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ARTICLE

Third-Party and Bankruptcy Effects under Chinese Trust Law: Comparisons with English Trust Law

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Abstract

In English law, the trust's third-party and bankruptcy effects contribute significantly to its wide use in commercial transactions. In view of the trust's attractiveness in conducting commercial dealings, China has also introduced the trust model into its domestic legal system to enhance its financial infrastructure. However, given the extent to which Chinese law has been influenced by the Roman-Germanic tradition, China's replication of the trust's third-party and bankruptcy effects has encountered doctrinal obstacles. Drawing upon the experience of its Northeast Asian forerunners, China has established two mechanisms to achieve the third-party and bankruptcy effects: the regime of trust fund independence and the granting of the right of rescission to beneficiaries. These two mechanisms represent the adjustments made by Chinese legislators in the process of transplanting the trust model into the Chinese legal context. Adopting a comparative law perspective, this article examines these mechanisms in the Chinese law setting for two reasons: first, to explore the mechanisms' constituent elements and their operation, as well as the roles of both mechanisms in the Chinese trust law system; and second, to furnish comparative law scholarship with broader insights into rule transplantation and reconciliation.

Introduction

In common law jurisdictions, 'the trust has become a valuable device in commercial and financial dealings'.[1] As Lord Toulson convincingly observed in the English Supreme Court case of *AIB Group (UK) Plc v Mark Redler & Co Solicitors*, '[t]rusts are now commonly part of the machinery used in many commercial transactions, for example, across the spectrum of wholesale financial markets, where they serve a useful bridging role between the parties involved'.[2] Aside from its internal governance rules,[3] the popularity of the trust is primarily due to the third-party effect (ie, third parties who are not *bona fide* purchasers are subordinate to the interest of beneficiaries) and the bankruptcy

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[1] *Target Holdings Ltd v Redferns* [1996] AC 421, 436.

[2] *AIB Group (UK) Plc v Mark Redler & Co Solicitors* [2015] AC 1503, [70].

[3] The internal governance rules constitute the check-and-balance mechanisms between trust parties, including the duties of trustees and rights of beneficiaries. For an account of the trust's internal governance rules, see Robert H Sitkoff, 'Trust Law as Fiduciary Governance Plus Asset Partitioning', in Lionel D Smith (ed), *The Worlds of the Trust* (Cambridge University Press 2013) 430–434; John H Langbein, 'Mandatory Rules in the Law of Trusts' (2004) 98(3) Northwestern University Law Review 1105, 1106.

effect (ie, beneficiaries are ranked above the trustee's other personal creditors when the trustee becomes bankrupt) inherent in the utilisation of the trust device. The two effects derive from the proprietary incident of a beneficiary's interest in trust assets.[4] In view of the 'objective of using the trust to enhance their financial infrastructure',[5] a few East Asian jurisdictions have introduced the trust model into their domestic legal systems. China is one of them: when Chinese legislators enacted the *Trust Law of the People's Republic of China* (Trust Law)[6] in 2001, they officially introduced the express trust model into Chinese law.[7]

Legal transplantation involves maintaining logical consistency and coherence between the transplanted law and the recipient's existing rules.[8] In replicating the English trust's third-party and bankruptcy effects,[9] the primary question facing the Chinese lawmakers in the course of legal transplantation was: would it be possible for Chinese law to take the same approach as English law in characterising beneficiaries as having a proprietary interest in trust assets? If the answer is negative, the next question worthy of attention is: given China's domestic legal rules, what approach can Chinese legislators adopt to achieve the third-party and bankruptcy effects of a trust? The proprietary regime adopted in English law is incompatible with China's property law rules in various respects,[10] suggesting a negative answer to the first question. A close inspection of the Trust Law shows that, similar to its Northeast Asian predecessors, Chinese law implements two mechanisms to achieve the aforementioned third-party and bankruptcy effects: the regime of trust fund independence (TFI regime) and the granting of the right of rescission to beneficiaries.[11] As products of the 'functional analysis of legal rules',[12] the two mechanisms are supplementary to each other in preserving the integrity of the trust fund. They also demonstrate the efforts of Chinese legislators to reconcile the trust model recognised by English law with China's domestic legal rules.

The research conducted thus far is incommensurate with the significance of the two mechanisms under Chinese trust law. The existing analysis that touches upon these mechanisms is primarily descriptive in nature, focusing on the constituent elements of each mechanism and how such elements can be construed.[13] There is a paucity of in-depth analysis as to the legal consequences associated with the implementation of each mechanism and the interaction of the two mechanisms in a

[4]For an account of the two effects in English law, see the section 'The Proprietary Regime in English Law' below in this article.

[5]Lusina Ho, 'The Reception of Trust in Asia: Emerging Asian Principles of Trust?' [2004] Singapore Journal of Legal Studies 287, 287.

[6]中华人民共和国信托法 [Trust Law of the People's Republic of China], National People's Congress, 28 Apr 2001.

[7]For the purpose of this article, 'China' refers to the People's Republic of China, excluding the Hong Kong Special Administrative Region, the Macau Special Administrative Region, and Taiwan Region.

[8]Ying Khai Liew & Matthew Harding, 'Introduction', in Ying Khai Liew & Matthew Harding (eds), *Asia-Pacific Trusts Law: Theory and Practice in Context* (Hart Publishing 2021)1, 8–9; Hui Jing & Siyi Lin, 'The Transplantation of Quistclose Trusts in China: Difficulties in Law and Normative Uncertainties' (2021) 15 Journal of Equity 153, 155.

