FACV Nos. 3 and 6 of 1999 (Consolidated)

IN THE COURT OF FINAL APPEAL OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

FACV No. 3 of 1999

FINAL APPEAL NO. 3 OF 1999 (CIVIL)
(ON APPEAL FROM CACV NO. 196 OF 1998)
(Consolidated with Final Appeal FACV No. 6 of 1999)

Between :

THE COMMISSIONER OF INLAND REVENUE Appellant

- and -

EMERSON RADIO CORPORATION Respondent

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FACV No. 6 of 1999

FINAL APPEAL NO. 6 OF 1999 (CIVIL)
(ON APPEAL FROM CACV NO. 196 OF 1998)
(Consolidated with Final Appeal FACV No. 3 of 1999)

Between :

EMERSON RADIO CORPORATION Appellant

- and -

THE COMMISSIONER OF INLAND REVENUE Respondent

Court: Chief Justice Li, Mr Justice Litton PJ, Mr Justice Ching PJ, Mr Justice Nazareth NPJ and Lord Hoffmann NPJ

Date of Hearing: 23 November 1999

Date of Judgment: 14 December 1999

J U D G M E N T

Chief Justice Li :

I agree with the judgment of Lord Hoffmann.

Mr Justice Litton PJ :

I have had the advantage of reading in draft Lord Hoffmann NPJ's judgment. The background facts are fully set out in his judgment and need not be repeated here.

The royalty agreement in essence says two things: (1) The Hong Kong company wishes to continue to sell products carrying the trademark "Emerson" to customers in the USA and (2) it agrees to pay fees to the US company for the use of the trademark on those products, calculated as a percentage of the sales price.

On its face this agreement relates to the use of the US registered trademark, as applied to goods sold in the USA. It says nothing about the use in Hong Kong of the trademark registered here. But, in order that the Hong Kong company should be able to sell those goods to customers in the USA they have to be manufactured: It is common ground that, at the time of the royalty agreement, goods were manufactured in Hong Kong and in other parts of Asia on the Hong Kong company's order. These goods bearing the "Emerson" trademark were shipped direct by the manufacturers to the customers in the USA. This is the context in which the words in the royalty agreement "[The Hong Kong company] *wishes to continue* to sell ... etc" were used. Inevitably, as part of the arrangement under which the fees were paid, the Hong Kong company used the "Emerson" trademark in placing orders for the manufacture of the goods. Construing the agreement in this context it seems right to say that, by implication, it was a term of the royalty agreement that the fees were not only for the use of the US registered trademark in the USA but also for the use of the trademark in those countries where the goods were manufactured. The concession on this matter by counsel for the taxpayer in the lower courts, and before us, makes it unarguable.

Once this point is reached, the conclusion is inevitable that part of the sums received by way of fees were sums *received for the use in Hong Kong of a trade mark*, in terms of s.15(1)(b) of the Inland Revenue Ordinance.

The Recorder, on appeal from the Board of Review, took a robust approach. He held that part of the fees were subject to the charge: That is, the fees received or accrued in relation to the sale of goods manufactured in Hong Kong: This, he was told by counsel, presented no practical difficulty. It was, in fact, the "fall back" position adopted by both parties. The Recorder did not engage in any further refinement of the issue and ask himself whether, in relation to *those* goods (manufactured in Hong Kong and sold to customers in the USA), there had to be a *further* apportionment of the fees to distinguish between the use of the Hong Kong registered mark and the US registered mark. Rightly so, as this would have been a virtually impossible exercise.

In my view the Recorder had reached the right conclusion on the questions posed in the Stated Case and the majority of the Court of Appeal were also right to uphold his judgment.

Mr Justice Ching PJ :

I agree with the judgments of Litton PJ and Lord Hoffmann NPJ.

Mr Justice Nazareth NPJ :

I agree with Lord Hoffmann's judgment.

