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Who Owns the Mirage? Comments on A Recent Chinese Securitization Case from A Comparative Perspective

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WHO OWNS THE MIRAGE? COMMENTS ON A RECENT CHINESE SECURITIZATION CASE FROM A COMPARATIVE PERSPECTIVE

LINGYUN GAO*

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I. BACKGROUND

A. *Securitization in China*

Securitization, often used as an interchangeable term of structured finance¹, originated in the United States in the 1970s² and now has been developed as a

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mature financing device internationally. Chinese government has been showing interest in securitization for a long time and the theories and practices of the securitization in the United States have provided valuable experiences for China to learn. The securitization practice in the mainland China had not been developed until mid-1990s, when Chinese academic scholars and financial lawyers had started to explore this field and made quite achievement since then. For example, in 1996-97, there had been three successful cases of securitization in China.³ One of them, Zhongyuan Company, issued 300 million U.S. dollars' securities in the United States through private placement and these securities were backed by the company's income from its flights to and from North America.⁴ Zhuhai Highway also successfully issued 200 million U.S. dollars' bonds in the United States backed by the registration fee of transportation vehicles and the toll fee of the highway.⁵ These cases, however, all involved overseas issuing, and strictly speaking, they were not local Chinese securitization cases.

From September 2000, the state-owned banks in China started to be involved in asset securitizations. However, the State Council of the People's Republic of China (hereinafter "PRC" or "China") was very cautious until 2005 when it finally approved the State Development Bank and the Bank of Construction to conduct the so-called "test" securitization of credit assets and home loan mortgages.⁶ Later on, asset-backed securitization (ABS) also started to emerge in China. For example, a trust and investment company in Shenzhen launched a cash-trust⁷ plan in 2006 by pooling public investors' funds. The trust raised RMB 80 million Yuan's funds⁸ and

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¹ Steven L. Schwarcz, *Securitization and Structured Finance*, in ELSEVIER'S ENCYCLOPEDIA OF FINANCIAL GLOBALIZATION 1 (2011).

² *Id.*, at 3.

³ Lihua Duan, *A Research on Pricing Based on Mortgage-Backed Securitization* (2004) (unpublished M.S. thesis, University of International Business and Economics) (on file with author).

⁴ Jun Liang, *Case Study on the Zhongyuan's Securitization*, RESEARCH ON INVESTMENT BANKS, <http://web.cenet.org.cn/web/ibmasters/index.php3?file=detail.php3&nowdir=&id=35618&detail=1> (last visited on Sept. 5, 2013).

⁵ *Analysis on the Securitization Cases in China*, FINANCIAL WORLD, <http://www.jrj.com.cn/NewsRead/Detail.asp?NewsID=149543> (last visited on Sept. 5, 2013).

⁶ Chunming Zhou, *A New Thought on Asset Securitization: Banks Ready for Securitization*, FINANCES WEEKLY OF THE SOHU FINANCES (Oct. 8, 2012), <http://business.sohu.com/22/66/article203576622.shtml>.

⁷ If the trust property is money other than the other types of property, the trust is called a "cash trust" which is subject to stricter rules in China.

⁸ The exchange rate of U.S. Dollars to RMB Yuan on Sept. 6, 2013 is 1: 6.1728 according to the People's Bank of China. The same amount of RMB Yuan was worth less U.S. Dollars back in 2006 owing to the appreciation of the RMB. *6 Yuan Central Parity Rate at 6.1728*

was backed by the expected 3-year net income of a hotel.⁹ It is fair to say that the localization of asset securitization in China has kept the same pace as the other Asian countries during this period.

Since 1999, securitization has become the focus of many important research projects conducted by the PBC and the China Securities Regulatory Commission (CSRC), and it has also been regarded as an important chapter in the plan of Chinese government to convert Shanghai into a financial center. Shanghai government has submitted various reports to the PBC asking for approval for pioneering home loan mortgage securitization.¹⁰ In late March 2001, when the then chief of the PBC, Mr. Xianglong DAI, explained the recent financial reform tasks, he especially pointed that mortgage-backed securitization would be encouraged in order to promote the construction of residential houses. In April 2001, the PBC Shanghai Branch submitted a proposal to Shanghai government in which non-Mortgage backed securitization was listed as one of the most important tasks that Shanghai government needed to implement.¹¹ In the same year, the National People's Congress (NPC) of China passed the Trust Law, which formally introduced the trust system originated in the common law countries into China and thus it is regarded as a milestone because it has removed certain legal obstacles for asset securitization. People believe that trusts are the most common vehicle used in securitization.

Local securitization cases quickly emerged in China, especially in the real estate area. Generally, the trust companies pooled money from public investors through issuing trust certificates, and then use the funds thus raised as loans to the real estate developers and expect the value of the real estate project would be greatly increased after the project being completed, which had been true for quite a long time. The trusts established this way are "cash trusts" subject to strict rules and regulations as further introduced below.

B. The Context of the Case

The State Council of the PRC unleashed a RMB 4 trillion Yuan's economic stimulus package in November 2008¹² in responding to the world economic crisis. As a result, the real estate industry in China had risen abruptly and the house prices had soared in the latter half of 2009, which in turn stimulated the development of real estate financing. However, the China Banking Regulatory Commission ("CBRC") had issued a series of rules and regulations since 2005 to regulate this

Against U.S. Dollar Fell 32 Basis Points (Sept. 6, 2013) <http://www.instant-news.us/news-5358234.html>.

⁹ *China's Market for Securitization Products Developed Steadily*, ECONOMIC DAILY NEWS (Nov. 16, 2006), available at <http://www.sei.gov.cn/printpage.asp?ArticleID=84342>.

¹⁰ Chuanquan Li, et al, *Preface of Translators part 4*, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (CHINESE TRANSLATION), Tsinghua University Press (2003), available at: <http://www.sinobook.com.cn/b2c/scrp/bookdetail.cfm?iBookNo=100004> (last visited on Jan. 13, 2015).

¹¹ *Id.*

¹² Chen Wei, *The New Economic Stimulus Package: Upcoming or Awaiting*, ECONOMIC REFERENCE DAILY (Apr. 15, 2009), available at http://jjckb.xinhuanet.com/yw/2009-04/15/content_153737.htm (last visited Aug. 20, 2013).

area, among others, the real estate developers must, in order to get financing, have at least class-II qualification, and their real estate project must have four certificates: the certificate of land-use right¹³, the certificate of land planning permit, the certificate of project planning permit, and the certificate of project construction permit.¹⁴ These strict rules made it difficult for the real estate developers to get loans from banks or other financial institutions. Therefore, the developers turned to the trust investment companies for funding.

Chinese Trust Law was promulgated in 2001, largely based on the common law of trusts. However, Chinese people are not familiar with the trust system since it is not a traditional system in China; therefore, there have been few private trusts, if any. Instead, people establish trusts almost always for commercial purposes, and mostly, securitization. These trusts are called “营业信托” in Chinese, which could be literally translated as “trusts for profit¹⁵.” The trustees must be the trust companies authorized to engage in trust businesses.

In the beginning, the trust property of most of these trusts was money, and the regulator names it as “cash trust” to distinguish it from the “non-cash trust” where the trust property is other forms of property. Comparatively speaking, the “cash trusts,” especially the trusts with multiple settlors (investors), are more heavily regulated in China because they are easy to be regarded as devices for “illegal money-polling (or illegal fund-raising)” which is a crime under Chinese Criminal Law¹⁶. The most concern is that for a cash trust, the trustee may solicit public funds

¹³ According to Chinese law, all lands are owned by the State and private individuals or institutions may only have the right to use the land.

¹⁴ The trust companies were also required to conduct self-compliance examinations regarding these rules. See *Notice on Trust Companies' Risk Warnings on Real Estate Trusts Businesses*, CRBC, No.343, (2010), http://www.law-lib.com/law/law_view.asp?id=335491.

¹⁵ A “trust for profit” is different from a business trust or commercial trust in the common law countries in that it refers to a trust where the trustee is a trust and investment company authorized by government to do trust business for a profit.

¹⁶ Article 192 of Chinese Criminal Law prescribes:

Those who illegally raise funds through frauds for purpose of illegal possession and if the amount is comparative bigger, shall receive no more than five years' imprisonment or detention, plus a fine of no less than RMB 20,000 Yuan but no more than RMB 200,000 Yuan; if the amount is huge or if the circumstance was severe, an imprisonment of no less than five years but no more than ten years will be imposed, plus a fine of no less than RMB 50,000 Yuan but no more than RMB 500,000 Yuan; if the amount is extremely huge or if the circumstance was extremely severe, an imprisonment of no less than ten years or life imprisonment shall be imposed plus a fine of no less than RMB 50,000 Yuan but no more than RMB 500,000 Yuan, or forfeiture of personal property.

by promising an attractive investment return while using the funds for personal benefits so as to harm the investors' interests. The PBC required each such cash trust with multiple settlors have no more than 200 settlors with each settlor investing no less than RMB 50,000 Yuan.¹⁷ The CBRC subsequently revised the regulations in 2007 and 2009, removing the "200 investors" cap by requiring the number of individual investors being no more than 50 and the number of institutional investors unlimited.¹⁸ However, it requires the investors (settlors) of such cash trusts must be "qualified" investors (settlors).¹⁹ These requirements have made it difficult for trust companies to pool public funds through establishing cash trusts.

Since 2005, Chinese government decided to halt the irrational development of the real estate industry by imposing restrictions on bank loans through requiring the real estate developers to have certain qualification, and that the project must have obtained the aforementioned "four certificates." Both banks and trust companies have been affected and subject to the same rules. However, since many real estate developers need the money before they can get the "four certificates," the trust companies and the real estate developers have explored the possibility of establishing "non-cash trusts" to fund the projects to avoid the strict rules governing cash trusts.