[9]The United Kingdom has three legal systems: English law, which applies in England and Wales; Northern Ireland law, which applies in Northern Ireland; and Scots law, which applies in Scotland. When referring to English trust(s) in this article, it particularly means the trust(s) created under English law.

[10]For an analysis of these aspects, see the subsection 'The *Numerus Clausus* Principle' in the section 'Doctrinal Obstacles to Legal Transplantation' below in this article.

[11]The trust laws in Japan, South Korea, and Taiwan also adopt the trust fund independence regime and the mechanism of the right of rescission. See Ying-Chieh Wu, 'Trust Law in South Korea: Developments and Challenges', in Lusina Ho & Rebecca Lee (eds), *Trust Law in Asian Civil Law Jurisdiction: A Comparative Analysis* (Cambridge University Press 2013) 46, 52–53; Makoto Arai, 'Trust Law in Japan: Inspiring Changes in Asia, 1922 and 2006' in Lusina Ho & Rebecca Lee (eds), *Trust Law in Asian Civil Law Jurisdiction: A Comparative Analysis* (Cambridge University Press 2013) 27, 30–31; Chih-Cheng Wang, 'The Main Features of Trust Law and Practical Issues of Offshore Trust in Taiwan' (2014) 20(4) Trusts & Trustees 391, 394–395.

[12]James Boyle, 'Legal Realism and the Social Contract: Fuller's Public Jurisprudence of Form Private Jurisprudence of Substance' (1993) 78(3) Cornell Law Review 371, 381.

[13]See, eg, Ruiqiao Zhang, 'Trust Law of China and Its Uncertainties: Examination of the Rights and Obligations of Trust and Ownership of Trust Property' (2015) 10 National Taiwan University Law Review 45, 57; Stephen Tensmeyer,

trustee's day-to-day management of trust assets. The past two decades have exposed numerous defects in the Trust Law, giving rise to an increasing voice – inside and outside of academia – that has called for the reform of trust law rules in light of the last twenty years' trust practice.[14] Against this background, the current article explores the two mechanisms under Chinese trust law, for two reasons: first, this study enables an appreciation of the core features of a Chinese trust. These features constitute the basis upon which discussions around trust reform can be conducted and developed. Second, given that Chinese private law is a legal system where 'accurate nomenclature plays a vital role … in the realm of analytical science',[15] examining the two mechanisms sheds light on the interaction between trust and its neighbouring institutions (eg, contract and agency) and on the unique role of trusts in this context.

This article is divided into five parts. After the introduction, the next section studies the 'Proprietary Regime in English Law'. It explains the third-party and bankruptcy effects under English trust law and the mechanisms it has adopted to achieve those effects. The article then explores the 'Doctrinal Obstacles' encountered by legislators in the transplantation of the trust model recognised by English law into China's domestic legal system. Thereafter, the article analyses the 'TFI Regime' under Chinese trust law by explaining its role in the creation of trusts and the legal consequences flowing from its implementation. In the penultimate section, the article discusses the 'Beneficiary's Right of Rescission'. It studies the scenarios under which this right can be exercised and the relevance of this right to a trust's third-party effect. The final section will conclude the article.

The Proprietary Regime in English Law

Orthodox English trust law theories hold that with the creation of a valid trust, the legal title will be vested in the trustee and the equitable title in the beneficiary.[16] The content that the beneficiary's equitable title entails in substance has been the subject of academic and judicial writings for decades. Several terms have been introduced to describe a beneficiary's equitable title, including 'equitable ownership'[17] and 'beneficiary ownership'.[18] At the same time, there has been considerable

'Modernizing Chinese Trust Law' (2015) 90 New York University Law Review 710, 724–725; Eric Linge, 'Trusts as Institutions in China's Financial Markets' (2011) 3(2) Tsinghua China Law Review 283, 297.

[14]See, eg, Rebecca Lee, 'Convergence and Divergence in the Worlds of the Trust: Duties and Liabilities of Trustees under the Chinese Trust', in Lionel D Smith (ed), *The Worlds of the Trust* (Cambridge University Press 2013) 406, 414–420; Lingyun Gao, 'The Development of Private Trusts in Mainland China: Legal Obstacles and Solutions' (2014) 20(4) Trusts & Trustees 350, 357–361; Lusina Ho, 'Business Trusts in China: A Reality Check' (2020) 88(3) University of Cincinnati Law Review 767, 791–795; Zhang, 'Trust Law of China and Its Uncertainties' (n 13) 72.

[15]Ying-Chieh Wu, 'East Asian Trusts at the Crossroads' (2015) 10(1) National Taiwan University Law Review 79, 95.

[16]Civil lawyers tend to interpret the approach of vesting legal titles in trustees and equitable titles in beneficiaries as a 'division or split of title'. See Ignacío Arroyo Martinez, 'Trust and the Civil Law' (1982) 42(5) Louisiana Law Review 1709, 1718; Peter Hefti, 'Trusts and Their Treatment in the Civil Law' (1956) 5(4) American Journal of Comparative Law 553, 561. This interpretation has recently been criticised as misleading: an equitable interest is not carved out of a legal estate but impressed or engrafted onto it. See *Akers v Samba Financial Group* [2017] AC 424, [50]; *DKLR Holding Co (No 2) Pty Ltd v Commissioner of Stamp Duties (NSW)* (1982) 40 ALR 1, 36; Daniel Clarry, 'Fiduciary Ownership and Trusts in a Comparative Perspective' (2014) 63(4) International and Comparative Law Quarterly 901, 903; AS Burrows (ed), *English Private Law* (3rd edn, Oxford University Press 2013) [4.150].

