warranties, in contrast, are secondary or collateral terms. A breach of warranties only gives rise to a claim for damages, not the right to terminate the contract.

Innominate terms occupy a middle ground. They are terms capable of being broken either in a manner that is trivial and capable of remedy by award of damages or in a way that was so fundamental so as to undermine the whole contract.[25]

A party will be held to have repudiated a contract where it breaches a condition, or an innominate term in such a way as to deprive the innocent party of substantially the whole benefit of the contract. In other words, the breach goes so much to the root of the contract that it makes further commercial performance of the contract impossible.[26]

The high threshold in establishing repudiation is exemplified in *Grand China Logistics Holding (Group) Co. Ltd -v- Spar Shipping AS*[27] where, absent an express term, obligation to make timely payment of hire in a time charterparty was held not to be a condition. In reaching this decision, the court emphasised the need to balance certainty and undesirability of treating trivial breaches as carrying the disproportionate consequences of breaches of condition.

Express or implied repudiation

Repudiation does not necessarily require proof of an actual breach of contract. It may be established by an express renunciation of contractual obligations or conduct from which an intention to abandon the contract can be inferred. In assessing such conduct, the court examines whether a party has acted in such a way so as to lead to a reasonable person to conclude that they do not intend to fulfil their part of the contract or will be unable to perform at the stipulated time.[28] This intention will not be inferred lightly. The court will uphold contracts where the consequence of the breach is not sufficiently serious to warrant termination.

The Election: Acceptance or Affirmation

A repudiatory breach does not automatically end the contract. Instead, it presents the innocent party with a critical election: to accept the repudiation and treat the contract as at an end, or to affirm the contract which continues to exist.

Acceptance of repudiation requires clear and unequivocal words or conduct demonstrating an intention to treat the contract as terminated. This communication may take any form, whether in writing, spoken words or by conduct, provided that it is sufficiently unequivocal to convey the decision to end the contractual relationship.

Affirmation of contract occurs when the innocent party, with knowledge of the repudiatory breach, conducts itself in a manner consistent with treating the

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23 Para. 351, Halsbury's Laws of England, Volume 22 (2025).

24 *Mersey Steel and Iron Co Ltd v Naylor, Benzon & Co* (1884) 9 App Cas 434 ("*Mersey Steel*") at 443

25 28-046, Chitty on Contracts, 36th Ed., Vol. 1.

26 *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd [1962] 2 QB 26*

27 [2016] EWCA Civ 982

28 *Universal Cargo Carriers Corp v Citati* [1957] 2 QB 401

contract as still in force. This may include continuing to perform contractual obligations, demanding performance from the other party, and even failing to communicate a decision to terminate within a reasonable time.

Whilst the innocent party may require time to resolve its position following a repudiatory breach, whether such delay will deprive the innocent party of its right to terminate depends on whether the circumstances surrounding the delay dictate that it must have affirmed the contract.[29] The focus remains on whether the conduct of the innocent party demonstrates an intention to affirm the contract in the specific circumstances of the case.

The election carries profound implications. A valid acceptance discharges both parties from future obligations. Affirmation, however, keeps the contract alive for both parties, though in either case, the innocent party can claim damages for losses sustained from the other party's breach.

Conclusion

The high threshold for proving repudiation underscores the court's caution in recognising a right to terminate, ensuring that parties cannot lightly abandon their contractual obligations while offering protection to the innocent party whose counterparty's words or conduct manifest a clear intention to repudiate.

Lilian Chiu

[29] *Cheung Ching Ping Stephen v Allcom Limited* [2010] 2 HKLRD 324

Stablecoins Ordinance (Cap. 656)

Introduction

To align with Hong Kong's efforts to enhancing its virtual asset regulatory framework under the "same activity, same risks, same regulation" principle, the Stablecoins Ordinance (Cap. 656) ("SO") was gazetted on 30 May 2025 and came into operation on 1 August 2025.

The SO establishes a licensing regime for fiat-referenced stablecoins ("FRS"), by implementing safeguards against monetary and financial stability risks posed by FRS while ensuring adequate protection for FRS users. By following global regulatory standards, the SO reinforces Hong Kong's position as an international financial centre.