With both the restrictions on directly granting loans to real estate companies and the restrictions on establishing cash trusts, the trust companies had been seeking alternatives to engage in real estate investment. They actually might help the real estate developers to establish a trust to securitize the real estate project they own; however, for the reasons analyzed below, most of them decided to get financing only through using the "proceeds accruing from" their real estate project. These trusts are given a fancy name "XXX资产收益财产权信托", and literally translated as "Trusts on the Right to Proceeds to be Accrued from XXX Project Assets." They may also be called "Right to Proceeds Trusts" or simply "Right Trusts" in the paper. From its name, such a trust is apparently not a cash trust, and the trust property seems to be the right to proceeds only, instead of the underlying project assets. Doesn't it sound like a mirage? And, is it true that the right to proceeds is the trust property in such trusts?

With these questions unanswered, such real estate trusts have become very popular in China since 2009 and there had been no disputes until 2013 when A Company sued B Company based on such a device in an intermediate court of Shanghai. Statistics show that the beneficial interests in such trusts in China had reached RMB 800 billion Yuan by the end of 2012, and among them, 310 billion had

(promulgated by the National People's Congress (NPC) in 1997, amended several times with the most recent revision made in Feb. 2011).

¹⁷ See *Provisional Measures on Management of Cash-Trusts by Trust Investment Companies*, PBC DIRECTIVE, No. 7, art. 6, (2002), <http://www.pbc.gov.cn/rhwg/021601f.htm> (issued by the People's Bank of China (PBC) and effective from July 18, 2002).

¹⁸ See *Measures on Management of Cash-Trusts with Multiple Settlers by Trust Investment Companies*, CBRC DIRECTIVE, No. 3, art. 5, (2007), http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/200909155AD71D59AFD82FB5FA27E225216B800 (issued in Jan. 2007, and revised in Feb. 2009).

¹⁹ See *id.* Article 6.

been due in the year of 2013.²⁰ One of the reasons why real estate trusts are so popular in China is because of the high demand from the real estate industry and the high return to both the real estate industry and the trust companies.

However, the real estate bubble is very easy to burst. When it does, who owns the money, who owns the un-finished building, who owns the mirage (the right to proceeds), and who suffers the loss? With disputes arising, these first-impression questions are presented before the Chinese courts. This paper will examine the first Chinese case seeking to answer the above questions and try to identify the most legal obstacles against the development of commercial trusts and securitization in China.

C. The Case

B Company is a real estate developer in China. Being driven by the high profits in the real estate industry, it launched an ambitious real estate project “K Project” adjacent to Shanghai in 2009, planning to build luxurious villas and office buildings, and expecting high return after they were completed and sold based on the then real estate market. However, it needed finance of about RMB 215 million Yuan. Since the government had imposed stricter restrictions on banks or other financial institutions (including trust companies) to directly grant loans to real estate developers since July 2009, B Company could not get loans owing to its lack of the required qualification, and owing to the fact that the K project had not yet received the “four certificates.”

A Company is a trust investment company authorized by the CBRC to do trust business in China. As a public company listed in Shanghai Stock Exchange since 1994, it has been actively engaged in the real estate trust business to finance real estate companies, especially after the strict rules have been implemented on the real estate loans.

On this background, A Company and B Company fit in quickly with each other, and signed a Financing and Accounting Consultation Service Contract (“Financing Service Contract”) in August 2009, under which A Company undertook to help with B Company’s financing. One month later, A and B signed a Trust Contract on the Right to Proceeds to be accrued from K Project (“Trust Contract”) under which B Company is the settlor and A Company is the trustee.

According to this Trust Contract, the trustee would divide the trust property into 62,700 units (with each unit representing RMB 10,000 Yuan’s value) and issue the same amount of trust certificates to beneficiaries. The beneficiaries include two classes: the senior beneficiaries and general beneficiary (also called “subordinated beneficiary”). B Company is the sole general beneficiary, and the senior beneficiaries are the investors identified by A Company upon creation of the Trust. Senior beneficiaries will purchase no less than 21,500 but no more than 23,000 units of the trust certificates, and the rest would be held by the general beneficiary, B Company. Through this structure, B Company would get the loan of no less than RMB 215 million Yuan and thus would achieve its goal of finance. According to the Trust Contract, the underlying property is K Project under construction, and the land-use rights in the land under the K Project which are lawfully owned by B Company. The

²⁰ *The Case Arising from Kunshan Chungao’s Default Causing More Debates, Judicial Organ Postponing the Decision-Making*, No. 1 TRUST NET (March 27, 2013), <http://www.dyxtw.com/news/2013032711173.html>.

trust property is said to be the right to receive the proceeds to be accrued from the underlying property, and the property obtained through managing, utilizing, selling, or disposing of the underlying property. The term of the Trust Contract was three years.

In order to ensure the Trust Contract to be properly performed by B Company, A Company signed a few other contracts with B Company, including an Agreement on Fund Supervision, a Loan Contract, a Mortgage Agreement, and a Framework Agreement on Financing (“Framework Agreement”), and problems arose from these contracts, especially the Loan Contract.

The Loan Contract provided that A Company would grant loans of no more than RMB 230 million Yuan to B Company for purpose of developing the K Project. The term of the loan would be three years with an annual interest rate of 10%. To secure this loan, B Company mortgaged the underlying property as defined in the Trust Contract with A Company, and has made the mortgage agreement properly registered according to law.

In both the Trust Contract and the Loan Contract, the parties agree that B Company may sell the underlying property and transfer the proceeds to the Trust Account held by the trustee according to a schedule. They further imposed an obligation on B Company to keep certain minimum amount of funds in the Trust Account at different points. For example, before the end of 2009, the minimum amount of funds would be RMB 20.7 million Yuan, and upon one year after the Trust was created, the minimum amount would be 10% of the total amount of the loan.

After these contracts have been executed, A Company issued the trust certificates to investors and B Company successfully received the funds as needed for its project construction. However, owing to Chinese government’s macro-control of the real estate market, as well as for other reasons, the sale of the K Project has not been as good as expected. As a matter of fact, B Company could not keep the minimum amount of funds with the Trust Account as early as September 2010 when the Trust had been established for only one year. Upon September 23, 2012, the Trust term expired and the loan was due, but B Company had never been able to honor its commitment under either of the contracts.

A Company then sued B Company on the ground that the latter breached the Loan Contract, requesting the court to order B Company to repay the principal and interests of the loan plus various default penalties, compound interests, and attorney’s fee. Alternatively, A Company requested foreclosure of the collateral to satisfy the debt. Meanwhile, the Trust was automatically extended until September 24, 2013, and the extended deadline for disposing of the collateral will be on September 30, 2013. The main issues before the court included, among others: (1) whether the cause of action of this case is one based on the Loan Contract or one based on the Trust Contract; (2) whether the defendant breached the contract, and if so, what would be its liability; (3) whether the plaintiff may enforce its mortgagee’s rights based on the Mortgage Agreement affiliated to the Loan Contract.

Since there are RMB 800 billion Yuan’s funds involved in similar transactions in China, the court’s decision on this case would no doubt be very significant because it may determine the rights and obligations of all the other trust companies and real estate companies, as well as the public investors. Because of the complexity of the legal relationships in this case, also because the potential impact of this case on the

whole real estate trust industry, it took the first instance court about three months to make the final decision.

II. ANALYSIS

Since the cause of action raised by A Company was breach of the Loan Contract, while B Company alleged that the relationship between the parties should be based on the Trust Contract instead, the main dispute of this case is whether B Company's securitization transaction was done through establishing a trust, or through structuring a secured loan. In other words, whether the Trust Contract (and the Trust created hereunder) and the Loan Contract (and the relevant documents) are effective respectively, and simultaneously. This case is regarded as the first case ever involving and testing Chinese trust law in a real sense.

This part will analyze this case based on Chinese law on trusts and securitization and from a comparative approach.

A. *The Effectiveness of the Trust*

1. Title Transfer of the Trust Property Not Required

In China, the trust is a system transplanted from the common law. As a wealth management scheme which separates ownership rights and equitable interests, the common law trusts feature the "dual ownership" concept under which the trustee owns the legal title of the trust property and the beneficiaries own its equitable interests.²¹ However, this concept has an inherent conflict with the "one property one right (Eine Sine Sache, Ein Recht)" principle followed by the civil law system; thus many civil law countries, when transplanting the trust system, have modified the dual ownership requirement.²² China promulgated the Trust Law in April 2001 which modified the common law of trusts in a Chinese way. Article 2 of the Trust Law provides²³:

For purposes of this Law, trust refers to that the settler, based on his faith in trustee, *entrusts* (委托给) his property rights to the trustee and allows the trustee to, according to the will of the settler and in the name of the trustee, administer or dispose of such property in the interest of a beneficiary or for any intended purposes. (Emphasis added.)

²¹ See George T. Bogert, *Trusts* 1 (6th ed. West Publ'g Co. 1987); See also Restatement (Third) of Trusts § 3 (2003).

²² Some civil law scholars call the legal title as "ownership in name" and the equitable interest "ownership in substance" or "right to benefit." See Jialin Fang, *Theories and Practice of Trust Law*, CHINA U. OF POL. SCI. & L. PRESS, 70-71 (2004), cited in LINGYUN GAO, *TRUST LAW – A MISUNDERSTOOD SYSTEM* 28 (Fudan Univ. Press 2010).