[17]*Shell UK Ltd v Total UK Ltd* [2010] EWCA Civ 180, [116]; *Bieber v Teathers Ltd (in liq)* [2012] EWHC 190 (Ch), [75]; *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (in administrative receivership)* [2012] Ch 453, 473; *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2010] Ch 347, 385; James Glister & James Lee, *Hanbury and Martin Modern Equity* (22nd edn, Sweet & Maxwell 2021) [1-019]; Michael Bryan et al, *A Sourcebook on Equity and Trusts in Australia* (Cambridge University Press 2016) 383.

[18]*Marr v Collie (Bahamas)* [2018] AC 631, 633; *Stack v Dowden* (2007) 2 AC 432, 466; James E Penner, 'The (True) Nature of a Beneficiary's Equitable Proprietary Interest under a Trust' (2014) 27(2) Canadian Journal of Law and Jurisprudence 473, 486; Sheila M Crummey, 'Judicial Light Shed on the Meaning of Change in Beneficial Ownership' (2006) 25 Estates, Trusts & Pensions Journal 311, 313.

criticism of the characterisation of a beneficiary's interest in trust assets as ownership. For instance, Tony Honoré once explained:

> Given two separate systems of courts, it was tempting to treat the holder of the legal title as owner in courts of law and the holder of the beneficial or equitable interest in trust assets as owner in courts of equity. *But while trust beneficiaries undoubtedly possess a beneficial interest in trust assets, there is no compelling reason, it seems to me, to describe this as a form of ownership.* Economically, it is of course a form of property holding, but so is any chose in action. True, it may be important for the beneficiary's sense of autonomy and economic freedom that his relation to the trust assets be described as a form of ownership. *But to speak of the beneficiary's ownership or property right is unpalatable to many civil lawyers*, given the central position that ownership occupies in the civil law tradition.[19]

Daniel Clarry expressed the same line of thinking, observing that 'a return to doctrinal analyses of the trust [requires] a concerted effort to move away from the use of "dual" or "split" ownership metaphors in trusts discourse toward the fiduciary ownership of trust property'.[20] Regardless of the heated debate over the nature of a beneficiary's interest, there is no doubt that beneficiaries under express trusts have a certain kind of proprietary interest in trust assets. Consistent with the recognition of a beneficiary's proprietary interest in trust assets, the English Court of Chancery has developed the beneficiary principle for express trusts, whose origin dates back to the notable case of *Morice v Bishop of Durham*.[21] This principle suggests that 'the equitable proprietary rights of the beneficiaries'[22] lies at the heart of an express trust and that it is 'the proprietary entitlement of a beneficiary that generates a right to enforce the terms of the trust'.[23]

Such a proprietary understanding of a beneficiary's equitable interest bears upon the dynamics between beneficiaries and third parties, who transact with trustees involving trust assets, and between beneficiaries and the general creditors of trustees when the trustees become insolvent. As regards the first pair of relationships (ie, beneficiaries and third parties transacting with trustees), three observations can be summarised here. First, a beneficiary's equitable proprietary interest in trust assets is overreached where the transactions are authorised by the trust instrument.[24] Second, a beneficiary's equitable proprietary interest in trust assets is overridden where the transactions are not authorised by the trust instrument, but the third party in question falls into the ambit

[19]Tony Honoré, *On Fitting Trusts into Civil Law Jurisdictions* (Oxford Legal Research Paper Series No 27, 2008) 13 <https://rivistataf.eu/documenti/Honore_1630257184.pdf> accessed 8 Apr 2024 (emphasis added).

[20]Clarry (n 16) 933.

[21]*Morice v Bishop of Durham* (1805) 32 ER 947, 955; *Morice v Bishop of Durham* (1804) 9 Ves 399, 405.

[22]Ben McFarlane, Charles Mitchell & Jessica Hudson, *Hayton, McFarlane and Mitchell on Equity and Trusts* (15th edn, Sweet & Maxwell 2022) [8-061].

[23]ibid 176. In contrast, charitable trusts are widely conceptualised as purpose trusts and, hence, they have no beneficiaries as understood in the context of an express private trust. As regards enforcement, it is assumed that charitable trusts are policy-oriented and, therefore, a person's entitlement to enforce the trust terms is granted by legislation or case law as a matter of public policy. See Jonathan Garton, *Public Benefit in Charity Law* (Oxford University Press 2013) [6.05]; Kathryn Chan, *The Public-Private Nature of Charity Law* (Hart Publishing 2016) 80; Warren Barr & John Picton, *Pearce & Stevens' Trusts and Equitable Obligations* (8th edn, Oxford University Press 2022) 513–514; Lynton Tucker et al (eds), *Lewin on Trusts (Volume I)* (20th edn, Sweet & Maxwell 2020) [1-031]; Hui Jing, 'Enforcing Charitable Trusts: A Study on the English Necessary Interest Rule' (2022) 42 Legal Studies 228, 244.