Key provisions of the SO

"Specified stablecoin"

Under s.3 of the SO, "stablecoins" means a cryptographically secured digital representation of value that meets all the criteria set out in s.3(1), but excludes digital currencies issued by a central bank and digital representations of value already regulated under existing regimes (e.g. securities under the Securities and Futures Ordinance (Cap. 571) ("SFO"), deposits under the Banking Ordinance (Cap. 155) ("BO"), and deposits placed for stored value facility ("SVF") under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584)). Under s.4 of the SO, a specified stablecoin is defined as a stablecoin that purports to maintain a stable value with reference wholly to one or more official currencies, or other units of accounts or stores of value specified by the Hong Kong Monetary Authority ("HKMA"). HKMA may also specify other digital representations of value as specified stablecoin by notice published in the Gazette.

Regulation of activities involving specified stablecoins

It is an offence for a person to carry on, or hold himself out as carrying on, a "regulated stablecoin activity" without a licence or exemption granted by HKMA (s.8). The activities regulated include issuing a specified stablecoin in Hong Kong in the course of business, issuing a specified stablecoin outside Hong Kong in the course of business where the specified stablecoin is pegged (whether wholly or partly) to Hong Kong dollars ("HKD"), and actively marketing to the Hong Kong public that the person carries on or purports to carry on such activities (s.5).

It is also an offence for a person who is neither a "permitted offeror" nor exempted by HKMA to offer, or hold himself out as offering, a specified stablecoin (s.9). The regulated acts include actively marketing offering of a specified stablecoin to the public, whether in Hong Kong or elsewhere (s.6). "Permitted offerors" include issuers of specified stablecoins licensed by HKMA, corporations which have been granted a licence by the Securities and Futures Commission to operate a virtual asset exchange, SVF licensees regulated by HKMA, licensed corporations for Type 1 regulated activity

under the SFO, and authorized institutions under the BO. A permitted offeror may (i) offer to the public a specified stablecoin that was issued under a HKMA stablecoin-issuer licence, or (ii) offer a specified stablecoin to persons specified by the Financial Secretary for the purpose of s.9(2)(b)(iii) of the SO (i.e. professional investors), provided that the issue of the specified stablecoin is not prohibited by s.8 of the SO (e.g. non-HKD-referenced stablecoin).

Other offences covered under Part 2 of the SO include advertising unlicensed or unauthorized stablecoin activities (s.10), making fraudulent or reckless misrepresentations for the purpose of inducing another person to enter into, or offer to enter into, an agreement to acquire, dispose of, subscribe for or underwrite a specified stablecoin (s.12), and fraud or deception in relation to specified stablecoin transactions (s.11).

Licensing Regime

The SO provides for a licensing regime in relation to the carrying on of a regulated stablecoin activity, under which HKMA is empowered to issue, suspend and revoke a licence.

Apart from the conditions attached to a licence according to s.17 of the SO, a licensee must ensure that the minimum criteria set out in Schedule 2 to the SO are fulfilled. These minimum criteria include the following:

(a) to maintain a fully-backed reserve pool at all times with assets of high quality and liquidity matching the par value of outstanding specified stablecoins in circulation, ensuring proper segregation and management of reserve assets, and making adequate and timely disclosure in relation to the reserve assets (s.5 of Schedule 2);
(b) to ensure a right of redemption for each holder whereby the licensee must pay the holder the par value of the specified stablecoin without imposing unduly burdensome conditions and unreasonable fees upon receiving a valid redemption request (s.6 of Schedule 2);
(c) to be a company as defined under s.2(1) of the Companies Ordinance (Cap. 622) (i.e. a company formed and registered in, or re-domiciled to, Hong Kong) or an authorized institution under the BO which is incorporated outside Hong Kong (s.3 of Schedule 2);
(d) to possess a minimum paid-up share capital of HK$25 million (s.4 of Schedule 2);
(e) to have fit and proper persons responsible for regulated stablecoin activities as the chief executive, directors, stablecoin manager or controller of the licensee (s.7 of Schedule 2); and
(f) to have adequate and appropriate risk management policies and procedures (s.9 of Schedule 2).

HKMA's power

HKMA is empowered to appoint a statutory manager for a licencee (s.80) to: direct a licensee to take any action to bring it into compliance with the SO (s.115), institute investigations under Part 5 of the SO, and impose civil sanctions (including pecuniary penalty on licensee) under Part 6 of the SO. A Stablecoin Review Tribunal ("Tribunal") is established under Part 7 of the SO to review HKMA's decisions, with appeals to the Hong Kong Court of Appeal on a point of law against a decision of the Tribunal on review.