²³ [Trust Law of People's Republic of China] (promulgated by Standing Comm. of the Ninth Nat'l People's Cong., Apr. 28, 2001, effective Apr. 28, 2001), art. 2, available at http://www.china.org.cn/china/LegislationsForm2001-2010/2011-02/12/content_21907980.htm (2011). [hereafter referred to as the "Trust Law"] Unless otherwise indicated, all articles of Chinese law and the articles of the various contracts involved in the case at issue cited in this article are translated by the author.

It shows that the Chinese Trust Law has generally adopted the features of the common law of trusts, but avoided the “dual ownership” issue by allowing the trust property to be “entrust[ed] (委托给)” instead of “transfer[red]” to the trustee.²⁴ One of the purposes of the common law of trusts is to separate the ownership rights and the beneficial interests of the trust property; however, the Chinese Trust Law neither clearly recognizes nor explicitly denies this division of ownership. Without distinguishing trust relationship from agency relationship, the trust system and the trust law in China have a latent defect which needs to be addressed and rectified. However, before it is done, the trusts created through “entrustment” or other ways under which the title to the trust property is not transferred should be determined as valid according to the current Trust Law.

The Trust Contract involved in this case did not explicitly mention whether the title to the trust property would be transferred to the trustee, but stipulated in article 6.3.1 that “the total proceeds to be generated by the underlying real property will be part of the trust property under this Trust and are *not part of the settlor’s assets*,” which may have two possible interpretations: first, the parties’ intent was that the trust property should be independent from the other assets owned by the settlor, and second, the trust property had actually been transferred to the trustee. No matter which one is true, it shall not affect the validity of the trust, because even if the former prevails, it would at least prove that the parties had mutual assent to the creation of the trust.

2. Creation Requirements Generally Satisfied

Under Chinese Trust Law, the elements for creation of a trust²⁵ include the following:

- a. There must be a lawful purpose.²⁶ The purpose of the Trust at issue was “to realize the liquidity of the underlying assets” which is not unlawful.
- b. There must be a settlor who intends to create a trust using his lawfully-owned property.²⁷ B Company is qualified here.

²⁴ Chinese scholars have different understandings on article 2 of the Trust Law. Some scholars believe that “entrust[ing] to (委托给)” should mean “entrust[ing] and giv[ing] to,” which actually means that the property ownership must be transferred so that there is no difference from the common law concept of trusts. However, since the Draft of the Trust Law used the term “transfer[ring] to (转移给),” which was only be changed into “entrust[ing] to (委托给)” after the legislature’s final review, other scholars argue that “entrust[ing] to (委托给)” clearly indicates an agency relationship and does not involve title transfer. See Baoyu He, *Research on Trust Law Principles*, CHINA U. OF POL. SCI. & L. PRESS, 10-11 (2005), cited in LINGYUN GAO, *TRUST LAW – A MISUNDERSTOOD SYSTEM* 278 (Fudan Univ. Press 2010).

²⁵ The elements listed here are those required for non-charitable trusts. For charitable trusts, there are special requirements and will not be discussed here because they are irrelevant to this paper.

²⁶ See Trust Law, *supra* note 24, art. 6.

²⁷ *Id.* at art. 7. See also *Id.* at art. 19. (Article 7 prescribes that “. . . such property must be the property lawfully owned by the settlor.” Article 19 provides that “the settlor shall be a natural person, a legal person, or an organization established in accordance with law, that has full capability for civil conduct.”)

c. There must be a trustee who has full civil capacity and is willing to serve as the trustee.²⁸ A Company is qualified here.

d. There must be a beneficiary (or beneficiaries) who is (are) specified or can be specified.²⁹ Articles 4.3 and 4.4 of the Trust Contract provides that the beneficiaries of the Trust include no more than 199 senior beneficiaries and the subordinated beneficiary (i.e., the settlor), and that the senior beneficiaries would be identified by A Company. If sufficient number of senior beneficiaries could not be identified, the Trust would not be created at all. Further, since article 43 of the Trust Law allows the settlor to be the beneficiary, the subordinated beneficiary in this case is also legitimate. Therefore, both the senior and subordinated beneficiaries are specified upon creation of the Trust.

e. There must be trust property which is definite and specified or can be specified.³⁰ It does not require the trust property be specified upon creation of the trust, and can be inferred that as long as the trust property can be specified (based on a certain standard), the trust will be valid. According to the stipulations stated in article 3 of the Trust Contract, “the initial trust property is the property right of the Settlor in the proceeds to be accrued from the underlying assets (3.1),” “the trust property under this Trust also includes the property received by the Trustee for managing, utilizing, and in any other ways disposing of the underlying assets (3.2),” and that “the proceeds in any form accruing from the underlying assets will become part of the underlying assets, and the proceeds will automatically become part of the trust property under this Trust (3.4).” Here the “proceeds” does not exclude the original value of the underlying assets and there is no distinction of trust income from the trust corpus. Carefully reading the above three articles together, one may conclude that *all property and property rights in the underlying assets and the proceeds thereof are trust property under the Trust Contract*, which satisfy the requirement for definiteness (to be specifiable).³¹

f. There must be a writing to evidence the trust.³² Chinese Trust Law does not recognize declaration of trusts; therefore, a trust could only be created in writing. This Trust Contract was in writing.

Again, transfer of title is not one of the requirements to create a trust in China. Through the above analysis, the Trust involved in this case generally complies with

²⁸ *Id.* at art. 24.

²⁹ *Id.* at art. 11. Article 11 of the Trust Law lists the situations where a trust may be held invalid, and the fifth item is that “the beneficiary or the scope of the beneficiaries cannot be specified.” It may be concluded that the beneficiaries must be specified or specifiable.

³⁰ *Id.* at art. 7. Article 7 of the Trust Law provides that “to create a trust, there must be specified trust property, and such property must be lawfully-owned by the settlor.” “The property referred to in this Law includes lawful property rights.” Among the list provided in Article 11 that may invalidate the trust, item 2 is “the trust property cannot be specified.” *Id.* at art. 11. Reading these articles together, it can be concluded that the trust property must be specified or specifiable.

³¹ However, neither A Company nor B Company would admit it. Traditionally people are very reluctant to admit title transfer in a context other than sale.

³² Article 8 of the Trust Law provides that “to create a trust there must be a writing.” See Trust Law, *supra* note 24, art. 8.

the elements for creation required by the Chinese Trust Law. The Trust here is one created by B Company as the settlor, based upon trust in A Company, as the trustee, using “the lawful right to proceeds to be accrued from the underlying assets and the other property obtained through managing, utilizing, or disposing of the underlying assets” as trust property. The purpose of the trust was “to realize the liquidity of the underlying assets” through “issuing trust certificates to investors.”³³

3. Registration Requirement Arguably Met

Although all of the six elements as listed above have been satisfied, it is still possible to argue that the Trust is invalid because article 10 of the Chinese Trust Law has not been satisfied. Article 10 prescribes:

To create a trust, where the relevant laws or administrative regulations require the trust property be registered, the trust shall be so registered.

Where the trust has not been registered in accordance with the above paragraph, a ratification registration shall be made; otherwise, the trust shall have no effect.³⁴

This provision shows that registration generally is not a necessary element for creation of a trust in China, unless the trust property has such a special nature that another law or regulation requires it be registered. In this situation, the trust could be invalid if without registration. However, this provision does not specify whether “the relevant laws or administrative regulations” refer to the laws and regulations that are specifically about trust registration, or the laws and regulations that require registration of property rights; therefore it may invoke multiple interpretations.

At present, trust registration is the most vulnerable point of the Chinese trust system because there is neither a central registration system nor local registration systems for trusts to register. The current registration systems for real property and personal property do not intend to include trust registration at all. The only trust registration institution – Shanghai Trust Registration Center (STRC) – which is located in Pudong area, Shanghai City, is a platform for companies only to voluntarily register their trusts, and its evidential value remains to be tested by judicial proceedings. Based on the available information, A Company had actually registered the Trust at issue with the STRC. While the law is ambiguous regarding trust registration and the mandatory registration institution is unclear, it is reasonable to recognize that the registration with the STRC is effective, and the challenge of the validity of the Trust at issue solely because it was not registered is not sound.

4. Conclusion: The Trust Validly Created

Considering that the Trust in this case generally complies with the requirements for creation of trusts and for registration under the Chinese Trust Law, and that A Company had formally notified the senior and subordinated beneficiaries on Sept. 24, 2009 of the creation of this Trust, conclusion may be made that this Trust has been validly created, and the Trust Contract is lawful and effective.

³³ See article 2 of the Trust Contract (on file with author) involved in this case.

³⁴ See Trust Law, *supra* note 24, art. 10.

The trial court held that the Trust Contract was valid but the reasoning was quite simple and only contained two points: First, the court reasoned that although the plaintiff sued on breach of the Loan Contract, the defendant defended on the ground of the Trust Contract while the plaintiff did not deny the existence of the latter; Second, the Trust Contract reflected both parties' true intention, and did not violate any prohibitive clauses of law and regulations.³⁵ The court did not even analyze any of the above elements.

There is actually a policy consideration to support this conclusion. Since 2009, there have been huge amount of similar trust products issued to the capital market involving a large amount of real estate companies, trust companies, and investors. Upon creation of these trusts, people only saw benefits but ignored the risks. The trust companies provided large amount of funds to the real estate companies expecting unreasonably high return; meanwhile, they tried to avoid the legal obstacles through designing so called "right trusts." In order to further protect their own interests, they signed separate loan contracts and subordinated security contracts (to be discussed below). If everything went well, the trust companies would rely on the trust contracts; however, when the real estate market went down, these trust companies would claim against the real estate companies based on the loan contracts. After carefully reviewing these trust contracts, it is easy to find that most of the articles are in favor of the trustees. The main reason is that the parties' negotiation powers were in great disparity and the real estate companies which badly needed funds were apparently at the weaker position. It is undeniable that the real estate companies themselves had the fault in the first place in that they rushed to the real estate development projects before they obtained the required qualification or certificates in order to obtain unreasonably high benefits. It is thus reasonable that when crisis occurs, the real estate companies and the trust companies shall collectively assume the first risks, and the investors should only assume the secondary risks. Determining such trust contracts invalid may cause moral hazards.