[24]For an account of the overreaching doctrine, see Richard C Nolan, 'Vandervell v IRC: A Case of Overreaching' (2002) 61 (1) Cambridge Law Journal 169, 172–173; MP Thompson, 'Overreaching after Boland' (1986) 6(2) Legal Studies 140, 144; David Fox, 'Overreaching', in Peter Birks &Arianna Pretto (eds), *Breach of Trust* (Hart Publishing 2002) 95, 95–100; Richard Nolan & Matthew Conaglen, 'Good Faith: What Does It Mean for Fiduciaries and What Does It Tell Us about Them?', in Elise Bant & Matthew Harding (eds), *Exploring Private Law* (Cambridge University Press 2010) 319, 335.

of 'equity's darling'.[25] Third, where the transactions are unauthorised and the third parties are not *bona fide* purchasers, the trust or the substitute assets concerned will be held by the third-party recipient on constructive trust for the beneficiary, as long as the beneficiary – with the assistance of following and tracing rules – can establish a proprietary base over the trust or the substitute assets in the possession of the third-party recipient (the so-called 'third-party effect').[26] The way in which English law deals with the aforementioned three scenarios demonstrates the court's commitment to upholding 'relational justice'[27] between trustees and third parties, and its efforts to strike a sensible balance between protecting beneficiaries' legitimate interests and securing transaction certainty. When it comes to the second pair of relationships (ie, beneficiaries and trustees' general creditors), the proprietary incident of a beneficiary's interest accords them a separate status in the context of the trustee's bankruptcy. Instead of being placed 'at the bottom of the insolvency order of distribution',[28] the beneficiary can claim immunity of trust assets from the bankruptcy procedure of the trustee (the so-called 'bankruptcy effect'). Similar to the third-party effect, the bankruptcy effect is part of the *in rem* effect of the proprietary incident of the beneficiary's interest in trust assets.

Doctrinal Obstacles to Legal Transplantation

Trust practice shows that a trust's third-party and bankruptcy effects have contributed exceptionally to its wide use in the structuring and conducting of commercial transactions.[29] As Ying Khai Liew convincingly observed:

> [Many] well-rehearsed features of express trusts, for example, that trust assets are bankruptcy remote [and] that misappropriated trust assets are traceable against third parties[,] … significantly increase the distinctiveness of express trusts as a facilitative device as compared to other facilities available within the law.[30]

According to the analysis presented earlier, the English legal system achieves the third-party and bankruptcy effects of a trust by categorising the right of the beneficiary as a form of proprietary interest.[31] This means that the distinct status of the beneficiaries over the personal creditors of the trustees and third parties who are not *bona fide* purchasers is justified by their equitable proprietary interest. The Trust Law demonstrates that, during the process of legal transplantation, Chinese legislators have not embraced the English proprietary regime, primarily due to its incongruity with China's domestic property law rules. Upon closer examination of Chinese property

[25]*Credit and Mercantile plc v Wishart* [2015] EWCA Civ 655 [46]. There is a policy concern underlying the doctrine of equity's darling: this doctrine is devised by Equity to track the parties' patterns of moral responsibility for the dilemmas they face, whilst serving the shared goal of encouraging owners and purchasers to make effective investments to prevent such dilemmas. See Aruna Nair & Irit Samet, 'What Can "Equity's Darling" Tell Us about Equity?', in Dennis Klimchuk, Irit Samet & Henry E Smith (eds), *Philosophical Foundations of the Law of Equity* (Oxford University Press 2020) 264, 290; David Fox, 'Purchase for Value Without Notice', in Paul S Davies, Simon Douglas & James Goudkamp (eds), *Defences in Equity* (Hart Publishing 2018) 53, 63.

[26]Graham Virgo, *The Principles of Equity & Trusts* (4th edn, Oxford University Press 2020) 592–593.

[27]'Relational justice' demonstrates the notion of interpersonal respect of each other's autonomous interest. See Hanoch Dagan, 'The Challenges of Private Law: A Research Agenda for an Autonomy-Based Private Law', in Kit Barker, Karen Fairweather & Ross Grantham (eds), *Private Law in the 21st Century* (Hart Publishing 2017) 67, 73.

[28]Wenming Xu & Zhicheng Wu, 'Regulation-Driven Legal Doctrines of Investment Trusts in China' (2022) 23 European Business Organization Law Review 391, 402.

[29]John H Langbein, 'The Secret Life of the Trust: The Trust as an Instrument of Commerce' (1997) 107 Yale Law Journal 165, 173; Ying Khai Liew, 'Justifying Anglo-American Trusts Law' (2021) 12 William & Mary Business Law Review 685, 698; Henry Hansmann & Ugo Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73(2) New York University Law Review 434, 459.

[30]Liew, 'Justifying Anglo-American Trusts Law' (n 29) 698.

[31]See the section 'The Proprietary Regime in English Law' above in this article.

law, two insurmountable obstacles can be identified: the *numerus clausus* principle and the legislative requirements for creating and transferring property rights.[32] The sections below elaborate on these two obstacles.