Lord Hoffmann NPJ :

Emerson Radio Corporation ("Emerson") is an American corporation which manufactures and sells electronic equipment. It is the registered proprietor of trade marks consisting of the name "Emerson" in the United States, Hong Kong and many other countries. It has a wholly owned subsidiary in Hong Kong called Emerson Radio (Hong Kong) Ltd ("Emerson HK"). Emerson HK contracts with manufacturers in various Asian countries, including Hong Kong, for the manufacture of electronic equipment which it exports mainly to the United States but also to other places. It does not however sell any goods in Hong Kong.

On 1 April 1984 Emerson entered into a "royalty agreement" with Emerson HK. The following are the relevant terms:

> "1. Emerson holds the rights for the use of the trade mark "Emerson" for electronic home entertainment products sold in the United States of America (US). Emerson HK wishes to continue to sell "Emerson" brand products to customers with locations in the US.
>
> 2. Emerson HK agrees to pay Emerson for the use of the "Emerson" trade mark on products it sells to its US customers...."

There followed provisions concerning the amount and payment of a royalty on sales. The agreement was expressed to be governed by the law of New York. On 1 April 1987 the parties entered into a new agreement in identical terms save for an increase in the rate of royalty.

The Commissioner of Inland Revenue assessed Emerson to profits tax on its royalty income. In principle, profits tax is chargeable only on persons "carrying on a trade, profession or business in Hong Kong in respect of...assessable profits arising in or derived from Hong Kong": see s.14(1) of the Inland Revenue Ordinance Cap. 112. Emerson does not carry on any business in Hong Kong. But by s.15(1), certain receipts are deemed to be "arising in or derived in Hong Kong from a trade, profession or business carried on in Hong Kong." They include, under paragraph (b) -

> "sums...received by or accrued to a person for the use of or right to use in Hong Kong ...a trade mark..."

The Commissioner said that the royalties were for the use of a trade mark in Hong Kong. The Board of Review upheld the assessment. On an appeal to the Court of First Instance by way of case stated, Mr Recorder Ribeiro SC (as he then was) held that only those royalties payable for goods manufactured in Hong Kong (where the mark would have been applied) were for the use of the mark in Hong Kong. A majority of the Court of Appeal (Mortimer V-P and Rogers J.A.) agreed. Godfrey J.A. dissented, holding that none of the royalties were for the use of the mark in Hong Kong. The Commissioner has appealed, seeking to restore the decision of the Board of Review that all the royalties were taxable, whether the goods had been made in Hong Kong or not. Emerson has cross-appealed, seeking to uphold the judgment of Godfrey J.A.

I shall deal first with the cross-appeal. In the Court of Appeal, Rogers J.A. said that as a matter of construction of the express terms of the royalty agreement, it dealt only with the United States registered trade mark. In my opinion, that was right. It is apparent from the recital in clause 1: "Emerson holds the rights for the use of the trade mark "Emerson" for electronic home entertainment products sold in the United States of America (US)." The rights conferred by the registration of trade marks are territorial. A trade mark registered in the United States enables the holder to complain of infringing acts in the United States but not elsewhere. To complain of infringing acts in Hong Kong, one must have a mark registered in Hong Kong. So the rights in respect of products sold in the United States must be rights under the United States registered mark. Therefore, in clause 2, when it is said that "Emerson HK agrees to pay Emerson for the use of the "Emerson" trade mark on products it sells to its US customers....", the "Emerson trade mark" must mean the U.S. registered trade mark. Trade marks registered elsewhere in respect of the same mark would be irrelevant to the sale of products to US customers.

In the Court of Appeal, however, Mr Barlow (for Emerson) conceded that it was an implied term of agreement that it also included the right to use the Emerson mark registered in other countries, and in particular in Hong Kong, if it was necessary to use the mark there for the purpose of manufacturing goods to be sold in the United States. If the goods are manufactured in Hong Kong, the mark will be applied to the goods in Hong Kong. By s.39 of the Trade Mark Ordinance (Cap. 43), reproducing the effect of s.31 of the U.K. Trade Marks Act 1938, the application of a mark in Hong Kong to goods to be exported from Hong Kong is deemed to constitute use of that mark. Emerson HK did not manufacture anything itself. It contracted with independent manufacturers to do so. But they would apply the Emerson mark by direction of Emerson HK and it was not suggested that the use of third parties made any difference to the question of whether Emerson HK could be said to be using the Hong Kong registered mark in Hong Kong.

