

## **Trust as the Greatest and Most Distinctive Achievement of the English:**

### **Can the Civil Law do Better?**

San Marino Symposium, May 22-23, 2015

## **Trust Law in China: A Temple Built on Faulty Foundation?**

Lusina Ho\*

### **Introduction**

In China, concepts of private – and especially property – law are drawn from Soviet civil law, albeit tempered by specialist laws in numerous areas where there has been rapid economic advancement. Interestingly, there are heavy traces of common law influence in these recent laws, as China interacts extensively with common law jurisdictions in trade and commerce. The trust is a good example on point. In 2001, China took the bold step of enacting a specialist Trust Law of the People's Republic of China,<sup>1</sup> and along with this Law an administrative regulation that gives trust companies the exclusive right to operate collective capital trusts, a structure similar to collective investment trusts.<sup>2</sup> Even though the Trust Law is rudimentary and riddled with conceptual gaps, it fuelled burgeoning growth in collective capital trusts. In 2003, the total assets managed by trust companies were CNY 250 million (USD 39 million); by the end of 2014, it has grown by 58,000 times to nearly CNY 14 trillion (USD 2.18 trillion).<sup>3</sup>

This is not necessarily good news, however, as the Trust Law, being the first trust statute in China, is understandably fraught with weaknesses in its conceptual foundation. Before this foundation receives its necessary reinforcements, the massive

---

\* The present paper is substantially drawn from Lusina Ho & Rebecca Lee, "Trust Law in China: A Critical Evaluation of its Conceptual Foundation" in Lusina Ho & Rebecca Lee (eds.) *Trust Law in Asian Civil Law Jurisdictions: A Comparative Analysis* (Cambridge: Cambridge University Press, 2013) ch 6.

<sup>1</sup> Trust Law of the People's Republic of China, Order No. 50 of 2001 (hereafter 'Chinese Trust Law') (official trans. National People's Congress ('NPC')), China, available at [http://www.npc.gov.cn/englishnpc/Law/2007-12/10/content\\_1383444.htm](http://www.npc.gov.cn/englishnpc/Law/2007-12/10/content_1383444.htm), last visited April 26, 2015.

<sup>2</sup> Measures for the Administration of Trust Companies' Trust Plans of Aggregate Funds (trans. [www.fdi.gov.cn](http://www.fdi.gov.cn)), available at [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/MinisterialRulings/P020071112552834211265.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/MinisterialRulings/P020071112552834211265.pdf), last visited April 26, 2015. The Measures took effect from 1 March 2007, and repealed the Tentative Measures for the Administration of Trust Companies' Trust Plans of Aggregate Funds 2002.

<sup>3</sup> Statistics available from China Trustee Association, last accessed April 26, 2015.

collective capital trust industry will continue to rest on a shaky legal foundation. This paper will examine the core features of the Chinese trust with a view to explaining how the common law trust is rationalised within the Chinese civil law system and understood by the judges, and propose ways to improve the existing law to enable a better fit between the Chinese trust and both the common law trust and the Chinese civil law system. It is hoped that this rationalisation will provide a sound and stable foundation for the growth of healthy and diverse trust practices in China. Until 2014, this exercise has been severely hampered by the lack of open access to judgments of the Chinese courts. The recent pronouncement of the Supreme People's Court in mandating the online publication of all Chinese judgments has finally made this task possible; the present paper will therefore also take into account judicial treatment of the trust concept.<sup>4</sup>

### **Core features of the Chinese trust**

Any civil law jurisdiction that is considering transplanting the trust will need to deal with at least four conceptual issues in order to put in place the essentials of a coherent and effective trust: the doctrine of *numerus clausus*; the absolute nature of ownership; the necessity of public notice for a right to be enforceable against third parties; and the ring-fencing of the trust fund from the personal creditors of the trustee. This part will examine how the Chinese trust tackles these issues.

#### *Numerus Clausus: trust as contract?*

Following the examples of Japan, Korea and Taiwan, the Chinese Trust Law requires all *inter vivos* trusts to be established by contract.<sup>5</sup> This technique situates the trust in the chapter on Obligations (as a special type of contract) rather than on Rights to Things (as a new property right), and hence complies with the doctrine of *numerus clausus*.