The Numerus Clausus *Principle*

The first obstacle that discourages Chinese legislators to adopt the English proprietary regime in their enactment of the Trust Law is the *numerus clausus* principle. Deeply rooted in the Roman-Germanic tradition, nomenclature and taxonomic classification are essential in understanding rights, obligations, and their interrelationships under the infrastructure of Chinese private law.[33] Akin to its Northeast Asian predecessors, such as South Korea and Japan, China adopts the 'dichotomous system in respect of [its] private law dealing with property: the law of property and that of obligation'.[34] The *numerus clausus* principle is developed under the heading of the law of property. It states that only the legislature is empowered to create new types of rights that have *in rem* effects against the world; the number of property rights and their standardised incidents must be defined by law.[35]

Two policy concerns underpin the operation of the *numerus clausus* principle. The first is to enhance the autonomy of individuals. This principle functions 'as a means of facilitating stable categories of state-supported property [law] institutions and standardising their incidents'.[36] In this sense, its operation enables people to predict what they will get when entering various kinds of property relationships (eg, easement, co-ownership, and mortgage) and to structure and plan their lives accordingly.[37] The second concern relates to the protection of innocent third parties. Allowing individuals to freely create property arrangements increases the difficulty of providing notice to third parties regarding the content of such arrangements. In the absence of precise notice standards, these third parties may unfairly bear 'the risks of possible misunderstandings due to [the] idiosyncrasy or ambiguity [of these arrangements]'.[38] The two policy concerns thus represent the tension between Chinese property law's commitment to enhancing individual autonomy and to facilitating the 'interpersonal respect for self-determination'[39] between property owners and third parties. The *numerus clausus* principle was introduced by legislators as a conduit to give effect to

[32]These two obstacles are not unique to Chinese law; they also emerged when transplanting the trust model into other civil law jurisdictions, such as Japan and South Korea. See Ho, 'The Reception of Trust in Asia' (n 5) 303; Ying Khai Liew, 'Trusts and Choice of Law in South Korea: The Case for Adopting the Hague Trusts Convention' (2021) 20(1) Journal of Korean Law 57, 62; Masayuki Tamaruya, 'Japanese Law and the Global Diffusion of Trust and Fiduciary Law' (2017) 103 Iowa Law Review 2229, 2237–2238.

[33]Chen Lei, 'The Historical Development of the Civil Law Tradition in China: A Private Law Perspective' (2010) 78 Legal History Review 159, 178; George Mousourakis & Matteo Nicolini, *Comparative Law and Legal Traditions: Historical and Contemporary Perspectives* (Springer 2019) 240; Zhu Qingyu (朱庆育), 民法总论 [*General Theory of Civil Law*] (北京大学出版社 [Peking University Press] 2016) 6–7.

[34]Wu, 'East Asian Trusts at the Crossroads' (n 15) 81. See also Liming Wang, 'The Systematization of the Chinese Civil Code', in Lei Chen & CH (Remco) van Rhee (eds), *Towards a Chinese Civil Code: Comparative and Historical Perspectives* (Martinus Nijhoff Publishers 2012) 21, 25; Cui Jianyuan (崔建远), 物权: 规范与学说 [*Property Rights: Norms and Doctrines*] (清华大学出版社 [Tsinghua University Press] 2011) 4–5.

[35]中华人民共和国民法典 [Civil Code of the People's Republic of China], National People's Congress, 28 May 2020, art 116. For an account of the Chinese *numerus clausus* principle, see Yuanshi Bu (ed), *Chinese Civil Law* (Hart Publishing 2013) 193; Weiguo Wang, 'Restructuring Modern Property Law on a Theoretical Basis', in Lei Chen & CH (Remco) van Rhee (eds), *Towards a Chinese Civil Code: Comparative and Historical Perspectives* (Martinus Nijhoff Publishers 2012) 109, 111.

[36]Dagan (n 27) 78.

[37]Tian Yin, 'Reflection on the Criticism of Numerus Clausus' (2006) 1 Frontiers of Law in China 92, 99.

[38]Irit Samet & Hanoch Dagan, 'Express Trust: The Dark Horse of the Liberal Property Regime', in Simone Degeling, Jessica Hudson & Irit Samet (eds), *Philosophical Foundations of the Law of Express Trusts* (Oxford University Press 2024) 139, 149. See also Mo Zhang, 'From Public to Private: The Newly Enacted Chinese Property Law and the Protection of Property Rights in China' (2008) 5(2) Berkeley Business Law Journal 317, 347; Yin (n 37) 99.

[39]Hanoch Dagan, 'Autonomy, Relational Justice and the Law of Restitution', in Elise Bant, Kit Barker& Simone Degeling (eds), *Research Handbook on Unjust Enrichment and Restitution* (Edward Elgar Publishing Limited 2020) 219, 221.

these policy concerns, and its observance is crucial to the smooth operation of the Chinese property law system. Based on this understanding of the *numerus clausus* principle, it can be reasonably asserted that before the beneficiary's right is added to the legislated list of property rights under Chinese law, any discussion attempting to characterise the beneficiary's right as a kind of proprietary interest is futile and otiose.

The Legal Requirements for Creating and Transferring Property Rights

The legal requirements for creating and transferring property rights pose a second obstacle to defining a beneficiary's statutory right as a form of proprietary interest under Chinese law. According to Chinese property law, two actions must be carried out for the creation and alteration of a property right: (a) concluding a contractual agreement, and (b) fulfilling the formality requirement, which involves delivery for movables and registration for immovables.[40] The two acts have distinct rules (eg, rules on capacity, formality, and legality of content),[41] consistent with Chinese law's approach to the idea of 'separation of the obligation from the performance of the obligation'.[42] The performance of the first act only gives rise to the contractual obligation on the part of each party involved in the transaction. For a legally recognised property right to be created or transferred, the formality requirement regarding delivery or registration must be properly performed by the relevant parties.[43]