I should say that, speaking entirely for myself, I am not confident that Mr Barlow's concession of an implied term was correct. If Emerson and Emerson HK had simply been parties dealing at arms' length, I would have had no doubt that a licence to use the mark in the course of manufacture should be implied. It would be absurd for Emerson, having licensed the use of the US mark for exports to the U.S., then to be able to complain that the manufacture of the goods in Hong Kong was an infringement. But Emerson HK was a wholly owned subsidiary of Emerson and there had clearly been other arrangements by which it was expressly or impliedly allowed to use the Emerson marks both before and after the conclusion of the royalty agreement in 1984. The Case Stated mentions another agreement under which Emerson provided services to Emerson HK in return for a fee. These included "the promotion of the brand name" and one would therefore expect that, expressly or impliedly, that agreement gave Emerson HK the right to use the brand name. Clause 1 of the Royalty agreement in 1984 recites that Emerson HK wished to "continue to sell 'Emerson' brand products to customers with locations in the US", which suggests that they had previously been doing so without paying a royalty. And the royalty agreement plainly did not impliedly authorise the use of the Emerson mark in other countries to which goods were exported. So the use of these marks in those countries must have been licensed under some other express or implied arrangements. There are accordingly grounds for supposing that it would have been unnecessary to imply into the royalty agreements any licence to use the Hong Kong or other non-U.S. marks because Emerson HK already enjoyed those rights under the wider arrangements between the parties. The royalty agreements were what they purported on their face to be, namely a payment for the use of the Emerson mark in its principal market, the United States. This would be confirmed by the letter which Emerson wrote to Emerson HK on 11 July 1991, asking for an increase in the royalty rate. It said that "The value of the Emerson name *in the U.S.* and the maintenance of that name *in the U.S.* has seen a substantial cost increase since the last amendment." (Emphasis added).

The test for the implication of a term into a written agreement is, as Lord Wilberforce said in *Liverpool City Council v. Irwin* [1977] A.C. 239, 253-4, one of necessity. A term will be implied only if it is necessary to make the contract work. I have considerable doubt as to whether, on the facts as found in the Case Stated, this test was satisfied. There is evidence to suggest that, by virtue of other subsisting understandings between the parties, the royalty agreement would have worked perfectly well without such an implication.

If no such implied term in question had existed, I would have agreed with Godfrey J.A. that none of the royalties were received or accrued for the use of a trade mark in Hong Kong. The agreement licensed only the U.S. mark and, given the territoriality of the rights conferred by a trade mark, it was not possible for any of those rights to be used in Hong Kong. Mr Kotewall SC, who appeared for the Commissioner, said that it did not matter that the agreement did not license the use of the Hong Kong registered mark. One must look at what was actually done, which was that Emerson HK did use the Hong Kong mark. I do not agree. The question is whether the royalties were received "for" the use of the mark in Hong Kong. If the payments were wholly for the use of the U.S. mark, then nothing was received for the use of the mark in Hong Kong. Of course in deciding whether the royalties were for the use of the Hong Kong mark, one looks at the realties of the situation. The Commissioner is not bound by the language used by the parties. But if the reality was that Emerson HK, as a wholly-owned subsidiary, was allowed to use the Hong Kong mark for nothing, or that the right to use that and other marks (excluding the U.S.) was covered by the fee paid under the service agreement, then in my view no tax would have been payable on the royalties.

Mr Barlow however was firm in his concession before this Court, as in the Court of Appeal, that this appeal should be decided upon the footing that the royalty agreement impliedly licensed the use of the Hong Kong mark. Accordingly, that is how I think it should be decided. And on that basis, I do not see how it can be said that the royalty was not received for the use of a trade mark in Hong Kong. True, it was for something else as well, namely the use of a mark in the United States. But, in the absence of some form of apportionment, the requirement of s.15(1)(b) in respect of royalties paid on goods manufactured in Hong Kong is satisfied.