In characterising the trust as a species of contract (or personal claim), however, there is danger in overlooking the uniqueness of the trust. Judicial decisions in China

---

<sup>4</sup> The author is indebted to Y J Cai for the judicial decisions discussed in his paper (on file with the author). Two of the judgments discussed in this paper were identified in Cai's paper.

<sup>5</sup> Chinese Trust Law, art. 8 (1). Testamentary trusts shall be created by will.

show that the courts see the trust as a three-party contract involving the settlor, the trustee and the beneficiary, with the result that it readily invokes the Law of Contract in conjunction with the Trust Law. At times, the resort was redundant. For example, in *Gao Chunhui v Ye Zhengjie*,<sup>6</sup> when a foreigner entrusted funds with a local resident to participate in a public listing project in the latter's name, in order to get around restrictions on foreign investment, the court declared the trust void. It could have done so simply by invoking article 11(1) of the Trust Law, which stipulates that trusts that infringe laws and regulations are void. However, the court also invokes article 58 of the Contract Law to declare the contract void, revealing their characterisation of the trust as a special type of contract. In a similar vein, in *Kaifeng Zhengda Co. Ltd v Shanghai Bangying Co*,<sup>7</sup> when a trust was declared void, the court invoked the provisions of Contract Law to order the return of the trust property.

While the invocation of Contract Law in the above decision is innocuous, albeit otiose. There are times when the Contract Law was invoked even where it was inappropriate to the trust concept. For example, in *Yanxin Co. Ltd v. Huabao Trust and Investment Co. Ltd*,<sup>8</sup> where the settlor entrusted shares with the trustee in favour of the settlor himself as sole beneficiary, and subsequently assigned his 'rights as settlor and beneficiary' to an assignee in a flip-sale to inflate the price of the underlying shares, an issue arose as to whether the settlor was permitted under the Trust Law to assign his right as settlor. The Trust Law is silent, but the Shanghai High Court quickly resorted to the Chinese Contract Law to justify the assignment as one by a contracting party, albeit that on the facts the conditions for assigning contractual rights are not satisfied. One wonders how the settlors' rights under the Trust Law, being to monitor the trustee and provide necessary direction to trust administration,<sup>9</sup> can be assignable for value just like a beneficiary's rights; and if so, whether it means that the settlor's statutory rights

---

<sup>6</sup> Guangzhou Intermediate People's Court Case No. 7 of 2008, <http://www.91law.org/jinrong/show-2833.aspx>, last visited April 26, 2015.

<sup>7</sup> Shanghai Intermediate People's Court Case No. 14 of 2004 (July 23, 2004) Available at [http://www.hshfy.sh.cn/shfy/gweb/flws\\_view.jsp?pa=adGFoPaOoMjAwNKOp6bSu9bQw/HI/SjjzCmz9dfWtdoxNDW6xSZ3c3hoPTEPdcssz](http://www.hshfy.sh.cn/shfy/gweb/flws_view.jsp?pa=adGFoPaOoMjAwNKOp6bSu9bQw/HI/SjjzCmz9dfWtdoxNDW6xSZ3c3hoPTEPdcssz), last visited April 26, 2015.

<sup>8</sup> *Yanxin Co. Ltd v. Huabao Trust and Investment Co. Ltd*, Shanghai Intermediate People's Court Case No. 226 of 2004 (16 March 2005); on appeal from *Yanxin Co. Ltd v. Huabao Trust and Investment Co. Ltd*, Case No. 201 of 2004 (25 November 2004).

<sup>9</sup> Chinese Trust Law, art. 21: 'If, due to special reasons unexpected at the time the trust is created, the methods for administrating the trust property are not favourable to the realisation of trust purposes or do not conform to the interests of the beneficiary, the settlor shall have the right to ask the trustee to modify such methods.'

of monitoring are also substantive contractual rights. The contractual foundation of the trust and the court's readiness to reinforce the settlors' rights by invoking the Contract Law suggests that China sees trust as a contract, where the main contracting parties are the settlor and the trustee, and the beneficiary as a passive recipient with a secondary role in enforcing contractual duties.

