

The new trust law in China

Introduction

The peoples congress of the Peoples Republic of China (the “PRC”) recently passed a law on trusts (the “Law”) which will come into force later this year. This is noteworthy for several reasons. Firstly, it is unusual for civil law jurisdiction to introduce a system of trust law. Secondly, there is a strong possibility that trusts will be used as a legal vehicle for the eagerly awaited new pension funds. Lastly, the trust is likely to impact upon the ownership of assets in Hong Kong by mainland based organisations.

Use of trust law in a civil law country

Many would regard trust law as one of the distinguishing hallmarks of a common law jurisdiction. The use of trust law in civil law jurisdictions has been unusual. Quebec and Louisiana are both civil law jurisdictions which have well developed trust systems. However, they are also unusual in being islands of civil law in countries which otherwise have common law systems. Some European countries have implemented limited trust law systems but this has not been widespread. In many ways, the countries of Central and Eastern Europe have had similar recent transformations to those currently being undertaken in the PRC. Although these countries have implemented exceptionally far reaching legal changes, none have implemented a trust law system. In many ways trusts could have proved useful, because of the wide spread development of private pension fund systems. However, in most cases, the introduction of a trust law does not even seem to have been contemplated. Perhaps in part, this stems from the Franco Germanic legal traditions in those countries.

Therefore, the Chinese are to be applauded for their far-sighted attitude. Trusts can and will play an important role in a number of areas as China continues its transition. This does not mean there aren't problems with the Law. There are. However, these should not detract from the brave and far sighted step which the PRC has taken.

What is a trust?

A trust is a common law vehicle which enables one party (the settlor) to give property to (or settle property on) another party (the beneficiary) whilst keeping its legal ownership separate. The legal ownership of the property vests in a separate party (the trustee) who holds that property for the benefit of the beneficiary.

The personalities of a trust are:

- (1) The settlor - the party who gives or settles the trust property;
- (2) The trustee - the party who is the legal owner of the trust property;
- (3) The beneficiary - the party for whose benefit the property is held by the trustee; and
- (4) The object of the Trust - the property to be held by the trustee.

A settlor may be a beneficiary under a trust. A rule has been developed in some common law jurisdictions that a trustee and a beneficiary cannot be the same person because an individual cannot be under an obligation to himself.

In addition to the personalities, common law legal systems have developed three other elements to be present, often called "the three certainties". The first of these is that there must be the certainty of intention to create the trust on the part of the settlor. This is typically evidenced by a trust deed. The second certainty is that of subject matter. This means that the property which is settled must be ascertainable or definite. The third certainty is that of the object of the trust i.e. the beneficiary, who must again be defined or ascertainable. The above rules might suggest that trusts are an inflexible vehicle however, case law over the centuries has expanded the reach of the trust and with it the scope of the three certainties. Therefore, in many cases the intention to create the trust can be implied through dealings or conduct creating the concepts of resulting and constructive trusts. Objects or beneficiaries can be expressly named, as is often found in a private trust or be of a defined class such as the members of a sports club, as is often found in public and charitable trusts. The certainty of property expands to cover real (or immovable) property and personal (or movable) property, shares or cash.

Trustees

An analysis of trusts cannot be had without briefly describing the obligations of the trustee. A trustee is under a fiduciary duty to deal with the trust property in an appropriate manner. The common law has developed a “prudent man” test as to whether a trustee has attained the standard expected of him. The test being objectively whether the trustee has dealt with the property in such a way that a prudent man would have done, which includes taking expert advice where decisions are out his sphere of knowledge. Some legal systems have gone further than this by including the actual knowledge of a trustee in determining whether the trustee has reached the required standard. In this second case if an accountant or a lawyer were to be a trustee they would be expected to use the knowledge and skill that is expected of their profession. Being a trustee is not a job to be taken lightly.

In many common law jurisdictions two trustees are required to ensure the fair dealing of property so that there is always a check on the dealings of the other. Even if the law does not require this it is common in certain types of trusts, such as pension trusts, for there to be multiple trustees. The law has also expanded to allow trust corporations to be established to exercise the powers that would normally be exercised by individual trustees. For the directors of the trust corporation, who fill a role analogous to individual trustees this has the benefit of shielding them with limited liability. It is common for trust corporations to employ staff to deal with the many different trusts of which it is trustee. This has the benefit of allowing the trust assets to be dealt with in a professional and commercial manner. In many jurisdictions there is also a public trustee who is the trustee of last resort and who typically deals with the estates of people who have died intestate.