Implications for the market

The SO offers a clear framework, outlining requirements for asset reserves, audits, and operational standards for licensees, thereby reducing uncertainty for stablecoin businesses and fostering long-term market stability.

The SO also strengthens consumers' trust in stablecoins. The JPEX case, involving allegations of misleading marketing, unlicensed operations, and inability to honour redemptions, exposed significant risks of liquidity shortfalls and fraud in the unregulated stablecoin sector. In response, the SO mitigates these risks by mandating 1:1 reserve backing, segregated and audited reserves, and full redemption rights to ensure users can always exchange stablecoins at par value. Further, strict HKMA licensing and restrictions on unlicensed marketing help ensure transparency and accountability, thereby reinforcing stablecoins' credibility as reliable digital assets.

Conclusion

With the SO having come into operation, the licensing regime provides suitable guardrails for relevant stablecoin activities. This marks a milestone in facilitating the sustainable development of the stablecoin and digital asset ecosystem in Hong Kong.

Angel Li

Chapman Development Limited v Commissioner of Inland Revenue [2025] HKCU 6229

Facts

Chapman Development Ltd ("Chapman") was a member of a group of companies and was mainly engaged in the manufacturing and trading of fabric and yarn and the provision of trade related services.

Chapman appointed its associated company, Profit Gain Trading (BVI) Limited ("Profit Gain"), as its management agent for all knitted and dyed fabric production required in the PRC factories under a management agreement ("Management Agreement"). The Management Agreement stipulated that Chapman would pay a service fee ("Service Fees") to Profit Gain in consideration of the services provided by Profit Gain. In this regard, it is worth noting that the sums claimed by Chapman for tax deduction ("Actual Fees") were not all calculated according to the written terms of the Management Agreement.

Following a tax audit in relation to Chapman's tax affairs, the Assistant Commissioner considered that part of the Actual Fees claimed by Chapman were not deductible under ss. 16 and 17 of the Inland Revenue Ordinance (Cap. 112) because Chapman's appointment of Profit Gain as its management agent was a transaction carried out for the sole or dominant purpose of enabling Chapman to obtain a tax benefit by way of deduction of the Actual Fees and/or diverting part of Chapman's profits to Profit Gain, such that s. 61A of Cap. 112 should apply. The deduction of the Actual Fees (save to the extent of administrative expenses and bank interest incurred) was disallowed.

Chapman raised objections to the Assistant Commissioner's assessments but failed, and appealed to the Board of Review ("Board"), which held that the Actual Fees which exceeded the Service Fees ("Extraneous Fees") were not expenses incurred in the production of Chapman's assessable profits and hence were not deductible under ss. 16 and 17. It was also held that the entering into of the Management Agreement pursuant to which Chapman paid the Actual Fees to Profit Gain as well as each and every payment made thereunder (collectively, "Transaction") was a transaction entered into or carried out for the sole and dominant purpose of enabling Chapman to obtain a tax benefit within the meaning of s. 61A.

Chapman appealed to the Court of First Instance ("CFI") and subsequently to the Court of Appeal ("CA").

Issues

The CFI's ruling was affirmed by the CA.

There were two issues before the CFI and the CA, namely, the deductibility of the Extraneous Fees and the applicability of s.61A to the Transaction.

Deductibility of the Extraneous Fees

Chapman sought to challenge the Board's holding that the Extraneous Fees were not expenses incurred in the production of Chapman's assessable profits, and therefore not deductible under ss. 16 and 17.

The Board refused to draw a factual inference that the Extraneous Fees were paid pursuant to the Management Agreement as varied by an agreement by conduct. In this regard, the CFI and the CA held that this was a fact-finding exercise within the exclusive jurisdiction of the Board and there was no legal basis to challenge the refusal to make a positive finding in favour of Chapman. It could hardly be said that the Board's refusal to draw a positive factual inference was irrational or perverse to constitute an error of law.

Applicability of s. 61A to the Transaction

Under s. 61A, the "tax benefit" is determined by comparing a taxpayer's actual position under the impugned transaction with an alternative hypothesis of what would reasonably have happened absent the transaction. In this case, the accepted hypothesis was that Chapman would have done the production management work itself had Profit Gain not been appointed ("Alternative Hypothesis").