### Who owns the trust property in a Chinese trust?

The Chinese Trust Law uniquely defines a trust as a legal relationship whereby: 'the settlor ... *entrusts* the rights in his property to the trustee and the trustee manages or disposes of such property in his own name'.<sup>10</sup> In using the word 'entrust', which is the same term used for creating an agency relationship that does not involve the transfer of ownership, the Chinese Trust Law does not mandate the transfer of ownership over the property to the trustee, nor does it prohibit it. Thus, a Chinese trust may simply be created upon the entry into a trust contract between the settlor and the trustee, much like an agency, albeit almost all Chinese trusts, being to hold capital or shares, involve transferring ownership of the trust property to the trustee.

This fuzzy definition was intentional, to sidestep the difficult conceptual issue as to who owns the trust property. Although the trust concept is not inconsistent with the settlor's continued ownership of the trust asset, many safeguards will be needed to ensure the integrity of the trust. For example, the trustee will need to exercise his power of management in a genuine manner; the trust assets also need to be ring-fenced from the settlor's estate. To achieve these, the settlor's ownership rights will need to be subject to fiduciary duties. However, none of these are properly provided for in the Chinese Trust Law.

Article 15 of the Chinese Trust Law only partially addresses the issue by stipulating the segregation of the trust property from the settlor's estate.<sup>11</sup> However, the Law does not impose on him any duty to segregate trust property or refrain from misappropriating trust property, or indeed any duty at all in relation to the exercise of

---

<sup>10</sup> Chinese Trust Law, art. 2 (emphasis added).

<sup>11</sup> There is no personal bankruptcy law in China.

his rights for the benefit of the beneficiaries. Again, agency thinking dominates: the settlor is seen as the primordial creator for whom the trust serves; after all, it is the settlor's property that is placed under the trust. The legislators had not contemplated the prospect that he would act contrary to the trust, or alternatively, that if he should be afforded to do so if he so changes his mind, like any principals could.

An early judicial statement in 2006 also corroborates this attitude. In *Beijing Haidian Science & Technology Development Co. Ltd v. Shenzhen Xinhua Jinyuan Touzi Fazhan Youxian Gongsi and others*,<sup>12</sup> where the trust property was actually transferred to the trustee, the Chongqing High People's Court nonetheless stated that either the settlor or the beneficiary was the real owner, but not the trustee. Such a view ignores the legal mechanism of the trust, and reveals the court's perception of the trust as but an agency arrangement in which the settlor continues to steer control over the trust property. This contrasts with the latest view expressed by the Deputy Chairman of the China Banking Regulatory Commission, the regulatory body of the trust industry, that as China does not recognise dual ownership in a trust, and the Chinese beneficiary only has a right to obtain benefit.<sup>13</sup>

#### Public notice of the beneficiaries' rights

As in most civil law jurisdictions, real rights in China must be publicly notified in order to be enforceable against third parties. A registration system is thus crucial to give notice of the beneficiary's right to the public. At the time of its enactment, the trust registration system was not yet ready; the Trust Law only stipulates, tentatively, that trusts involving registrable property must be registered, but does not say how it is to be registered. Moreover, although the trust should be registered at the time of establishment for it to take effect, the law also allows for subsequent registration without indicating how long this can be postponed.<sup>14</sup>

---

<sup>12</sup> *Beijing Haidian Science & Technology Development Co. Ltd v. Shenzhen Xinhua Jinyuan Touzi Fazhan Youxian Gongsi and others* (2006) Yugaofa Minchu zhi [First Instance, Civil Cases, Chongqing High People's Court] Case No. 14, Chongqing High People's Court (19 March 2007).