Traditional uses of a trust

The most common way that people encounter the trust is either by a family member settling property, typically on his children or grandchildren. This is either done during his lifetime or under a will. In these cases the trustees may typically comprise the family lawyer and a member of the family. Charitable trusts have also developed where the beneficiaries are typically a class of people such as the pupils of a school, the members of a youth organisation or even as wide a class as the poor of a particular area.

Pension funds

More recently in the history of the trust, pension funds have been developed on the basis of the trust principle. Commonly the employer as settlor will give contributions to trustees to hold for the benefit of its employees. Often the trustees will be drawn from the management and workforce of the employer. The contributions are then usually managed as a whole by an investment manager under the control of the trustees. At retirement commonly the employee's share of the investment, based on his contributions, is used to buy him an annuity to support him in his retirement. In some jurisdictions there is also the provision of a lump sum benefit. Investment funds in contrast do not provide long term benefits, they allow individuals to buy a share of a pooled investment which they can sell at any time. They have the benefit of allowing a sole individual to invest in a diverse set of assets which he could not purchase alone.

The New Trust Law in the People's Republic of China

The Law was passed by the 21st Session of the Ninth People's Congress' Standing Committee on 28 April 2001, and will come into effect on 1 October 2001. It is described as being formulated to create the trust concept, regulate trust activity, protect the interests of the parties to the trust and promote the development of the trust in China. However the conduct of trust institutions is subject to separate regulations.

Creation

As one would expect, the Law provides a trust must have a settlor, a purpose and property which is owned by the settlor, for the trust to be valid. It must also be established in writing, thus expressly excluding the concepts of constructive and resulting trusts, and envisaging trusts to be used only in a defined set of circumstances. The trust document or "trust deed" as common lawyers would call it, must also specify the purpose of the trust, give the name and address of the settlor, the trustee, the beneficiary or the scope of the beneficiaries, the scope, type and condition of the property subject to the trust and the means by which the beneficiary receives his interest.

The Law provides that where the trust property, the beneficiary or the scope of the beneficiaries

cannot be ascertained the trust is void. It is as yet unclear how general the descriptions in the trust document can be before this provision is activated. Caution should be exercised in drafting trust documents and, if at all possible, the strict requirements of the Law should be adhered to. Particular problems are envisaged in relation to pension, mutual and investment funds as the trust property cannot be exactly specified at the outset as contributions will be made over a period of time. The problem may also arise in the case of will trusts, the executor will know that the trust contains the deceased's property but not exactly what it is or its value.

The Law only appears to contemplate domestic trusts as there is no allowance for either the beneficiary or the settlor being a non-Chinese national. In that case there is a strong argument in favour of placing a choice of law clause in the trust document. The Law applies to a trust document entered into between Chinese nationals in respect of trust property in China. Where either a beneficiary or settlor is a non-Chinese national, it is up to the parties to determine whether PRC law applies or whether to choose the law of another common law jurisdiction with a more sophisticated and well-developed trust law to govern the trust document.

There is only a requirement that the trust be registered where a separate law or regulation requires it. It is disappointing that the PRC government did not take advantage of this unique opportunity to require registration for all trusts. Compulsorily registration could have only helped to further the transparency of trusts, which in turn could have only promoted their use. The simple step would have been to have family and inheritance trusts registered at the family court. However, the Law does require that a public trust must be approved by the authority in charge of public interest undertakings. It is unclear whether investment and pension funds are required to register with any particular body. It is hoped for the regulation of these areas that they be required to register with the China Securities Supervision and Administration Committee or another supervisory body.