B. The Nature of the Trust

1. A Commercial Trust

The traditional trusts in the common law countries are private trusts; however, with the economic development, commercial trusts have increasingly become an active participant in the capital market. Just because of the unique feature of the commercial trusts in the financial area, many civil law countries have transplanted the trust system. It can be illustrated from the Chinese Trust Law which allows for "trusts for profits (营业信托)" that Chinese law clearly recognizes the legal status of commercial trusts.

One of the main differences between private trusts and commercial trusts in the common law countries is whether the settlor receives consideration for the transfer of the property to the trustee.³⁶ If no consideration is received, i.e., if the transfer of the trust property is gratuitous, the trust created is a private trust, also called

³⁵ See Shanghai No. 2 Intermediate People's Court, CIVIL JUDGMENT, (2012) Hu Er Zhong Min Liu (Shang) Chu Zi No.7 at 29-30 (on file with author).

³⁶ See Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 Bus. Law. 559 (2003).

gratuitous trust. If the settlor receives consideration for transferring the property to the trustee, then the trust is a commercial trust. Another important distinction between private trusts and commercial trusts is whether the settlor retains residual interests in the trust property. The settlor in a commercial trust generally retains the residual interests in the trust assets after the business transactions have been completed, while the settlor of a private trust may or may not retain such an interest.³⁷ Therefore, commercial trusts have become an important vehicle of structured finance. It may be used in securitization transactions as well as in other types of finance transactions with a view to diversifying loan risks.

The Chinese Trust Law encourages the development of trust system; however, there has been no specific rules implementing the Trust Law after its promulgation. Therefore, there is no rule specifying the commercial trusts, their status, or function. Nevertheless, in practice, most of the trust companies have all been conducting structured finance transactions, and mostly based on the commercial trusts of the common law model. To this end, even if Chinese Trust Law has not clearly provided that the title to the trust property must be transferred, the settlor in a commercial trust must transfer the ownership right in the trust property to the trustee, because they have received consideration for it.

The Trust in this case is clearly a commercial trust. It is not possible that B Company, the settlor, gave away the trust property to A Company, the trustee, for free. The purpose of the trust as stated in the Trust Contract is that “the settlor wants to realize liquidity of the underlying assets (art. 2),” and there is a stipulation that the trustee shall “give to the settlor, upon successful creation and effectiveness of the Trust, in a lump sum” the funds invested by the investors (art. 4.6.1), which fully illustrates that the purpose of the settlor’s transfer of the trust property to the trust was to receive consideration. Meanwhile, the settlor, as the subordinated beneficiary, retains residual interest in the trust assets (art. 4.5). Thus, the Trust at issue here satisfies the requirements for a commercial trust.

2. A Commercial Trust in Structured Finance

In a structured finance transaction, the company that needs financing, as the initiator, will pool together the assets it owns that may generate stable future cash flow, and then divide them into smaller units to issue to the investors in the capital market. Doing so, they could diversify the risks associated with the capital, and meanwhile, may obtain finance at a lower cost. Since there are more restrictions and more risks on the initiators to issue securities by themselves, they would normally establish a special purpose vehicle (SPV) for the structured finance transaction. The initiator may package and sell the assets to the SPV, who in turn pays to the initiator the consideration for purchasing these assets. The common form of the SPV is commercial trusts. The SPV does not have sufficient money to pay for the trust property, so it will raise funds through borrowing or turning to the capital market through issuing asset-backed securities. These securities may take the form of commercial paper or debt-like trust certificates. The investors purchase these securities because they have confidence in the value of the assets supporting the

³⁷ *Id.*

securities. In other words, the credibility of these securities is much higher than that of the secured debts of the same company.³⁸

Actually, the trusts used in structured finance are not different from the traditional private trusts. In both situations the settlor will transfer his lawfully-owned assets to the trustee for him to manage. However, the trustee in a structured finance will need to pay consideration to the settlor. Normally the trustee would divide the trust property and its proceeds into smaller units and issue trust certificates to the investors. The purchase price thus received by the trustee will be paid to the settlor, and the investors who purchase the trust certificates become the beneficiaries of the trust. Afterwards, the trustee will manage the trust property, and use any proceeds accruing from the trust property to repay the investors.

When the trust assets in a structured finance transaction are money, the trustee may personally manage the trust property; nevertheless, when the trust property is other forms of tangible property, the trustee normally will hire some specialized institutions, i.e., servicer, to manage the trust assets. The reason is because the trustees are mostly financial institutions who do not have experience or expertise to specifically manage these properties. Sometimes, because of the special feature of the trust assets, the trustee may entrust the original owner of the trust property, i.e., the settlor, to be the servicer, because the settlor as the initiator of the original assets has experiences and expertise in managing the assets. Furthermore, from the settlor's point of view, they are also willing to provide routine service (which actually is the business that they have been doing) for the structured finance transaction and charge a fee. The financing cost may be further lowered.³⁹

Apparently, the Trust at issue is exactly such a commercial trust used in a structured finance transaction. The settlor is B Company, who delivered its assets to the trustee, A Company, and the latter divided the assets into smaller units (627,000) to issue part of them to public investors (senior beneficiaries) and the rest to the subordinated beneficiaries (B Company). Afterward, A Company paid the funds received from the senior beneficiaries as consideration to B Company. Thus, the financing purpose of B Company had been realized, and the financing was completed. The trust property is managed by A Company as trustee.

Since the trust property in this case would be the relevant real estate and their future proceeds, the management of which is not the routine business of A Company, article 6.2 of the Trust Contract provides that “[d]uring the term of this Contract, the underlying assets shall be kept in its original form, and the settlor commits that they will well keep the underlying assets, and will be responsible for managing, operating, and selling the underlying assets,” which shows that the trustee A Company entrusted B Company as servicer to manage, construct, and sell the trust property – the underlying real estate, and that B Company should transfer the sales proceeds to the trust account to repay the principal and expected interests to the senior beneficiaries. This provision may also implicitly support the argument that B Company only had the right to “keep” instead of “own” the trust property. Based on this understanding, when reviewing article 3 of the Trust Contract which provides

³⁸ See generally Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133 (1994).

³⁹ Regarding the functions of a servicer, see generally, Ian H. Giddy, ASSET SECURITIZATION IN ASIA, available at: <http://people.stern.nyu.edu/igiddy/ABS/absasia.pdf> (last visited on Jan. 13, 2015).

“[a]ll of the proceeds in whatever form accruing from the underlying assets *held* by the settlor will become part of the underlying assets, and the proceeds will automatically become part of the trust property under this Trust (art. 3.4),” it is reasonable to conclude that B Company held the trust property as a “servicer” under entrustment of A Company instead of owning the assets as an owner.

It is interesting, however, that there is no stipulation in the Trust Contract about any remuneration that B Company will receive for its managing the trust property; instead, article 6.2 of the Trust Contract provides that “[a]ny expenses arising from keeping the underlying assets should be borne by the settlor,” which means that all expenses that incurs to the servicer – B Company would be borne by itself. It is certainly fine if this stipulation was assented to by the parties after fully understanding its meaning, but it is very possible that the parties had not even thought about B Company’s role as the “servicer.”

3. Co-Existence of Two Trusts

It is to be noted that there may have two trusts in a structured finance transaction, especially if the SPV issues trust certificates to public investors. The first trust is to be considered from the view of the initiator who needs financing: it delivers the property to the trustee who will in turn manage and operate the property and distribute any proceeds to the beneficiaries. In this trust, the trust property is the non-cash property or property rights. There is still a second trust, i.e., a cash trust. In a cash trust, the public investors are settlors, and they deliver the money they lawfully own to the trustee who will in turn manage the money and invest it in a specific project, and distribute any proceeds to the investors (as beneficiaries). To this end, the beneficiaries of the first non-cash trust are the settlors of the second cash trust, and the cash trust is a self-benefited trust which means the settlors establish this trust for their own benefits. In a same financing transaction, these two trusts may exist simultaneously while the trustee could be the same, and the settlor(s) and beneficiaries are different. Thus, when analyzing the trust relationship, one must be able to clarify the interaction of these two trusts, and should also consider whether it is lawful to use the first non-cash trust to avoid the regulation and restrictions imposed on the cash trust (as Chinese government does). Since this issue is not the focus of this case, there will be no further discussion about it in this paper.

4. A Property Trust or A Right Trust

Article 7 of the Chinese Trust Law provides:

To create a trust, there must be specified trust property which must be lawfully-owned by the settlor.

The “property” herein includes the lawful interests in the property.⁴⁰

When the Chinese trust companies initially designed trusts, they preferred cash trusts, and non-cash trusts were very rare. However, in order to avoid the stringent legal regulations on cash trusts, also because recently the Chinese government started macro-regulation and control on the real estate sector, some attorneys and

⁴⁰ See Trust Law, *supra* note 24, art. 7.

trust companies have collectively created a new type of trusts mainly focusing on the right to proceeds accruing from the real estate as the parties to this case did. The name of the Trust in this case is exactly such a Right Trust. In order to determine whether such trusts are lawful, we need firstly distinguish a few confusing concepts.

a. Proceeds, Right to Proceeds, and Beneficial Rights

It is necessary to distinguish proceeds, right to proceeds, and beneficial rights, especially because they are pronounced quite similar and sometimes seem to be tongue-twister in Chinese, and thus are very easy to be mis-spelled.