<sup>13</sup> Speech of Jiakai Yang at the China Trustee Association, available at <http://www.xtxh.net/xtxh/mediumpoints/22773.htm>, last accessed April 26, 2015

<sup>14</sup> Chinese Trust Law, art. 10: 'Where laws or administrative regulations stipulate that registration formalities shall be gone through for the creation of a trust, such formalities shall be gone through

The absence of a recognised right of beneficial ownership and a trust registration system have posed impediments on the transferability and exigibility of the beneficiary's right. Belatedly, this problem is likely to be addressed somewhat, as there is now draft Measures on the Management of Trust Registration that will mandate, as a first step, the registration of all trust products issued by trust companies. It is likely that a nation-wide registration system will be established in the Free Trade Economic Zone in Shanghai. There is no news yet as to the registration of trust generally.

### Ring-fencing the trust fund

For the trust to have a true competitive advantage over agency and contracts for the benefit of third parties, the trust fund ought to be immune from the claims of the trustee's personal creditors, heirs and spouses. The Chinese Trust Law entrenches this principle by stipulating that the trust property is segregated from other property held or owned by the trustee,<sup>15</sup> and not available to meet the claims of the trustee's heirs and personal creditors.<sup>16</sup> Unlike civil law jurisdictions such as Scotland or Quebec, it does not expressly provide for a separate patrimony of the trust fund: while trust creditors clearly have a right to assert claims against the trust assets; the law does not expressly say that they are prohibited from asserting claims against the trustee's personal assets.

Save in the exceptional circumstance when a trust is established to preserve an asset and not to invest with it, the very purpose of a trust is to maintain and grow the trust assets. To achieve this aim, the ring-fencing must not be limited to the initial trust property, or else the protection offered by trust law will be illusory. To this end, the Chinese Trust Law does provide that the trust property comprises the initial settled property, and property obtained from the use, management or disposal of such initial property, both lawfully,<sup>17</sup> or unlawfully.<sup>18</sup>

---

accordingly. Anyone who fails to go through the registration formalities ... shall go through the formalities as required; otherwise, the trust shall have no effect.'

<sup>15</sup> Chinese Trust Law, art 16: '(1) The trust property shall be segregated from the property owned by the trustee ...'.

<sup>16</sup> Chinese Trust Law, arts 15-18.

<sup>17</sup> Chinese Trusts Law, art 14: '(1) The property obtained by the trustee due to a trust accepted is trust property. (2) The property obtained by the trustee through administering, using or disposing of the trust

At a brief glance, therefore, the core principles of substitution and segregation of trust property are observed in the Chinese Law. However, it is one thing to lay down the exhortations in the Law, but another to put in place the legal mechanism for enforcing it. To ensure segregation and continuity of the fluctuating trust fund, there must be a framework of enforceable duties and remedial measures to address abuses. This paper will accordingly turn to the rights and duties between the trust parties, as they provide insight into how the integrity and continuity of the trust fund are maintained.

### **The relationship of the trust parties *inter se***

Superficially, the Chinese Trust Law stipulates the standard range of duties on the part of the trustees,<sup>19</sup> and grants correlative rights of enforcement to the beneficiaries and settlors. Unlike common law settlors, the Law leans more heavily in favour of the settlors. Chinese settlors are given far more extensive rights in monitoring the trustee and steering the continuous management of the trust property. This is not in and of itself objectionable – after all, it is not uncommon to see extensive settlor rights in US law; and it is even more common these days for settlors to reserve extensive powers to themselves. However, given the secondary and parasitic nature of the beneficiaries' rights and the lack of independence on the part of the trustee, the balance of power is very different in the Chinese trust than in a common law trust. Three observations may be made in this context.

First, the success of the common law trust lies in maintaining a continuing tension between the trustee and the beneficiaries. The trustee, in virtue of his legal ownership and distributive powers, has independent discretion in relation to trust management. It is accountable to beneficiaries who have rights to monitor trustee

---

property or by other means falls within trust assets.'

<sup>18</sup> Chinese Trust Law, art. 26: 'Where the trustee ... seeks interests for himself by using the trust property, the interests gained therefrom shall be integrated into the trust property.'