On this point, Chapman alleged that no tax benefit would have been conferred on it under the Alternative Hypothesis as the profits derived from carrying out such tasks in the PRC would be sourced outside Hong Kong and not be chargeable to tax in Hong Kong.

The CFI and the CA considered that the true profit-generating transactions would continue to be the trading activities, which were carried out entirely in Hong Kong; while the production management work would be activities ancillary and incidental to its profit-producing transactions and ought to be disregarded in considering the source of the profits. Accordingly, under the Alternative Hypothesis, Chapman would not have paid any fees to Profit Gain,

but would have incurred directly Profit Gain's own expenses, being administrative expenses and bank interest, which the Assistant Commissioner had allowed Chapman to deduct.

Thus, under the Transaction, Chapman enjoyed a tax benefit in the form of a reduced profits tax liability, whereas under the Alternative Hypothesis, no such deductions would arise and Chapman's assessable profits would be higher.

The application of s. 61A is not directed at challenging the source of a taxpayer's profits or any legitimate choice of location in arranging its business.

It is not a requirement under s. 61A that the transaction or any entity involved is a sham. The facts that (i) the Service Fees were not arbitrary or excessive; (ii) Profit Gain was not a sham and carried on real operations; and (iii) it was not unusual that Chapman and Profit Gain did not strictly follow the terms of the Management Agreement for payment, were of no relevance to the question whether the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.

Given the clear financial pattern, namely, a significant diversion of profits from Chapman to Profit Gain while the overall profits remained within the group, the Board was entitled to conclude that the arrangement's sole or dominant purpose was to secure a tax benefit for Chapman.

Accordingly, it was held that the Board made no error of law in finding that there was a tax benefit to Chapman in that the tax liability would be lower by interposing the Transaction which enabled a deduction of the Actual Fees.

Concluding Remarks

Even where services are genuinely performed by an offshore associate and the fees payable are commercially justifiable and deductible under ss. 16 and 17, the use of such structure may still be struck down under s. 61A if the sole or dominant purpose is to avoid liability for tax, particularly where the overall profit is shifted outside Hong Kong but retained within the group of companies.

Silvia Tang

China Life Trustees Ltd v China Energy Reserve and Chemicals Group Overseas Co Ltd [2024] HKCFA 15

In this case, the Court of Final Appeal ("**CFA**") reviewed leading authorities on Quistclose trusts in determining whether a Quistclose trust existed in the context of an intra-group transfer.

Background

SPV 1 and SPV 2 were two special purpose vehicles ("**SPVs**") and members of a corporate group ("**Group**") which was engaged in oil and natural gas exploration and the production and marketing of related chemical products. The SPVs were established solely for the purpose of issuing bonds to finance the Group's operations. Neither of the SPVs owned any assets or conducted any material operations.

SPV 1 maintained a bank account ("**Account**") which consisted of a HK$ sub-account ("**HK$ Sub-account**") and a US$ sub-account ("**US$ Sub-account**"). SPV 1 issued a series of bonds denominated in HK$ ("**2022 Bonds**") which would mature in 2022. The HK$ Sub-account was used exclusively for the 2022 Bonds. China Life Trustees Limited ("**China Life**") was the only bondholder of the 2022 Bonds.

Subsequently, SPV 2 issued a series of bonds denominated in US$ ("**2018 Bonds**") which would mature in 2018. The US$ Sub-account was used exclusively for the 2018 Bonds. The bondholders of the 2018 Bonds included 2 banks ("**Ad Hoc Committee**").

Funds generated by the 2022 Bonds and the 2018 Bonds were transferred by SPV 1 and SPV 2 respectively to the Group's treasury company ("**Trading Co.**") for internal distribution. Trading Co. would remit funds to the respective sub-account of the Account when interests on the 2018 Bonds or the 2022 Bonds fell due.

When the 2018 Bonds matured, the Group did not have sufficient funds to pay the principal plus interest payable. Eventually, there was a default on the 2018 Bonds which triggered a cross-default on the 2022 Bonds.

Thereafter, China Life ("**Respondent**") obtained a judgment against SPV 1 on the basis of the default of the 2022 Bonds and obtained a garnishee order in respect of the funds in the Account ("**Funds**") which included funds in the US$ Sub-account. On the other

hand, SPV 1 and the Ad Hoc Committee (collectively, "**Appellants**") attempted to set aside the garnishee order by contending that the Funds were subject to a Quistclose trust in favour of Trading Co.