Proceeds (收益) in Chinese means the earnings and income accrued from certain underlying assets, such as rental income and the increased value obtained from sale of real estate (the money received from the sale deducting its original value). Right to proceeds (收益权) refers to a right to receive the proceeds out of certain underlying assets, such as the right to receive rental income and the right to receive the increased value obtained from sale of real estate. The exercise of this right should not change the ownership status of the underlying assets.

In the trust law area, the beneficial right (受益权) refers to the right of the beneficiaries against the trust property, which is called “equitable interests” at common law, and “substantive ownership” or “beneficial right” under civil law.⁴¹ Therefore, the beneficial right is similar to a kind of quasi-ownership right.

Trust property includes trust corpus (principal) and its income; and the beneficial right owned by the beneficiaries of the trust may be against the trust corpus and/or income.

b. Trust Corpus and Trust Income

According to the common law of trusts, the property that the settlor transfers to the trust is trust corpus (or principal). Since the purpose of a commercial trust is to preserve and increase the value of the trust corpus through the trustee’s management, the increased value of the trust corpus could be part of the corpus and/or part of the income depending on different situations. Both the trust corpus and income constitute the whole part of the trust property. Therefore, the trust beneficiaries may be beneficiaries entitled to trust corpus and those entitled to trust income, or those entitled to both.

In a word, the proceeds in the context of trusts are the cash and non-cash property that the trustee received from the trust corpus as present profit, including a part of the income accrued from the sale, exchange, or settlement of the trust corpus after deducting its original value. Trust income means “money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, ...”⁴² Trust corpus is “the property held in trust for distribution to a remainder beneficiary when the trust terminates.”⁴³ If the trust corpus has been converted into a new type of property owing to change of its form, then the new type of property will be the trust corpus.

⁴¹ See Jialin Fang, *Theories and Practice of Trust Law*, CHINA U. OF POL. SCI. & L. PRESS 70-71 (2004).

⁴² See Unif. Principal & Income Act §102(4) (1997).

⁴³ *Id.* at §102(10).

The rights of the beneficiary entitling to receive income and the beneficiary entitling to receive the trust corpus are different, because they would obtain different interests from different part of the trust property. During the period of managing the trust, the trustee may receive money or other property from various sources for different reasons. They must be able to judge whether these “proceeds” should be part of the trust income or part of the trust corpus. This determination will directly affect the distribution to different types of beneficiaries. Therefore, the concept of distinction of “trust income” and “trust corpus” is very important at common law. The trustee, of course, may also distribute to a certain beneficiary from both the trust corpus and the trust income based on the settlor’s intent.

The Chinese Trust Law, however, does not distinguish trust income from trust corpus; instead, it provides that any income and proceeds accruing from the trust property accepted by the trustee will become part of the “trust property.”⁴⁴ Since there has been no private trusts in China in a real sense, and the existing “trusts for profit” provided in Chinese Trust Law mostly have a simple distribution model which are basically self-benefited and the beneficiaries will almost receive all of the trust benefits, it seems to be unnecessary to consider the distinction between the distribution of the trust corpus and the trust income in China. Nonetheless, with the commercial trusts becoming more and more complex, the distribution model for different classes of beneficiaries will also be developed accordingly. There is no question that the Chinese Trust Law will need to address this issue in the near future.

c. Proceeds of Trust Property v. Right Trusts

The right to proceeds (收益权) in the trusts based on right to proceeds to be accrued from specific property (资产收益财产权信托, “Right Trusts”) emerging in China is a totally different concept from the proceeds of trust property (信托财产收益) discussed above. The proceeds of trust property refers to the income and proceeds accruing from the original trust property (i.e., trust corpus) after the trust is created, which may be distributed to various beneficiaries according to the stipulation contained in the trust instrument. On the other hand, the right to proceeds in a Right Trust reflects the concept of the trust corpus, which means that the property delivered to the trustee by the settlor is not a tangible property, but a right to receive the proceeds which are to be accrued from the underlying assets. Therefore, the underlying assets are not trust corpus, and only the right to receive the proceeds against the underlying assets is the trust corpus. If the underlying assets do not exist, the right to proceeds will become a mirage.

A very important issue thus involved is whether the right to proceeds can satisfy the requirement of the Trust Law that the trust property must be specified or at least could be specified. In order to answer this question, one should consider the value of the underlying assets (including whether there exists a market which may form its value) and the performance of the settlor in managing the underlying assets. However, the analysis below will reach a conclusion that the Right Trusts in China are actually trusts based on the underlying assets and its all proceeds, therefore the trust property is specified and definite, and thus can satisfy the requirements of the Trust Law. To this end, this paper will not further explore whether the right to

⁴⁴ See Trust Law, *supra* note 24, at Art.14 (“the property received by the trustee for managing, utilizing, disposing, or handling in other means also belong to the trust property.”)

proceeds may satisfy the Trust Law's requirements, and will research it further in the future.

Why is whether the right to proceeds may be trust corpus irrelevant to this case is because the trust property of the so-called "Right Trust" does not only include the right to proceeds, but also include the underlying assets. The Trust involved in this case is a good example. Such a Right Trust generally defines "right to proceeds" as "the beneficiary's right to the cash proceeds accrued from the advance sale, sale, or in any other forms utilizing and disposing of the underlying assets (deducting the taxes and expenses for the advance sale or sale)."⁴⁵ Compared with the definition of "income" contained in the Uniform Principal and Income Act 1997, "income" includes a *portion* of proceeds accrued from the trust corpus.⁴⁶ Here the "portion" apparently does not mean the total value thus received from the sale.

Hence, the Right Trusts in China are actually trusts based on property or assets, not trusts based on the right to proceeds only, because the so-called "specific assets" will directly become trust property based on the trust contract. In addition, according to Chinese Trust Law, any proceeds accrued from managing or disposing of the trust property will automatically become part of the trust property which may be used to distribute to the beneficiaries. Therefore, the term "Trusts based on Right to Proceeds to be accrued from Specific Assets (特定资产收益权财产信托)" is only playing the words to confuse people, and such trusts by nature are still trusts based on tangible property. Accordingly, the determination of the definiteness of the trust property in a Right Trust is not relevant here because its trust property is definite and specified.

To conclude, although the Trust involved in this case was named as a "Right Trust," since the underlying assets are also part of the trust property, after piercing its veil, the nature of this Trust is actually a non-cash property trust, or an asset trust. Almost all of the other Right Trusts existing in China are in the same category.

There is another question however involved in this case, which is the transfer of the trust property. Although Chinese Trust Law does not require a transfer of title of the trust property, if the settlor receives consideration for creating such a trust, like a trust used in securitization, things are different. In this case, the Trust Contract stipulated that "the proceeds in any form accrued from the underlying assets held by the settlor will become part of the underlying assets, and the proceeds will automatically become part of the trust property under this Trust (art. 3.4)," and that "during the term of this Trust, the underlying assets involved in this Trust shall be kept as it was originally kept, and the settlor commits that they will well keep the underlying assets, and will be responsible for managing, operating, and selling the underlying assets (art. 6.2)." (The "underlying assets" mentioned in all above situations are the real estate based on which B Company established the Trust.) These articles fully support the argument that the right of B Company against the trust property is only a right to "keep" and not a right to own.

In summary, the Trust involved in this case is a commercial trust used in the structured finance transaction initiated by B Company and the trust property includes the underlying assets of the K Project and their future proceeds. It is misleading to

⁴⁵ See *e.g.*, Art. 1, Item 10 of the Trust Contract in this case interpreting "the right to proceeds of the underlying assets."

⁴⁶ See Uniform Principal and Income Act, *supra* note 43, at §102(4).

state that only the right to proceeds accrued from the above underlying assets is the trust property. However, the first instance court did not make any comment on this point in its decision.

C. The Legal Relationship in the Trust

The above analysis is based on the fundamental principles of the trust law as well as the review of the Trust Contract at issue; this section will analyze the legal relationship among the parties to the Trust.

The Trust involved in this case is a commercial trust, the purpose of which is to conduct structured finance in order to “realize the liquidity of the underlying assets (art. 2).” As stated above, in a commercial trust used in securitization or other types of structured finance, the purpose of the settlor to create the trust is to resolve the financing problem; therefore, they must ask for consideration for the transfer of the trust property. Even if Chinese Law does not so require, the ownership right in the trust property should be transferred in a structured finance transaction because the settlor will receive consideration therefor.

There are, of course, exceptions. For instance, in a trust used to finance real estate development, if the real estate developer as the settlor receives a consideration from the trustee the amount of which approximately matches the value of the real estate (the trust property) (less taxes and service fee, etc.), the consideration is one for transferring the title of the real estate. However, if there is a huge difference between the amount of consideration received and the value of the real estate, it is not the consideration for transferring the title of the real estate. Generally, the purpose of the real estate companies to establish trusts is always to get maximum amount of funds based on the value of the real estate, it is unlikely that they would only like to get financing based on the increased value of the real estate they originally own.

In this case, the consideration A Company paid to B Company included RMB 215 million Yuan raised from the senior beneficiaries and the residual interest of the trust represented by the subordinated trust certificate held by B Company. In return for this consideration, it is reasonable to argue that B Company has actually transferred the title to the trust property to A Company.

If the title transfer is recognized, the question comes back to the registration issue stated in part I. The trust property in this case is real estate, the transfer of which must be registered so as to constitute public notice in order for the Trust to be effective according to Chinese law. While the law requires registration but in reality there is no institution responsible for such registration, how to complete registration has become a greater problem. Under this circumstance, one may argue that the trust, as well as the transfer of the trust property should be recognized as long as the parties have done their best to post public notice of the creation of the trust (e.g., the parties registered with Shanghai Trust Registration Center in this case).