<sup>19</sup> For example, the duty to abide by the terms of the trust (art. 25(1)); segregate trust assets (art. 16 & 29); not to delegate trust management unless necessary to do so (art. 30); provide accounts (art. 33); make distributions to beneficiaries (art. 34); and provide information (art. 39); manage the trust with honesty, good faith, prudence and efficiency and in the best interest of the beneficiary (art. 25).

performance but is not bound to accede to their wishes slavishly. The trustee is an office and enjoys discretionary powers fettered by fiduciary duties; he is not merely a duty bearer. The court backs this up through its inherent jurisdiction in giving directions to the trustee and even to execute the trust itself.<sup>20</sup> While the Trust Law emphasises the trustee's duties, very little is said of its independent discretion and judicial review of this discretion. Under the Chinese Trust Law, it is difficult to see what general power or discretion the trustee has in the management of the trust property for the best interest of the beneficiaries. Rather, the definition of the trust states that the trustee is to act, 'according to the will of the settlor', to 'administer or dispose [trust] property in the interest of a beneficiary or for any intended purposes'.<sup>21</sup>

Second, not only are settlors given extensive rights in monitoring the trustee,<sup>22</sup> the beneficiaries' rights are arguably secondary to those of the settlor. The Trust Law merely replicates the settlors' rights for the benefit of the beneficiaries (by providing that the latter also enjoy the enforcement rights granted to the former), and briefly supplements this by stating that any conflict in the exercise of the beneficiaries' or the settlor's rights will be resolved by the court.<sup>23</sup> Furthermore, there is no overriding stipulation that the settlor exercise his rights and powers for the best interest of the beneficiaries. Where the settlor, for example, seeks to replace a defaulting trustee with one whom he has strong influence over, and may subjugate the beneficiaries' rights to his wishes, the Law is silent as to how the court may resolve any such conflict.

Third, the rights of the Chinese beneficiaries are much more circumscribed than their common law counterparts. First, it is clear that the trust property and its substitution are ring-fenced from the trustee's property and not available to his heirs and personal creditors.<sup>24</sup> Second, it is also clear that the beneficiary's right is assignable

---

<sup>20</sup> *McPhail v. Doulton* [1971] AC 424.

<sup>21</sup> Chinese Trust Law, art. 2.

<sup>22</sup> These include the right to obtain trust information (art. 20(1)), sue the trustee in breach and seek relief therefrom (art. 22(1)), remove a defaulting trustee, appoint a replacement trustee (art. 23), or remove an undeserving beneficiary (art. 51 (1) & (2)).

<sup>23</sup> Chinese Trust Law, art. 49: 'The beneficiary may exercise the rights that the settlor enjoys as stipulated in arts. 20 through 23 of this Law.'

<sup>24</sup> It is unclear whether it falls within the trustee's marital property to be shared by his or her spouse, as the Law is silent on this point.



and inheritable subject to the terms of the trust document.<sup>25</sup> Third, where the trustee makes an unauthorised disposition of the trust property, however, the property is no longer ring-fenced from the other assets of the third party transferee. Chinese Trust Law only provides for personal remedies against such third parties.<sup>26</sup> These take the form of either (a) a claim to rescind the unauthorised disposition or (b) a claim against the knowing transferee (or trustee) to return the property or make compensation. Since rescission does not have proprietary effect, in that it does not mandate the return of the property or any automatic reversion of title, the beneficiary is in effect only relegated to a personal claim against the knowing transferee, which closely resembles the common law claim of knowing receipt.<sup>27</sup> It is much weaker than the common law right of the beneficiary to assert a proprietary claim against the asset held in the hands of a transferee. Admittedly, to replicate the proprietary regime at common law would involve an over-kill, and this shows the acceptable boundary of the proprietary effect of the trust in civil law.

In the final analysis, the Chinese beneficiary's right differs from a typical *in personam*, contractual right only in that the assets from which their claims against the trustee are to be satisfied would be protected from his personal creditors. In this sense, it is a reinforced contractual right. Put another way, it is not a right against the trust asset, such that it can bring a priority claim against whoever that comes to hold the asset and also claim a right against it. Rather, as against third party disponees of the trust property, the beneficiary only has an *in personam* right to remedy the wrong they commit against him.

As compared to existing rights in Chinese Law, which comprise real rights (rights against things) and personal claims (claims against persons), the beneficiaries' rights are doctrinally closer to the latter, but is slightly stronger. It is most analogous to a creditor's right to rescind transactions made by his debtor that harm his interest, such

---

<sup>25</sup> Chinese Trust Law, art. 48.