The Court of First Instance ("**CFI**") and the Court of Appeal ("**CA**") both rejected the Quistclose trust argument. CA upheld the garnishee order absolute granted by CFI. CA dismissed an appeal by the Appellants but granted them leave to appeal to CFA.

Issues

The Court of Final Appeal ("**CFA**") considered the following questions:

(a) What is the required intention to give rise to a Quistclose trust?

(b) In the context of intra-group transfers, does common management control between the payer and the recipient preclude the finding of the required intention for a Quistclose trust?

CFA's decision

Question (a)

CFA reviewed the leading authorities on Quistclose trusts.

It was established in *Barclays Bank Ltd v Quistclose Investments Ltd*[30] that a trust comes into existence when a payer transfers money to a recipient by way of loan or otherwise and both parties intend that the money would be applied for a specific purpose only. If such specific purpose fails, the money is held on trust for the payer. The touchstone giving rise to the Quistclose trust is that objectively assessed, there is a mutual intention to restrict the use of the money for the specific purpose and that purpose only. Similarly, in *Twinsectra v Yardley*[31], the House of Lords treated the payment of money to be applied only for a specific purpose as the key requirement for determining that a Quistclose trust came into existence.

Ribeiro PJ found that with the parties' restrictive intention, it follows logically that the money is not intended to be part of the recipient's general assets or at the recipient's free disposal. Analyzing legally, beneficial ownership of the money is not passed to the recipient, who takes the money in a fiduciary capacity to apply the money only for the specific purpose. If the recipient becomes insolvent before the money is applied to the specific purpose, the money would not pass to the recipient's trustee in bankruptcy. If the specific purpose fails, the recipient must return the money to the payer.

The Respondent argued that an express restriction on the use of funds was required in order to establish a Quistclose trust. CFA rejected this argument. The court held that based on the authorities (including *Toovey v Milne*[32] which was cited in *Quistclose*), an express stipulation of the restricted use of money is not required provided that the facts of a case justify an inference that the money was transferred with such a restrictive intention on the part of the payer and agreement or acquiescence on the part of the recipient. The required intention may be inferred from an objective assessment of the circumstances. In other words, the necessary intention may be implied.

CFA held that, on the evidence of the present case, the Funds were impressed with a Quistclose trust. This is because the Fund was paid by Trading Co. into the US$ Sub-account solely for the purpose of fulfilling SPV 2's obligations under the 2018 Bonds and were not intended to become part of SPV 1's general assets or to be freely available for SPV 1's disposal. As a result, when the designated purpose (i.e. redemption of the 2018 Bonds) failed, SPV 1 held the Funds on trust for Trading Co. Since the Funds were not SPV 1's assets, they were not available to China Life as garnishee.

Question (b)

CFA noted that the question may be premised on the assumption that express stipulation on the restricted use of money or the reservation of beneficial interest of money is required to find a Quistclose trust. If that assumption holds, it would be unlikely for parties that are fellow subsidiaries under common management control to have any such express stipulations. Consequently, the intention required to establish a Quistclose trust would never be found in intra-group transfers.

CFA reiterated that express stipulations of intention

[30] [1970] AC 567.

[31] [2002] 2 AC 164.

[32] (1819) 2 B & A 683.

are not required in order to determine that a Quistclose trust has come into existence, and that this principle applies equally in the context of intra-group transfers.

Conclusion

CFA unanimously held that the Funds were held on a Quistclose trust for Trading Co. The court allowed the Appellants' appeal and discharged the garnishee order.

Fountain Hung

Sun Entertainment Culture Ltd v Inversion Productions Ltd [2024] 4 HKLRD 991

In this case, the Court of Appeal ("**CA**") held that default interest was not to be taken into account in determining "effective rate of interest" under s.24 of the Money Lenders Ordinance ("**MLO**").

Facts

The petitioner ("**Lender**") lent the respondent ("**Borrower**") US$7.5 million under a loan agreement, with initial interest at US$0.75 million ("**Initial Interest**") payable upon the maturity date and a default monthly interest rate of 4% ("**Default Interest Rate**") "*so long as a Default or Event of Default is continuing*". Pursuant to subsequent amendment agreements, the maturity date was extended six times with additional interest at a sum of US$6.45 million ("**Additional Interest**"), and the loan amount was increased to US$8.5 million ("**Principal**").