In the context of Chinese trusts, it is the settlor and trustee who are responsible for concluding the contractual agreement and fulfilling the formality requirement with respect to the trust assets.[44] Beneficiaries are not obliged to possess trust assets or register the titles of such assets under their names in order to acquire a beneficial interest in the trust assets. The wording of the Trust Law's provisions even implies that, in the absence of any knowledge concerning the trust being created, beneficiaries can still acquire a beneficial interest in trust assets. As elaborated in Article 44 of the Trust Law, unless otherwise stipulated in the trust instruments, a beneficiary's statutory right to trust assets accrues immediately upon the trust coming into existence.[45] Furthermore, Chinese law allows individuals to establish family trusts for the management of their assets. These trusts focus on governing 'the ownership-management of [properties] for a group of potential beneficiaries over a lengthy number of years',[46] under which beneficiaries are sometimes not yet born and, therefore, unable to play any role in the stage of trust creation. Upon reflection of the previous explanations, the fundamental nature of the second obstacle becomes apparent: due to the fact that beneficiaries are typically not engaged in executing the aforementioned two actions, it is

[40]Civil Code of the People's Republic of China (n 35) arts 209, 224.

[41]Huang Wei (黄薇) (ed), 中华人民共和国民法典解读: 物权编 [*Interpretation of the Civil Code of the People's Republic of China: Property Rights*] (中国法制出版社 [China Legal Publishing House] 2020) 26–27; Cui (n 34) 71, 74–77.

[42]Jens Thomas Füller, 'The German Property Law and Its Principles', in Wolfgang Faber & Brigitta Lurger (eds), *Rules for the Transfer of Movables: A Candidate for European Harmonisation or National Reforms?* (Sellier 2008) 197, 200.

[43]Cui (n 34) 179, 225; Birke Häcker, *Consequences of Impaired Consent Transfers: A Structural Comparison of English and German Law* (Hart Publishing 2013) 58.

[44]Article 10 of the Trust Law requires the registration of certain types of trust assets before a trust can be validly set up. However, the registration requirement has not been properly implemented due to the vagueness of the Trust Law in clarifying which types of assets require registration. Although the China Bank and Insurance Regulatory Commission enacted the *Administrative Measures for Trust Registration* (MTR) to supplement the implementation of the trust registration requirement, the MTR focuses on the registration of trust products rather than trust assets; therefore, it still falls short of achieving the goal of publicity underpinning trust registration. For details on this aspect, see Ho, 'Business Trusts in China: A Reality Check' (n 14) 776–777; Mark Hsiao, 'Chinese Trust Law: Registration as the Concept-Substitution and a Workout Solution for Investors (Beneficiaries)' (2015) 21(8) Trusts & Trustees 889, 898; Siyi Lin & Hui Jing, 'Registration of Chinese Trusts: Lessons from English Trust Law' (2023) 3 Conveyancer and Property Lawyer 267.

[45]For an analysis of Article 44, see Bian Yaowu (卞耀武), 中华人民共和国信托法释义 [*Interpretation of the Trust Law of the People's Republic of China*] (法律出版社 [Law Press] 2002) 125–126.

[46]For a discussion in relation to family trusts under English law, see *AIB Group (UK) Plc v Mark Redler & Co Solicitors* (n 2) [67].

conceptually challenging to categorise their statutory rights as a form of proprietary interest in accordance with Chinese law.

The Regime of Trust Fund Independence

Given the doctrinal obstacles examined earlier, it is not surprising that Chinese trust law diverges from the English approach of basing the trust's third-party and bankruptcy effects on the proprietary nature of the beneficiary's right. Instead, Chinese trust law adopts the trust fund independence (TFI) regime and empowers beneficiaries with the right of rescission to *functionally* achieve these two effects. This section of the article thus presents an in-depth analysis of the TFI regime and a trust's bankruptcy effect associated with its implementation.

Focusing on the function of the TFI regime in Chinese trust law, one can identify three questions that are relevant to understanding the role of such a regime and its operation:

1. Is the TFI regime an essential component in the creation of Chinese trusts?
2. What are the legal consequences associated with the implementation of such a regime?
3. In what ways can the TFI regime be properly implemented?

The sections below explore these three questions.

Question One

Chinese legislators have enacted specific provisions for the TFI regime.[47] Unfortunately, these provisions fall short of clarifying the relevance of the TFI regime to the establishment of Chinese trusts. The vagueness of the law has created inconsistencies in judicial practice. In *Shenzhen Xingyunxin Investment Development Company v Wang Yihong*, the Supreme People's Court stated that '[a]s there is no requirement for setting up independent trust assets in the agreement between the relevant parties, no trust is intended to be created, and this case falls outside the scope of the Trust Law'.[48] The People's Court of Yuhuatai District, Nanjing City, expressed a similar logic in the case of *Jiangsu Dafeng Rural Commercial Bank Company v Jiangsu Tiandi Metallurgical Industry and Trade Company*. It observed that '[t]he trustee used the assets entrusted by the settlor to offset their own debts, thereby violating the *Trust Law*'s requirement on the independence of trust assets. In light of this reason, the trust contract was void'.[49] These two judgments consider the due implementation of the TFI regime a necessity for creating Chinese trusts. By contrast, in the most recent family trust case of *Qin Moumou v Li Mou* (*Qin*), the Shanghai Jing'an District Court expressed a divided opinion, with the collegiate bench holding the following argument:

> As long as the trustee commits to accepting the trusteeship and legally possesses trust assets, the assets in question should be defined as trust assets in the Trust Law sense … segregating the trust assets from the trustee's own assets is *the legal effect flowing from the creation of trusts, rather than the constituent element for the creation of trusts*.[50]

[47]Trust Law (n 7) arts 14–18.