Validity

A trust may also be declared void if it is "established for the sole purpose of litigation or debt collection". The provision seems to envisage a situation where a trust is established to prejudice a creditor and thus the provision would enable the creditor to apply to the court to have the trust revoked. This is a vague provision, there is no indication as to the basis on which a court would decide why the trust was established, let alone if it was planned to avoid a creditor. There is also a time limit of one year from the time the creditor knew or should have known the reason

to have the trust revoked, in which a creditor may apply to the court for the trust to be set aside. This provision can be criticised to the extent that it covers all trusts. It would seem fairer if it only extended to trusts made in favour of either the settlor himself or his family members. A year is also a long time for the limitation period to run. A shorter period, such as six months would appear to be more proportionate. The real danger of this provision is that a trust could be created in good faith and then be attacked because the settlor's financial circumstances have changed dramatically within the one year period.

Trust property

Trust property is defined in the Law as being separate from the other property of the settlor, which is not subject to the trust and is different from the property originally owned by the trustee, which is called the trustee's "original property". There are also provisions governing what will happen to trust property on the occurrence of certain events.

Where the settlor is the sole beneficiary of the trust and he or she dies or the trust terminates due to dissolution or bankruptcy, the trust property becomes part of the settlor's legacy or liquidated property. In cases where there are other beneficiaries, apart from the settlor, the trust continues and the rights of the settlor (as a beneficiary) pass as a legacy or as liquidated property. In view of this provision, the trust document should clearly define the rights of the beneficiary where there is more than one.

How can a trustee terminate?

Importantly where a trustee dies or the trust is terminated due to dissolution, revocation or bankruptcy the trust property does not form part of his legacy or liquidated property. This is key in protecting beneficiaries from individuals claiming the trust property in connection with the trustee. Linked to this are circumstances where a claim can be made against the trust property. These are:

- (1) Where a creditor had a priority claim against the trust property before the trust was created and enforces that claim;
- (2) Where a creditor claims to pay off debts arising out of the disposal of trust affairs by the trustee;

- (3) Taxes owed on the trust property; and
- (4) Other circumstances provided by law.

Despite the express provisions in this part of the Law, there must be concern over the fact that the exceptions are too generally phrased and may prove open to abuse. Of particular concern is the ability of a creditor to attack trust property in order to receive payments of debts arising out of trust affairs. It is conceivable that this ground could be used to vexaciously attack trusts. Importantly for the trustee a creditor may not attack the trustee's "original property" in attempting to enforce payments of debts arising from the management of the trust.

The settlor

The settlor can be either an individual or a company or another organisation established under the law. This is to be welcomed as it recognises the wider use of trusts as commercial vehicles, for instance as investment funds and for companies providing pension benefits to their employees. The settlor is entitled to receive copies of trust accounts and reports concerning the management of the trust property. In addition, he has the right of access to trust papers including the right to copy them. Trust papers are defined widely and specifically include the accounting books and correspondence. This provision seems reasonable.

The Law also goes further allowing the settlor to instruct the trustee to manage the trust property differently where the present management is detrimental to fulfilling the aim of the trust or if it is not in the interest of the beneficiary, due to special circumstances not foreseen at the time of the trust's establishment. This provision could prove to be detrimental to the proper administration of trusts and is contrary to principles of trust law in most other jurisdictions. The trustee has the spectre of the settlor criticising his every action. This could result in the settlor having control over the trust, which runs contrary to the trust principle. A provision such as this should not be required, where trust law successfully hands over trust management to the trustee, whilst requiring him or her to act with prudence in the best interests of the beneficiary. In that situation such action should only be required where there was a sufficiently large breach of trust to warrant recourse to the court.

There are provisions where the settlor can make an application to the trustee for restitution or compensation in the event of violation of the trust purpose, violation of management duties or for misconduct where loss has been caused to the trust property. This is envisaged to run in

tandem with an application to the court to set aside the act or acts of the trustee which caused the loss or losses to the trust property. There is a one year limitation period which runs from the discovery of the act giving rise to the application for revocation. In cases of misconduct the settlor can apply to the court to dismiss the trustee. What is not clear from the Law is whether compensation is due for the cost of making the application to the court and/or any other related costs. Also, if compensation is not made, should the cost of the application come from the trust itself or be born by the settlor?