<sup>26</sup> For example, while profits obtained from a breach fall within the trust property (arts 14 and 26) and hence protected by the principle of segregation (art. 16), no provision suggests that they are segregated from the assets of a third party transferee.

<sup>27</sup> Chinese Trust Law, art. 22: '(1)... Where a transferee of the said trust property accepts the property while knowing the violation of the purposes of the trust, he shall return the property or make compensation.'

as making a gift of the debtor's property, transfer of his property in favour of a knowing donee at an undervalue, or release of a debt owed to him. In these situations, the creditor also has a right to annul such transactions and require the knowing donee or sub-debtor to return the property or make compensation.<sup>28</sup> This right to rescission has been described as a 'propertised' claim right.

### **Enhancing the Chinese Trust Law**

The above survey seeks to show that the Chinese trust is a rather different kettle of fish from the common law trust. It does not have all the 'bells and whistles' that make the latter so successful. While it is not possible to replicate the full common law trust without running into conflict with civilian concepts, there still is room to enhance various aspects of the Chinese trust. These include: requiring the transfer of ownership to the trustee (or imposing fiduciary duties on a settlor who continues to hold trust property); refraining from the inappropriate application of contractual law to the trust concept; recognising an overriding constraint on settlors to exercise their statutory rights for the best interest of the beneficiaries; clarifying the immunity of the trust property from the trustee's spouse; and implementing a general system for trust registration. Registration will significantly enhance the protection of the beneficiary's right, even if it is not a real right. The protection of the contractual right of a purchaser of real property is a good case on point. In Chinese Law, a purchaser who has entered into an agreement to acquire real property can make an advance registration of his contractual right in the land registry. Such registration renders invalid any subsequent disposal of the property without the registered purchaser's consent.<sup>29</sup> Because the right has been publicly notified through registration, its protection does not compromise civilian norms.

### **Conclusion – shadow banking and the trust curb**

Thus far, the conceptual imperfections of the current Chinese Trust Law and the lack of institutional infrastructure for trust (such as a general registration system) have not

---

<sup>28</sup> Chinese Contract Law, art. 74.

<sup>29</sup> Chinese Property Law, art. 20.

caused significant impediment to growth of trust industry. This is because about 95% of Chinese trusts involve cash / capital, which is transferred to the trustee and need not be registered. These trusts are but conduits to channel investments from investors to businesses or governments that need cash but are unable to borrow from the state banks. The settlor-investors are also beneficiaries, thus averting issues of conflict between the settlors' and the beneficiaries' interest. The trust often involve very little, if at all any active management and distribution of the trust fund, as the either takes from a single investor or pools investors' contributions to extend loans for infrastructure or property development projects. Investors are then paid the principal together with interest upon a maturity period. These trusts play the role of shadow-banking and trust companies thrive on the regulatory arbitrage between state-owned banks (that are subject to interest caps) and non-bank financial institutions that are relatively less regulated. More recently, this business model has been taken to new, risky heights by the so-called umbrella trust, a new form of equity leverage financing. In an umbrella trust, there is a sub-trust funded by institutional investors in exchange for fixed returns protected by a senior equity tranche, while private investors invest in the high-risk, junior equity tranche, but are allowed to have a much higher leverage ratio than that in traditional margin financing. In effect, they are borrowing from institutional investors. Although the scale of umbrella trusts is still small, at about 1% of China's market free-float. The impact it has on private investors once the stock market falls can raise serious social issues.<sup>30</sup>

This is a risky foundation for the long-term growth of trust companies, who have yet to develop core trust competences such as management of a wide asset portfolio, proper trust accounting, and management of clients with conflicting wishes. If China were to develop private family trusts, charitable trusts, for example, the current legal framework will need to be reinforced to enable the healthy development of the industry.

---

<sup>30</sup> See <http://www.scmp.com/business/banking-finance/article/1683799/china-crackdown-margin-lending-may-stoke-shadow-banking>, last accessed April 27, 2015.