Mr Barlow said that royalties were charged only on goods sold to customers in the United States. Without such sales, no royalties would be payable. Therefore all that Emerson HK was paying for was the right to sell in the United States. It was not paying for the right to use the mark in Hong Kong. This seems to me a *non sequitur*. Once one says that it was an implied term of the agreement that Emerson HK should be able to use the Hong Kong mark, one has to identify the consideration for that term. And the only possible consideration is the royalty.

Mr Barlow submitted that the Hong Kong legislature, at the time when s.15(1)(b) was enacted, had no constitutional power to impose taxation upon events which occurred outside Hong Kong, such as the sale of goods to customers in the United States. Therefore the section should not be construed as having this effect. But that, as it seems to me, begs the question which I have just been considering. It is true that a sale in the United States was necessary before the royalty became payable and that it was calculated on the sale price. But that was not the basis on which the tax was imposed. It was charged because the royalty was also for the use of the trade mark within this jurisdiction.

Mr Barlow criticised a passage in the judgment of Mr Recorder Ribeiro SC in which he said that use of the trade mark in Hong Kong which "forms an essential step" in the process by which royalty was earned was sufficient to bring it within the charge under s.15(1)(b). Mr Barlow said that the concept of an "essential step" was relevant to locating the source of income for the purposes of a charge under s.14 but had no part to play in the application of s.15(1)(b). In my opinion, if one reads the whole paragraph, the Recorder was saying only that the royalties were taxable because they were received for the use of a trade mark in Hong Kong and it did not matter that they were also received for the use of a trade mark in the United States. That seems to me a correct analysis.

I would therefore dismiss the cross-appeal.

I turn then to the Commissioner's appeal. Mr Kotewall put the point in various ways. First, he said that by authorising manufacturers outside Hong Kong (say, in Thailand) to apply the Emerson mark, Emerson HK was using the mark and since it was carrying on business in Hong Kong, it was using it in Hong Kong. In my view that ignores the territoriality of each mark. In authorising the use of the mark in Thailand, Emerson HK was using the Thai mark and the only place where the Thai mark could be used was Thailand. Secondly, Mr Kotewall said that by licensing Emerson HK to use the mark in Hong Kong and elsewhere, Emerson was itself using the mark (wherever registered) in Hong Kong. I think that this argument fails for the same reason as the first one and for the additional reason that s.15(1)(b) does not apply to income received by Emerson *from* its own use of the mark in Hong Kong (which would be taxable, if at all, under s.14), but *for* , i.e. in return for, the use of or right to use the mark in Hong Kong. This implies that the use is by, or the right to use has been conferred upon, someone else. Thirdly, Mr Kotewall said that the royalties were for the *right to use* the mark anywhere. If Emerson HK chose to use the mark in Hong Kong, that was its business. The royalty was for the right to use the mark wherever registered. There was some discussion about whether the Commissioner was entitled to raise a question based upon the royalties being received for the right to use the mark as opposed to for its use. It was not included in the questions of law stated for the court by the Board of Review. The Recorder was willing to entertain it but Mr Barlow said that he had no jurisdiction to do so. I prefer to express no view on this disputed point because it seems to me that the question is entirely academic. The royalty agreement contemplated that the royalties would be paid on goods which had been made and sold; that is, in respect of which the mark had actually been used. And in any case, the argument breaks down at the same point as the submissions on the actual use of the mark, namely that the right to use a Thai trade mark can be exercised only in Thailand and not in Hong Kong. I would therefore dismiss the appeal as well.

Chief Justice Li :

The Court unanimously dismisses the appeal and also the cross-appeal. The Court makes an order nisi that there be no order as to costs. Such order will become absolute unless any party makes written submissions copied to the other side within 14 days.

(Andrew Li)
Chief Justice

(Henry Litton)
Permanent Judge

(Charles Ching)
Permanent Judge

(G.P. Nazareth)
Non-Permanent Judge

(Lord Hoffmann)
Non-Permanent Judge

Mr Robert Kotewall SC and Mr Joseph Fok SC (instructed by Department of Justice) for the Appellant

Mr Barrie Barlow (instructed by M/s Baker & McKenzie) for the Respondent