The trustee

The Law contains many sensible provisions in relation to the trustee which reflect his or her position as independent custodian of the trust property. These provisions include prohibition on a trustee making a personal profit from trust property and self dealing by the trustee. There is also the requirement that trust property be kept separate from the original property of the trustee. A trustee must also keep full records and report regularly to the settlor and the beneficiary on the management of the trust.

The trustee has a duty to abide by the trust documents to act in the maximum interests of the beneficiary and to strictly perform his obligations with honesty, good faith, prudence, and efficiency. This is a good provision as far as it goes. However, it could be made stronger so that the trustee should act in the sole and exclusive interest of the beneficiary. Also, there should be a codified standard of care equivalent to that found in many sophisticated common law jurisdictions whereby trustees are required to act with the care, skill, prudence and diligence, that would be exercised by a prudent person familiar with the matter and acting under similar circumstances, dealing with the property of another. There is also no concept of fiduciary duties in the Law, which would provide a background to the standards expected from trustees.

The Law provides that joint trustees are to conduct trust affairs jointly unless otherwise provided in the trust document. Where there is disagreement between trustees the first recourse would be to the procedure in the trust document. In the absence of any provisions the decision rests with the settlor, the beneficiary or other persons with a related interest. Joint trustees are also to have joint and several liability. These provisions on the face of them appear to be workable. However, it would seem fairer if joint and several liability were limited to the situation where the other trustee(s) knew or should have known of the damaging acts of one of the other trustees. It would also be more in keeping with the independent running of the trust, if the decision maker

of last resort was an independent party such as the court or a public trustee. This criticism extends to the provision whereby the selection of the new trustee is also to be decided by the provisions in the trust document, but failing that, the decision goes to the settlor. If the settlor does not decide or is not capable of appointing a new trustee, the beneficiary makes the appointment.

There does not appear to be any consideration in the Law of the fact that the individual chosen to be a trustee may not wish to be one. Common law jurisdictions have ingrained in them that the position of trustee should be voluntary. The Law is not clear whether the person chosen by the mechanism in the trust document or by the settlor, or by the beneficiary, can decline to act. Also, the Law provides that a trustee can only terminate his trusteeship on death, when he lacks capacity, when he is declared bankrupt, when he loses legal qualification, when he resigns or is dismissed and in other circumstances provided by the law. This appears to be as one would expect, however on resignation the trustee has to continue to perform his duties until a new trustee is selected. This can hardly be fair for the trustee who no longer wishes to act in view of the onerous duties placed on him. It is also potentially unfair to beneficiaries because a trustee that is not a volunteer may well not perform his duties in a diligent manner. The more practical approach would be that where a replacement trustee cannot be found, the function should be transferred to some form of public trustee.

The beneficiary

The definition of beneficiary states that it can either be an individual, a legal person or a legally established organisation. It also states that settlors can be beneficiaries, as can trustees, but trustees cannot be sole beneficiaries. This definition may not be wide enough to catch a public trust that benefits members of the public generally. It is also restrictive in the sense that a group of people may not be part of a legally formed organisation, but may be a recognisable group, such as the sufferers of a particular disease. However, it may be that the Chinese courts will interpret this provision widely so the above problems do not arise. Please see the comments above in relation to the scope of the parties to a trust in the trust document.

Another important provision is that where a beneficiary has a debt, his rights under the trust may be used to discharge this, unless otherwise provided for in the trust documents or other laws. This is clearly not appropriate for all trusts. For example, pension funds are designed to encourage long-term saving for retirement. Their purpose would be frustrated where there could

be several attachments to the benefits throughout the contributors' lifetime. This is contrary to the practice in nearly every country where trusts are used for pension purposes.

Beneficiaries are also given the same powers as settlors, should disagreements arise between the beneficiaries and the settlor. It is clearly not appropriate for the beneficiaries to be given too much power in the trust as it would create problems for the trustees' management of the trust property and may also make a fiction of the trust principle.

Amendment and termination

The main provisions relating to termination contained in the Law are that a settlor may determine a trust where the beneficiary consents, as set out in the trust document, or where the beneficiary has committed a serious violation of the rights of the settlor. This last criterion may be difficult to ascertain as no examples are given. Even where a beneficiary has violated the rights of the settlor, it may not be appropriate for it to lead to the determination of the trust. For example, an employee participating in a pension fund may have committed an act which has caused his employment to be terminated. It is surely unfair, if his participation in the pension fund is then also terminated. It must be remembered that his contributions were given in good faith and at a time when the employee was abiding by the rules of the pension fund.