[48]深圳市兴云信投资发展有限公司与王一虹之间的信托纠纷 [*Trust Dispute between Shenzhen Xingyunxin Investment Development Company and Wang Yihong*], 最高人民法院 [Supreme People's Court], 民终 364 号 [Civil Division, Appeal Ruling, Case No 364], 26 Dec 2019 (author's translation).

[49]江苏大丰农村商业银行股份有限公司与江苏天地冶金工贸有限公司之间的执行异议纠纷 [*Execution Objection Dispute between Jiangsu Dafeng Rural Commercial Bank Company and Jiangsu Tiandi Metallurgical Industry and Trade Company*], 江苏省南京市雨花台区人民法院 [People's Court of Yuhuatai District, Nanjing City, Jiangsu Province], 雨板民初字第71号 [Civil Division, Initial Ruling, Case No 71], 17 Apr 2014 (author's translation).

[50]钦某某、李宜今与李水根、李莲芳等民事信托纠纷案 [*Civil Trust Disputes between Qin Moumou, Li Yijin, Li Shuigen, and Li Lianfang*], 上海市静安区人民法院 [People's Court of Jing'an District, Shanghai], 沪 0106 民初 30894 号[Civil Division, Initial Ruling, Case No 30894], 6 Apr 2021 (author's translation, emphasis added).

These divergent opinions provide an opportunity to revisit the legislative requirements for establishing Chinese trusts. A literal reading of the Trust Law suggests that Chinese legislators were inclined to adopt the idea expressed in *Qin*: that the proper implementation of the TFI regime is not a prerequisite for establishing Chinese trusts. This is implicit in Articles 9 and 10 of the *Trust Law*. Article 9 requires the specification of certain matters in the trust instrument, including the trust purpose, the type and condition of the trust asset, and the scope of beneficiaries; the absence of any matter would not give rise to a valid trust. Article 10 provides the registration requirement for certain trust assets before a trust can be created in a valid manner.[51] Reading and construing these two articles together demonstrates the resemblance between Chinese and English trust law in terms of establishing express trusts. This resemblance refers to the requirements regarding three certainties, namely certainty of intention, certainty of subject matter, and certainty of object, which make up the core aspect of the establishment of a valid trust,[52] notwithstanding that the criteria for assessing each certainty differ between the two jurisdictions. For present purposes, the 'certainty' that matters relates to the 'certainty of subject matter'. In both English and Chinese trust law, this type of certainty is concerned with the 'identifiability'[53] and 'permanence or stability'[54] of the trust assets.[55] Lord Wilberforce's statement in the English House of Lords case of *National Provincial Bank v Ainsworth* is instructive on this aspect:

> Before a right or an interest can be admitted into the category of property or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability.[56]

Understood in this way, the certainty of subject matter requirement has no relevance to the performance of a trustee's duty regarding the segregation of the trust assets from those of the trustee or settlor; nor is this requirement relevant to the emergence of a trust's bankruptcy effect. In other words, the creation of Chinese trusts is not conditional on the implementation of the TFI regime.

Question Two

After establishing the irrelevance of the TFI regime to the creation of Chinese trusts, the next point to consider is the function of the TFI regime in Chinese trust law. This relates to the exploration of the abovementioned second question: what are the legal consequences associated with the implementation of the TFI regime? The Trust Law provides the answer to this question,[57] and three major legal consequences can be summarised as follows: (a) immunity of trust assets to the bankruptcy procedure of trustees and settlors; (b) substitution of the trust assets; and (c) limited liability of trustees. Taken together, these three consequences demonstrate how a Chinese trust achieves its bankruptcy effect.

[51]See the section 'Doctrinal Obstacles to Legal Transplantation' above in this article.

[52]For an analysis of the three certainties in Chinese trust law, see Chen Xiangcong (陈向聪), 信托法律制度研究 [*Research on Trust Law System*] (中国检察出版社 [China People's Procuratorate Press] 2007) 10–13; Zhao Lianhui (赵廉慧), 信托法解释论 [*Interpretative Theory of Trust Law*] (中国法制出版社 [China Legal Publishing House] 2015) 94–100; Tan Zhenting (谭振亭), 信托法 [*Trust Law*] (中国政法大学出版社 [China University of Political Science and Law Press] 2010) 70–75; Zhou Xiaoming (周小明), 信托制度: 法理与实务 [*Trust System: Theory and Practice*] (中国法制出版社 [China Legal Publishing House] 2012) 43–49.

[53]*Herbert v Doyle* [2010] EWCA Civ 1095 [75].

[54]*National Provincial Bank v Ainsworth Ltd* [1965] 1 AC 1175, 1248.

[55]Regarding the certainty of subject matter, the degree of certainty varies in each case, depending on the type of the trust assets concerned. See Michael Bryan, Vicki Vann & Susan Barkehall Thomas, *Equity and Trusts in Australia* (2nd edn, Cambridge University Press 2017) [14.31]–[14.33]; David Hayton, 'Uncertainty of Subject-Matter of Trusts' (1994) 110 Law Quarterly Review 335, 336; *White v Shortall* [2006] NSWSC 1379 (15 Dec 2006) [211]; *Hunter v Moss* (1994) 1 WLR 452, 457; Zhou (n 52) 47–48; Zhao, *Interpretative Theory of Trust Law* (n 52) 189–194.