The Borrower failed to repay so the Lender petitioned for its winding up based on a debt comprising the Principal, the Initial Interest, the Additional Interest and the accrued default interest at the Default Interest Rate on the Principal ("**Default Interest**"). The Borrower opposed the petition, arguing, inter alia, that the loan agreement was unenforceable under s.24 of the MLO ("**s.24**") since it sought to impose an interest of over 60% per annum, taking into account the Default Interest.

At the material time, s.24 provided that any person who lent or offered to lend money at an effective rate of interest which exceeded 60% per annum[33] would commit an offence and that no agreement for the repayment of any loan or for the payment of interest on any loan shall be enforceable where the effective rate of interest exceeded the said rate.

The Court of First Instance rejected the Borrower's argument on s.24 and ordered the Borrower to be wound up. The Borrower appealed.

CA's decision

The Borrower submitted that the effective rate of interest of the loan exceeded 60% on three alternative calculations:

(1) the default interest of 4% per month was charged on a monthly-compounded basis and thus the annualised rate was 60.1%;

(2) the default interest was charged as simple interest equivalent to 48% per annum on both the unpaid Principal, the Initial Interest and the Additional Interest upon the maturity date, resulting in default interest payable in the sum of US$7.536 million, which was 88.66% of the Principal; and

(3) the aggregate of the pre-default rate of interest (i.e. 14.58% calculated based on the Initial Interest and the Additional Interest on the Principal) and the post-default rate of interest of 48% per annum was 62.58%.

CA rejected all the Borrower's calculations. CA considered that, on a proper construction of contractual documents, the Default Interest accrued only on the unpaid Principal and not on the Initial Interest or Additional Interest. Second, the loan agreement did not state that compound interest was charged. The fact that the Default Interest Rate was expressed as a monthly rate did not mean that the interest was compounded monthly. It was for the Borrower to show that there was express or implied agreement for compound interest and the Borrower failed to do so. Third, there was no basis to add up the pre-default interest rate calculated based on a period up to the

[33] This was amended to 48% in 2022.

extended maturity date and the Default Interest Rate, which was the applicable rate after that date. Accordingly, CA held that the Borrower's allegation that s.24 had been contravened failed at the beginning.

In addition, CA agreed that the Borrower's contention was contrary to the CA's decision in *Easy Fortune Property Ltd v Yung Chun Him*[34], which is a binding authority that the default interest is not to be taken into account in determining the effective rate of interest for the purposes of s.24.

The Borrower's appeal was thus dismissed.

Construction of s.24

While it was not strictly necessary to decide the issue, CA expressed the view that default interest shall not be taken into account in determining the effective rate of nterest under s.24.

CA considered that in determining effective rate of interest, the essence is to find an overall rate of accrual of interest in relation to time. Therefore, it is necessary to take into account the principal, the interest payable and the time in which payment is to be made. While there is usually a fixed term during which non-default interest accrued on a loan, the default period is indefinite. Without an end date of the default, it is impossible to calculate an average rate covering both the fixed term and default period.

Further, payment of default interest is engaged only upon a borrower's breach of its obligation to repay the loan. Where it is stated in a loan agreement that the rate of interest is X% per annum during the term, with default interest at a higher rate of Y% per annum, it seems to strain the language of s.24 to say that the lender lends or offers to lend money at an effective rate of interest of Y%, or at a combination of X% and Y% that depends on the proportional lengths of the term and the eventual period of default.

Moreover, s.24 imposes not only contractual unenforceability but also criminal offence. If s.24 is to apply to default interest, difficult questions would arise. For example, if a lender lent a loan at an ordinary interest rate but the default interest rate is specified at a rate which exceeds 60% per annum, it is difficult to determine whether the offence is committed at the inception of loan, immediately upon the borrower's default, or only when the borrower had defaulted for a sufficiently long time such that the average interest rate covering the pre-default period and the default period exceeded 60% per annum.

CA also considered that the relevant social evil targeted by s.24 is excessively high lending rates, and not the rates of default interest. This does not mean that the default interest would fall within an unregulated legal vacuum as it is regulated by ss.22 and 25 of the MLO and the common law on penalties.

Kennis Lam

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