It is praiseworthy that the court acknowledged the public notice of this Trust. The court held that public notice had been posted for both the creation of the Trust and the raising of the funds from the investors and that both had been completed. Therefore, the court determined that the Trust was a trust for profit (commercial trust), and that the nature of the dispute of the case was based on the Trust.⁴⁷

⁴⁷ *Supra* note 36, at 31.

1. Trust Relationship and Agency Relationship

Based on the above analysis, the legal relationships between the parties of this case include a trust relationship and an agency relationship. The trust relationship is as follows:

B Company is the settlor, who transferred the trust property – the right to use the land and the ownership right over the K Project under construction above the land – to A Company as trustee to manage. For this transfer, A Company paid to B Company as consideration RMB 215 million Yuan from the fund it received from the public investors who purchased the trust certificates it issued, plus the residual interest in the trust property. On the one hand, A Company believed that the K Project if sold in the future would generate proceeds far more than 627 million RMB Yuan considering the up roaring real estate market in China; on the other hand, the public investors also believed in A Company's advertisement believing that their investment in this project would never suffer loss. Furthermore, since B Company owned beneficiary right as a subordinated beneficiary, and would not participate in distribution before the senior (public) beneficiaries had been paid in full, it actually served as over-collateralization for the other beneficiaries and thus built up more confidence in the public investors. It is exactly one kind of credit enhancement that every securitization transaction would adopt.

In summary, in this Trust, B Company is the settlor, A Company is the trustee, the public investors are senior beneficiaries, and B Company itself is the subordinated beneficiary. The trust property is the K real estate project under construction and the right to use the land thereunder, as well as any future proceeds to be accrued from the project. The purpose of the trust is to get financing for B Company to construct the K Project.

After the Trust was created, according to the trust theory, the settlor – B Company received the consideration for transfer of the trust property and should not have legal title over the trust property, but only have the right to the residual interests as a subordinated beneficiary. The trust property was owned by the trustee ever since, and all risks associated with the trust property had also been transferred to the trustee accordingly. From then on, the trustee should be responsible for managing and operating the K Project.

However, similarly to the other international structured finance transactions, A Company as a financial institution did not have the qualification or expertise to manage and operate a real estate project; therefore, A Company as the trustee, also as the legal owner of the trust property, needed to hire a servicer to help manage and operate (including sell for profits) the trust property. Normally it needed to sign a servicing contract with the servicer and pay the service fee accordingly. This practice does not violate the Chinese Trust Law. As a matter of fact, article 30 of the Chinese Trust Law provides that:

The trustee shall handle the trust matters personally, except that the trustee may entrust another person to handle the trust matters if the trust instrument provides otherwise, or if the situation indicates that there is no other alternatives.

Where the trustee lawfully entrusts another person to handle the trust matters, the trustee shall be liable for the activities conducted by the latter.⁴⁸

Many times, the trustee hires the original owner of the trust property as the servicer. Likewise, A Company hired B Company as the servicer to “continue” the operation and management of the trust property. Article 6.1 of the Trust Contract provides that:

The fund invested by the senior beneficiaries of this Trust shall be delivered to the settlor by the trustee in accordance with the trust instrument, and the trustee shall supervise the settlor’s use of the fund to pay the unpaid expenses for K Project and to adjust its financial structure.

This article fully reflects the fact that B Company served as the servicer, and thus there established a new type of relationship between A Company and B Company: an agency relationship, under which A Company was the principal and B Company was the agent. According to the General Provisions of Chinese Civil Law⁴⁹ and Chinese Trust Law, the activities conducted by the agent will bind the principal, and the principal will be liable for the activities conducted by the agent.

Thus, there are both a trust relationship and an agency relationship between the parties to this case.

2. Who assumes the risk of loss?

The Trust Contract includes a paragraph on its cover page as a standard waiver made by A Company, which is also the general standard waiver in the whole trust and investment industry in China:

The trustee, when managing the trust property, shall strictly observe its duty, fulfilling the obligations of being honest, trustworthy, diligence, and effectiveness. The risks arising from the trustee’s management of the trust property based on the stipulations of the trust contract shall be assumed by the trust property. *Any loss of the trust property arising from the trustee’s inappropriate handling of the trust matters in violation of the trust contract shall be compensated from the trustee’s own assets; if the trustee’s own assets are not sufficient to pay the loss, the settlor shall assume the loss by him/herself.* (Emphasis original.)

The last sentence is very interesting because it does not even consider the situation that the party who might suffer loss may well be the beneficiary instead of the settlor (as what happened in this case) if the trustee’s own assets would not be enough to pay the loss. An obvious reason is that currently most trusts in China are

⁴⁸ See Trust Law, *supra* note 24, art. 30.

⁴⁹ The General Provisions of Chinese Civil Law (“Civil Law”) was promulgated by the NPC in 1986 and effective since Jan. 1, 1987. It is still valid today.

self-benefited trusts created by the settlor who is also the sole beneficiary. Of course, if the senior beneficiaries are all paid in full, then only the subordinated beneficiary (i.e., the beneficiary with a right against the residual trust property) will suffer loss, and most of the subordinated beneficiaries are the settlors. Thus, the Chinese trust companies have not considered all possible situations when they are designing trust instruments.

In this case, should A Company, as the trustee, assume the risk of loss of the trust property (e.g., if the underlying real estate cannot be constructed or sold as expected)? It will depend on whether the ownership right over the trust property had been transferred from B Company to A Company. Based on the analysis through the paper, in the context of commercial trusts, if the purpose of establishing a trust is to conduct structured finance, upon receipt of the consideration (financing fund) by the settlor, the title of the trust property should be owned by the trustee, and accordingly, all future proceeds or risks associated with the trust property will also be transferred to the trustee. If the trustee worries that the risk is too big to bear, it should be careful and prudent when negotiating with the settlor about the amount of consideration.

Some people may think that the Trust involved in this case is a trust based on “right to proceeds to be accrued from the underlying assets” and that the risk that the real property may not be duly sold as expected should not be associated with the trust property at all. This argument contributes to the ridiculous “mirage” theory, and is a misreading of the Trust Contract on the other hand. As analyzed above, the trust property (i.e., the property from which the beneficiaries will receive distribution) here not only includes the increased value of the underlying assets, but also includes the proceeds accruing from the disposing of the underlying assets themselves. Therefore, although such a trust is called a “Right Trust,” the veil should be pierced so that the nature of such a trust will be seen as a trust based on the underlying assets. The proceeds of the underlying assets will also become part of the trust property though. Accordingly, for a property trust, once the property is transferred, all proceeds and risks associated herewith should be automatically transferred altogether according to the principle of fairness of the Chinese civil law. This is the way how the interests of investors (beneficiaries) could be protected.

Hence, the following conclusion is made:

In this case, B Company transferred the underlying assets (K Project and the right to use the land under the Project) it owned to A Company, who paid the former consideration for this transfer through issuing trust certificates to public investors. A Company was expected to repay the public investors from the proceeds accruing from managing and operating (including constructing, managing, and selling, etc.) the underlying assets. All costs that A Company may incur during managing the trust may be paid out of the trust property according to the trust instrument. For convenience of operation and management, A Company entrusted B Company as the servicer to manage the trust property and requested the latter to deposit any proceeds accrued from the underlying assets to a trust account held by A Company. If the management and sale of the trust property went well, A Company would be able to repay the beneficiaries timely and in full, and the residual property would belong to the subordinated beneficiary, B Company. Upon distribution of trust benefit, A Company should firstly pay from the proceeds of the trust property; if such proceeds would not be sufficient to pay the senior beneficiaries, A Company might dispose of the trust corpus and use the proceeds to pay the senior beneficiaries. If the proceeds thus received still could not fully repay the senior beneficiaries, the beneficiaries

would bear the risk of loss, unless the loss occurred owing to the trustee's breach of fiduciary duty.

3. Protection of Beneficiaries' Interests upon Breach

As stated above, the trustee – A Company – might dispose of the trust corpus if the proceeds thereof would not be enough to pay the senior beneficiaries. A subsequent question is how A Company should dispose of the trust corpus. Since there is neither a central nor local registration system in China under which trusts may be registered, and that A Company had registered the Trust at issue here with STRC, it is reasonable to recognize that the trustee had the right over the trust corpus under the said Trust. Although such a right is weaker when compared with the security interests provided by law, after considering the inherent imperfection of the Chinese Trust Law, such a right should be recognized as long as no third party creditors are involved, or no conflicts existed against the rights of a third party creditor. If so, A Company would have the right to dispose of the trust corpus in order to repay the beneficiaries for their trust certificates.

However, if the trustee simply disposes of the trust corpus (here the underlying real estate) at an unreasonable low price and thus harms the value of the trust corpus, the trustee would breach the fiduciary duty. The beneficiaries (including the subordinated beneficiary) would have the right against the trustee for compensation.⁵⁰

The fiduciary duty is the most fundamental duty under trust law because the trust originally emerged simply because the settlor had confidence and faith in the trustee so that he transferred his own property to the trustee for management on behalf of the beneficiaries. Both the English term “trust” and its Chinese counterpart “信托” reflect such a confidence and faith. Thus the trustee owes a very high standard duty of fiduciary not only to the settlor, but also to the beneficiaries. Such a fiduciary relationship is different from a normal business relationship.