Automatic termination is contemplated for reasons set out in the trust document and where the continuance of the trust violates its purpose, the trust has accomplished its purpose or where it cannot be accomplished, the parties to it have agreed, the trust has been rescinded or it has been dissolved. Problems could arise where the parties are forced to agree to terminate the trust where there has been a disagreement. In this circumstance, an arbitration/mediation mechanism would be more appropriate rather than forcing a termination where the parties are prepared to talk. Also, termination of a charitable trust may not be appropriate where the purpose cannot be fulfilled. Public policy should dictate that a way should be found to derive some charitable benefit from the trust. Please see the discussion below on trusts for public benefit.

Trusts for public benefit

Trusts for public benefits are defined as having purposes which include poverty relief and education. The list is not exhaustive as it also contains the category for developments of other social and public undertakings. Despite this, the Law treats charitable and public trusts as synonymous. Clearly from western experience, the two may not be the same and in fact English law has quite frequently declined to treat certain public trusts as charitable preventing them from having the benefit of significant tax advantages. The Law does not mention any tax advantages and it is hoped that the new tax code will give them to public trusts. One problem as to the differentiation between the charitable and public trusts is that a charitable trust is more likely to operate on a non-profit making basis, while certain public trust may generate profits. It would have seemed sensible to make this distinction.

It is good that the Law provides that each trust for public benefit should have a 'trust supervisor' to protect the interest of the trust which extends to conducting litigation in the trust's name. However, the trust supervisor's duties should be set out in the Law. It is currently not indicated whether the trust supervisor is a form of trustee. Presumably the duties and responsibilities of a trustee do apply to a trust supervisor but again this is unclear.

The establishment of public trusts and the appointment of trustees are governed by the authority in charge of public interests undertakings (the "Authority"). A trustee of a public trust cannot resign without the permission of the Authority. This again causes the problems of a trustee not acting voluntarily, as described above, in relation to a normal trust. It may also mean that trust corporations or commercially minded trustees may be unwilling to undertake work for trusts on a voluntary or even a paid basis.

A good provision is the fact that the Authority may inspect the disposal of public trust assets and that the trustee must prepare an annual report on the affairs of the trust. This is published once it has been approved and verified by the trust supervisor and the Authority. The Authority also exercises control over the trustee and may replace him where he violates his duties or is incapable of performing them. It is unclear how this will be judged. If it is merely to be on the opinion of the Authority, this may be unfair and it may also overwrite any provision in the trust document.

Termination and liquidation reports are also referred to in the Law. These are presumably in a similar format to the annual report. Another feature of the Law is that on termination the trust property may be used for similar public benefits or transferred to another trust for public benefit

with a similar purpose on the approval of the Authority. Where approval is not given, it is not clear as to where the property should go. Presumably it follows the general trust law.

Until all the detail is given on public trusts in relation to the annual report and determination of liquidation reports, as well as the specific rules of the Authority, full comments cannot be given as to the effective functioning of public trusts. One provision which may ensure the smooth running of public trusts is that the settlor, trustees or beneficiaries may go to the court where the Authority breaches the Law. It may be that this provision should have been framed wider so as to review decisions of the Authority where their compatibility with the purpose of the trust is in doubt.

We now turn to the likely uses for the new trust law.

Applicability of the law to pension funds

Undoubtedly, one of the most noteworthy likely uses of the Law will be in relation to the creation of pension funds in the PRC. The PRC government has embarked upon a process of radical pensions reform and has already announced the introduction of a three pillar pension system.

Pillar I will be pay as you go state social security. Pillar II will be funded mandatory accounts. Pillar III will be voluntary arrangements. It is in pillar III that trusts are likely to play the most significant role. Although no pension fund legislation has yet been drafted, current thinking is that it will be possible for employers to create pension funds for their employees. It is also likely to be possible for institutions such as insurance companies to create open pension arrangements which will be marketed to the general public. Current thinking is that employer sponsored arrangements will be subject to the trust principle and it is also conceivable that open pension funds might be created in the same way. Currently, much consideration is being given as to how pension fund law and Law should interact.