The trustee who owes fiduciary duty to the beneficiaries must be honest, fair, and solely for the benefit of the beneficiaries when managing the trust property. The fiduciary duty of the trustee includes duty of care and duty of loyalty.⁵¹ In addition, the trustee should also treat the beneficiaries who hold different interests (such as senior and subordinated beneficiaries) impartially, and may not seek maximization of one class of beneficiaries' interests at the expense of the other class of beneficiaries' interests, so that the rights of all beneficiaries will be equally protected. If the trustee inappropriately disposes of the trust corpus and results in unreasonable loss suffered by the beneficiaries or one class of beneficiaries, then the trustee breaches its fiduciary duty.

In the announcement of creation of the Trust made by A Company to both the senior and subordinated beneficiaries in this case, there is such a sentence:

⁵⁰ See Trust Law, *supra* note 24, art. 25 (“the trustee shall observe the stipulations of the trust instrument and shall handle the trust matters for the best interests of the beneficiaries. The trustee when managing the trust property must strictly observe its duty and fulfill its obligations of being honesty, trustworthy, diligent, and effectiveness.”)

⁵¹ See Trust Law, *supra* note 24, art. 27.

This Company, as the trustee of the Trust, will prudently handle the various matters of the Trust with a view to maximizing the benefits of the beneficiaries and strictly in accordance with the trust instrument.

This is exactly the embodiment of the trustee's fiduciary duty. It can be inferred that A Company as the trustee fully understood its fiduciary duty.

In order to prevent breach of fiduciary duty, the trustee may, after fully examining the situations of the trust property make a reasonable business judgment. Meanwhile, since in this case public investors would be involved, the trustee might adopt measures such as convening the beneficiaries' meeting to find a solution to maximize the beneficiaries' benefits. For instance, upon consent of all of the beneficiaries, the term of the trust may be extended; the trust property may also be disposed of by various ways. From the background of this case, the main reason for the insufficiency of the trust income was because the government's policy changes, the going down of the real estate market, and the fact that upon establishment of the Trust, the parties to the Trust had an unreasonable expectation on the proceeds of the trust property. It is unreasonable to blame only and any one of the parties; therefore, each party shall assume corresponding liabilities.

If the ultimate result of the consultation would be that the trustee must sell the trust corpus through auction at a price lower than expected, then the proceeds of the auction should be firstly used to pay the management expenses of the Trust (including the expenses and reasonable remunerations of the trustee and the servicer), and then used to pay the senior beneficiaries. The residual interests, if any, would belong to the subordinated beneficiary. If the proceeds of the auction would not be sufficient to repay the senior beneficiaries, then the latter would assume the loss; at the same time, the subordinated beneficiary would not get any benefit from the Trust. The Trust is terminated.

However, the problem in this case is that A Company did not have the right to dispose of the trust corpus under any of the current law in China. As already explained, the Trust Law does not require title transfer, while the real estate law requires the title transfer be registered with the real estate bureau to evidence the ownership right in the real property. It was not possible for the parties to register any mortgage agreement secondary to the Trust Contract with the real estate bureau in China. Although A Company has actually registered the Trust with STRC, its probative value is uncertain and remains to be tested by the judicial proceedings. This is the crucial reason why A Company did not feel its rights sufficiently protected; therefore, it sought protection from signing a Loan Contract with B Company. It is disappointing that the court did not respond to this situation, and neither clearly announced the effectiveness of the registration with the STRC, nor resolved the title transfer issue. Therefore, the question regarding how to properly deal with the trust property in order to better protect the interests of the beneficiaries is still unanswered by the court.

D. The Loan Contract

In addition to the Trust Contract, the contracts involved in this case also include a Loan Contract, a Framework Agreement on Financing, and other relevant contracts. This section will focus on the Loan Contract.

In a normal business transaction, a trust company may provide loans to a real estate company, as long as no prohibitive provisions of any law or regulations are to be violated. However, it is unnecessary for us to specifically analyze whether in this case it was lawful for A Company to extend loans to B Company, because simply based on the Loan Contract as well as its performance, we conclude that this Loan Contract is without basis. The reason is because A Company had not provided any loan to B Company. Regarding the RMB 215 million Yuan that A Company transferred to B Company, it was stated as the “money received in exchange for the senior beneficiary’s interests,” and thus the 215 million was based on the Trust Contract, and the transfer of which was the prerequisite for the creation of the Trust. It was not the loan extended by A Company to B Company. If this sum of money were recognized as a loan, the following absurd arguments would have been made naturally:

a. One must recognize that after A Company had received the underlying assets as the trust property from B Company for free, it had again mortgaged the same underlying assets to itself as a condition to extend a loan to B Company. The disorder in logic is apparent; or

b. One must recognize that A Company had established a fake non-cash Trust without obtaining the underlying assets from B Company, the purpose of which was to extend a loan to B Company by establishing a cash trust but to avoid stricter regulations on cash trusts. It was illegal.

As a matter of fact, A Company gave RMB 215 million Yuan and the residual interests to B Company in consideration of the transfer of the trust property. According to article 4.6.1 of the Trust Contract, “the investors shall pay to the trustee within the soliciting period of the Trust and the payment will be paid to the settlor in a lump sum after the Trust is created and becomes effective.” Apparently this was the consideration for creating the Trust and not a loan. If it were a loan, A Company might have committed illegal fund-raising (which is a crime in China), because if it did not own any rights in the underlying real estate, how could it issue trust certificates backed by the underlying real estate to the public investors? On the other hand, even if B Company still owned the title to the underlying real estate and only entrusted A Company to issue the trust certificates, the sale’s proceeds should also belong to B Company based on the agency relationship, how could it be regarded as the loan granted by A Company? Considering also article 6.3.1 of the Trust Contract: “All proceeds accrued from the underlying assets are part of the trust property of this Trust and do not belong to the settlor’s assets.” It shows that B Company had no longer owned the ownership rights over the underlying assets and their proceeds. One could not imagine a more confusing logic than this: B Company gratuitously transferred the underlying real estate to A Company, and then managed and operated the underlying real estate at its own expense (art. 6.2) for A Company without charging any service fee; and ultimately all of the proceeds would belong to A Company, and the money received by B Company was surprisingly a loan!

Article 3.2(6) of the Loan Contract provides that “the successful establishment of the Trust would be the pre-requisite for the issuing of the loan;” chapter 5 of the Loan Contract further provides that “the Loan under this Contract would be used for the borrower to develop and construct the K Project and adjust its financial structure. The borrower shall not use the loan for any other purpose.” It further proves that the relationship between the parties in this case was and could only be trust relationship, unless B Company had received another RMB 215 million Yuan’s loan from A

Company after it received the first 215 million as the proceeds received from selling the trust certificates. Otherwise, there was no loan between A Company and B Company. Under the Trust Contract, it is impossible to have such a relationship that a fund financed through trust could be re-issued as a loan.

Moreover, article 5.2 of the Trust Contract mentioned that “the trustee shall, through disposing of the collateral according to the trust instrument, obtain funds to pay the senior beneficiaries’ principal and expected profits”; article 6.2 stipulated that “the settlor voluntarily mortgages the underlying real estate to the trustee as the mortgagee (and the parties shall execute a separate mortgage agreement) in order to ensure that the trustee will be able to exercise various rights in managing the trust property, including but not limited to the right to benefits and the right to disposing of the property, and to ensure that the settlor will fulfill the obligation to make up any fund deficiency.” In addition, after the dispute arose, the parties both acknowledged the validity and effectiveness of the Trust Contract. Based on the above reasons, the mortgage (if it did exist) based on the underlying real estate would be secondary to the Trust Contract, instead of any other loan contract.

However, owing to the deficiency of the Chinese trust law system, the mortgage may be alleged as invalid for lack of registration of the Trust Contract. Therefore, it is understandable that A Company decided to sign a fake Loan Contract with B Company as the primary contract so that the mortgage agreement might be registered as secondary to it. By doing so, A Company may better protect its own interests in that in case the mortgage secondary to the Trust Contract is regarded as invalid, the mortgage secondary to the Loan Contract would be valid because it complies with all legal requirements. It is fair to say that the reasons why many trust companies in China have tried to establish multiple protections for their own benefits in financial transactions include the misunderstanding of the transfer of the ownership right over the trust property and the lacking of the trust registration system. Since it is impossible to register trust property based on the trust contracts, many trust companies decided to use fake loan contracts to obtain the mortgage right. This practice has become an open-secret in Chinese trust industry except that it has never been challenged through judicial proceedings. With increasing number of such trusts created and huge amount of funds involved, the disputes arise more and more frequently. It is time for Chinese court to clarify the trust relationship and resolve the problem. Although this practice is understandable, it obviously has an illegal purpose covered by a lawful form; therefore the Loan Contract should be declared invalid. Accordingly, after piercing the veil, the Trust Contract, as well as the mortgage secondary to it, should be declared valid.

Fortunately, the Chinese court recognized the effectiveness of the Trust Contract, and determined that the alleged “loan principal” actually came from the trust property, and did not belong to A Company’s own assets, and thus A Company could not use this fund to grant to others as a loan.⁵² In addition, the court pointed out that A Company tried to make illegal gains for itself by charging a loan interest in the Loan Contract which was higher than the interest rate it promised to pay to the Trust beneficiaries. It actually wanted to make illegal gains for itself by using other

⁵² See Trust Law, *supra* note 24, art. 27 (prohibiting the trustee from turning trust property into its own assets).

investors' money in violation of the Trust Law which provides that the trustee may only receive remuneration according to the Trust Law and the Trust Contract.⁵³

However, the court did not directly invalidate the Loan Contract; instead, it held that the Loan Contract should be regarded valid as secondary to the Trust Contract for purpose of implementing the mortgage agreement, considering the situation that the real estate bureau would not register a mortgage agreement based on the Trust Contract.⁵⁴ The court especially reasoned that both parties intended to execute the Loan Contract in order to secure the performance of the Trust Contract. The defendant's argument that the Loan Contract should be held invalid was not supported by the court because the court worried that once the Loan Contract was held invalid, the mortgage agreement subordinated to the Loan Contract would also be invalid, thus the mortgagee's right would be denied. By making such a decision, the court acknowledged and compromised over the current situation in China regarding trust registration, and meanwhile, to a great extent, protected the large scaled similar trusts existing in China. Nevertheless, the court ignored a couple issues as discussed in this paper. If the court recognized (1) that the title of the trust property had been transferred to A Company, and (2) that the underlying assets were also part of the trust property, the property would be owned by A Company and therefore there would be no need for A Company to hold it as collateral. The court's worries would be unnecessary.