Regardless of how the final details are worked out, it seems clear that the potential for pension trusts is huge. Like most countries, the PRC has an ageing population. However, this trend has been exacerbated by the one child per family policy.

In common law countries, it is generally understood by trustees and by others that the role of the trustees is to act in the best interest of the beneficiaries. Fortunately, cases are rare of trustees using pension money for their own purpose. It is imperative that the PRC effectively educates trustees and potential trustees so that their duties and functions are understood.

Applicability of the law to syndicated loans

Currently, syndicated lenders taking security in China may encounter difficulty in transferring their rights and interests in a syndicated loan to a third party.

In order to ensure the validity and enforceability of security taken in China, it is necessary to comply with the approval and registration requirements under PRC law in respect of such security, regardless of the governing law of the security document. The practice in the international syndicated loan market is to have an agent holding the security as trustee for a syndicate of lenders.

Since currently there is no such concept of a trust under PRC law, when it comes to the actual registration of security in China, syndicated lenders often find it difficult to have the security agent registered as chargee because the relevant registration authorities do not understand the concept of a trust and may refuse to allow such a registration. Instead each of the syndicated lenders rather than the security trustee are registered as chargees.

When a lender transfers its interest in a syndicated loan to a third party (the "Transferee"), the Transferee has to make sure that the security provider will attend to the re-registration of the security such that the Transferee is added as one of the chargees. In the PRC, registration of security is not a matter of formality or priority but rather it goes to the validity of the security, that is that the security has to be registered to become valid security. Further, the registration must be attended by representatives of both the security provider and the lenders and cannot be done by the lenders or their legal advisers alone as in some other jurisdictions. Therefore, the Transferee cannot complete the registration procedures without the co-operation of the security provider.

With the promulgation of the Law, it is hoped that the registration authorities in the PRC will accept a security trustee as trustee for a syndicate of lenders and allow the security trustee to be registered as chargee without the need for all the beneficiaries to be noted. If this can be

achieved, there will be no need for re-registration after the transfer of a lender's interest in a syndicated loan to a transferee. This may stimulate transactions in the secondary loan market.

Applicability of the law to investment in Hong Kong and other areas

The Law may also have an impact on investment by PRC companies in Hong Kong and other areas. Although foreigners are keen to do business with China, companies in China are also interested in exploring investment and trading opportunities overseas.

It is not uncommon to see 'window companies' set up by corporations originated from provinces, cities and even counties of different parts of China ("PRC Corporations") doing business in Hong Kong. Usually the shareholders of such window companies are senior staff, sent by PRC Corporations to invest in Hong Kong, with funds provided by those PRC Corporations. In common law jurisdictions, such people would in fact act as trustees for the PRC Corporations. Since trusts are an alien concept in China, there is seldom any trust document entered into between the PRC Corporations and their delegates in Hong Kong.

With the introduction of the trust concept, the Law will definitely provide an effective means for PRC Corporations to protect their investments overseas. If a shareholder of a window company absconds with money realised from selling assets of the window company, it will be difficult for the PRC Corporation to trace and prove its beneficial interest in the assets in the absence of a trust relationship with the shareholder. As a result of the enactment of the Law, PRC Corporations can create a trust with their delegates acting as trustees in accordance with the Law or consider choosing Hong Kong laws or laws of other common law jurisdictions in the trust document. The existence of the trust will show their beneficial ownership of the assets legally owned by the window companies and serve as a device for safeguarding their foreign investment. Hopefully there will be a possible increase in investment by PRC Corporations overseas.

Conclusion

The PRC is to be applauded for its far sighted approach in introducing a trust law. The Law is not without its flaws but, undoubtedly, further amending legislation can overcome many of these problems.

Trusts could and should play an important role in economic development, both in the mainland and in Hong Kong. However, the introduction of an effective well functioning system of trusts does not just depend on the passage of a law. There also needs to be an understanding of the fiduciary nature of trusteeship and the divide between legal and beneficial ownership. It is to be hoped that the PRC will be able to ensure that there is this understanding on the part of Chinese trustees.

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