III. CONCLUSIVE REMARKS

Securitization as an innovation of financial world has been a hot topic in China in the recent decades. The initial motive for Chinese government to propose asset securitization was to resolve the bad debts of the state-owned banks.⁵⁵ Later, various advantages of securitization have been identified. For example, people believe that asset securitization will help the enterprises to get finance at a lower cost and will help develop Chinese financial industry. In the recent years, with the deepening of the reform of real estate system, home loan mortgages have been greatly developed in China; consequently, banks have a need to securitize these mortgage-based assets. In addition, non-mortgage-backed securitization has also developed in China to meet the market demands. Among them, trust companies have been playing an increasingly important role. It is widely recognized that commercial trusts are the most important vehicles used in securitization transactions, therefore, most of the securitization or structured finance transactions have utilized commercial trusts. Trust industry has even been regarded as the representative of the shadow banking in China.

However, owing to the facts that trust system is a transplanted system in China, and that the Chinese Trust Law has many inherent defects, the development of trusts has met quite a few obstacles. The most prominent ones are the transfer of title of the trust property and the public notice system of trusts. The case analyzed in this paper

⁵³ *Id.* at art. 26 & 35.

⁵⁴ *See Supra* note 36, at 32.

⁵⁵ Dan Huang, *Analysis on the Obstacles of Securitization in China*, 4 FINANCES AND ECONOMY (2001).

well illustrates these problems. If these problems are not resolved, the development of securitization in China will be greatly restricted.

The problems may be seen clearly from the case discussed in this paper. One of the parties of the case at issue was a real estate company that needed financing and the other party was a trust company that had or had access to funds, and therefore was at a stronger position. The irrational real estate market in the recent years made both parties believe that they could get huge profits out of the real estate development project, therefore they decided to work together to achieve their goal. However, the parties did not consummate a financing transaction through way of traditional lending because the real estate company did not meet the requirements imposed by the Chinese government; instead, they decided to use a more popular and advanced way of structured finance to raise funds from the public investors through establishing a commercial trust. Since Chinese government heavily regulates the cash trusts, they designed a non-cash trust using the “right to proceeds to be accrued from the underlying assets” as the trust property.

After carefully examining the Trust Contract executed by the parties, it can be concluded that the trust property actually included both the underlying assets and the right to proceeds to be accrued therefrom. When analyzing it in accordance with the Chinese Trust Law, the Trust Contract between the two parties was lawful and valid, and the Trust was effectively created. However, because of both congenital and postnatal deficiencies of the trust system in China, what was the trust property and who would own the trust property were uncertain. Since there is neither a trust registration system in China to post public notice regarding the ownership right in the trust property, nor a system allowing registration of security agreement under the trust contracts, the trust company did not feel that its rights would be protected by the Trust Law. Therefore, it signed another loan contract with the real estate developer to redefine the structured finance as a secured loan, trying to convert the parties’ relationship from a trust relationship to a debtor-creditor relationship, and thus obtained the mortgagee’s right against the underlying real estate of the trust property. When the real estate market went down and the underlying project failed to make the expected profits and thus the trust company could not repay the senior beneficiaries, the trust company sued the real estate developer based on breach of the loan contract.

However, the fatal problem of this allegation is that the only fund that the real estate developer had ever received from this financing transaction was the RMB 215 million Yuan received from the sale of the trust certificates, and it had never received any other loans from the trust company. Therefore, the creation of the trust relationship between the two parties actually prevented the establishment of the loan relationship between the same parties. As a reasonable result, the mortgage agreement registered as secondary to the primary Loan Contract should also be invalid.

The Chinese trial court had a hearing on March 7, 2013 to try this case and made a decision on June 7, 2013. The court held that the Trust Contract was valid, but did not invalidate the Loan Contract or the mortgage agreement on the ground that the execution of the Loan Contract was to ensure the proper performance of the Trust Contract, and therefore the Loan Contract should be regarded as a subordinated contract to the Trust Contract. To this end, the Court allowed the plaintiff (trust company) to foreclose the collateral based on the mortgage agreement secondary to the Loan Contract.

The case was appealed to the High People's Court in Shanghai and was affirmed in December 2013.⁵⁶ Since this case is the first ever in China to test the laws on trusts and securitization, and also because huge amount of money worth trust certificates have been issued by similar trusts in China, the decision of this case is very significant. Even before the court's final decision is made, as a result of the recent trust breaches, many trust companies have already compressed their trust business.⁵⁷ Unfortunately, the court's decision is not satisfactory.

There are at least three problems in the court's decision. First, the court determined that the trust property in this case was the right to proceeds other than the underlying real estate, which was misplaced. As analyzed in this paper, the trust property of the Trust Contract at issue, as well as most of the other similar trust contracts executed by the trust companies and real estate developers in China, actually includes both the underlying real estate and the right to proceeds to be accrued from the underlying assets because these trust contracts all provide that the trust property includes the proceeds to be received from managing, utilizing, and selling the underlying real estate without deducting its original value. This question is very crucial because it will determine whether the mortgage agreement under the Loan Contract would be valid or not. Since the court believed that the trust property was only the right to proceeds based on the wording of the Trust Contract itself⁵⁸, it ignored the substantial nature of the trust. As a result, it was reluctant to hold the Loan Contract invalid because doing so would render the mortgage agreement secondary to the Loan Contract invalid⁵⁹, and thus, the court believed that the investors' interests might not be able to be protected. Consequently, the court held that the Mortgage Agreement the parties executed under the Loan Contract was valid because they reflected both parties' true intent and did not violate any prohibitive provisions of Chinese law or regulations so that the trust company would be able to foreclose the collateral to satisfy its creditor's rights.

A related problem is the recognition of the transfer of the trust property in securitization transactions. Although the current Trust Law does not mandatorily require the title to the trust property to be transferred, the court should take into consideration the international practice as well as the custom in the trust industry and hold that the trust property in this case and the other similar cases had actually been transferred to the trustee. This way, the interests of the investors will be better protected and the mortgage agreement will not be necessary because the trustee now has already got the title to the property and therefore could dispose of the property to satisfy the beneficiaries' interests. The court would not have to make the ridiculous decision which upheld the Trust Contract but did not invalidate the Loan Trust and the subordinated mortgage agreement.

The third problem is that the court totally ignored the real estate developer's status as a servicer in the structured finance transaction, and upheld the obligation imposed by the trust company on the real estate company that the latter needed to

⁵⁶ Hu Gao Min 5 (Shang) Zhong Zi, CIV. JUDGMENT, 2013 (Shanghai High People's Ct. 2013).

⁵⁷ *Anxin Trust Company Swallowed the Bitter Pill*, 21ST CENTURY ECONOMIC NEWS (March 8, 2013), available at <http://money.163.com/13/0308/04/8PDRRPO600253B0H.html>.

⁵⁸ See *Supra* note 36, at 32.

⁵⁹ *Id.* at 36.

deposit minimum amount of funds to the Trust Account held by the trustee. If the court has resolved the above two issues, it would be easy to identify that the underlying real estate had already been transferred to and owned by the trust company, therefore the management and sale of the trust property would be the trustee's job instead of the real estate developer's obligation. Such a requirement would be held invalid. Even if the real estate developer would still be entrusted to keep and manage the underlying assets, it did so as a servicer only, and a servicer should not have the obligation to make sure the Trust Account have minimum amount of funds. The plaintiff alleged that by not keeping the minimum amount of funds in the Trust Accounts, the real estate developer had breached the Trust Contract and the Loan Contract. This argument was untenable but nevertheless supported by the Chinese court.⁶⁰

These problems have actually attacked the heart of the Chinese trust system. To resolve these problems, the Chinese legislature should revise the Trust Law and the relevant regulations to close certain loopholes in the law to clarify that (1) the trust property should be transferred in securitization transactions when the initiator will receive consideration; (2) the trust property in the so-called "right trusts" should include the underlying assets if all of the sales proceeds of the assets would be part of the trust property; and (3) after the commercial trusts are established, the obligation to manage the trust property should be upon the trustee instead of the settlor, although the settlor may be hired as a servicer.

After the trust system has been introduced into China, it has been incompatible with the Chinese system like water and fire. Although the Trust Law has been promulgated for over 13 years, it has never been materially tested by Chinese judicial system. Therefore, the trial of this case is very significant and has been expected to help clarify some misunderstandings in the trust law area, promote the development of Chinese trust industry, and make the trust law system originated from the common law countries to be fully integrated into Chinese legal system. Obviously, the court decision failed people's expectation.

When this paper was still under revision, Chinese government approved and established Shanghai (China) Pilot Free Trade Zone. It has sent a message to the world that China is going to deepen its economic reform and one of its focuses is its financial system and the capital market. Among others, securitization is still one of the things that the government will promote. To this end, the revision of the laws and regulations on trusts and securitization is necessary.

⁶⁰ *Id.* at 33.