[56]*National Provincial Bank v Ainsworth* (n 54) 1248.

[57]Trust Law (n 7) arts 14–18.

The Immunity of Trust Assets to the Bankruptcy Procedure of Trustees and Settlors

Articles 15 and 16 of the Trust Law state that trust assets should be carved out of the assets of the trustee and the settlor if they enter bankruptcy. The 'carving out' consequence illuminates the meaning of 'independence' in the TFI regime: trust assets are immune and shielded from the trustee's and settlor's personal assets if they become bankrupt. Consequently, these trust assets fall outside the ambit of Chinese bankruptcy law and are not distributed amongst the settlor's and trustee's other personal unsecured creditors in pursuance of the *pari passu* rule.[58] A similar 'carving out' consequence can also be seen in articles 12 and 18 of the Trust Law. The two articles prescribe that, because of the insulation of trust assets from the trustee's and settlor's personal assets, trustees are prohibited from using trust assets to offset the liabilities incurred by their personal assets or to execute the trust assets to discharge the debts owed to their personal creditors.

Contrary to its English and Northeast Asian counterparts, Chinese law allows settlors to 'entrust' (委托 *weituo*), rather than transfer, their personal assets to trustees for the creation of trusts.[59] This entrustment arrangement gives rise to an agency understanding of the trust relationship created under Chinese law.[60] At the same time, the law makes no mention of the meaning of the term 'entrust', which therefore grants settlors the 'optimum freedom'[61] to determine whether the titles of the trust assets are transferred to the trustee during the trust creation process. Regardless of the location of the titles of the trust assets, it is required by the TFI regime that trust assets be functionally segregated and protected from the settlor's and trustee's personal assets. In this regard, the TFI regime lays the basis upon which the Chinese trust's bankruptcy effect takes place. This is consistent with the following statement made by Ying-Chieh Wu regarding the operation of the TFI regime under the trust laws of Japan, South Korea, and Taiwan:

> The concept of trust fund independence resembles the concept of legal personhood. [The trust fund] exists and functions as if it were an *autonomous or self-contained* bundle of assets not affected by the trustee's personal bankruptcy, death or compulsory execution. In other words, the doctrine of independence of the trust fund turns a bundle of assets … into a *quasi-legal entity*.[62]

Construing the TFI regime as resembling a legal entity implies the difficulty in replicating a trust's bankruptcy effect via ordinary trust contracts, mainly due to the 'inability of a [trust] contract to limit the rights of non-privies',[63] such as the trustee's personal creditors. The asset partitioning rules that are inherent in a legal entity have the core function of separating the personal property

[58]The *pari passu* rule provides that in case the debtor's assets cannot satisfy all claims from its creditors, such assets will be distributed among the unsecured creditors in proportion to the sizes of their respective claims. See 中华人民共和国企业破产法 [Enterprise Bankruptcy Law of the People's Republic of China], 27 Aug 2006, art 113; Andrew Godwin, 'A Lengthy Stay? The Impact of the PRC Enterprise Bankruptcy Law on the Rights of Secured Creditors' (2007) 30 University of New South Wales Law Journal 755, 772; Roman Tomasic, 'The Conceptual Structure of China's New Corporate Bankruptcy Law', in Rebecca Parry, Yongqian Xu & Haizheng Zhang (eds), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Routledge 2016) 21, 35.

[59]Trust Law (n 7) art 1.

[60]Frances H Foster, 'American Trust Law in a Chinese Mirror' (2010) 94 Minnesota Law Review 602, 641; Rebecca Lee, 'Conceptualizing the Chinese Trust' (2009) 58(3) International & Comparative Law Quarterly 655, 659–660; Kai Lyu, 'Re-Clarifying China's Trust Law: Characteristics and New Conceptual Basis' (2015) 36 Loyola of Los Angeles International and Comparative Law Review 447, 471–472.

[61]*AIB Group (UK) Plc v Mark Redler & Co Solicitors* (n 2) 1531.

[62]Ying-Chieh Wu, 'Trusts Reimagined: The Transplantation and Evolution of Trust Law in Northeast Asia' (2020) 68(2) American Journal of Comparative Law 441, 463 (emphasis added).

[63]Sitkoff (n 3) 439. See also Mo Zhang, *Chinese Contract Law: Theory and Practice* (Martinus Nijhoff Publishers 2006) 315; Leng Jing & Shen Wei, 'The Evolution of Contract Law in China: Convergence in Law But Divergence in Enforcement?', in Yun-chien Chang, Wei Shen & Wen-yeu Wang (eds), *Private Law in China and Taiwan: Legal and Economic Analyses* (Cambridge University Press 2016) 63, 70.

and responsibility of the entity's managers from those of the entity itself.[64] The TFI regime replicates these asset partitioning rules by creating 'two distinct legal persons [of a trustee]: a natural person contracting on behalf of himself, and an artificial person acting on behalf of beneficiaries'.[65] This explains why a trustee's personal creditors are incapable of extending their claims to the trust assets for the satisfaction of their debts.[66]

Substitution of Trust Assets

The second consequence relates to the substitution of trust assets, which is evidenced in Article 14 of the Trust Law. Pursuant to this article, in the absence of any terms in the trust instrument, trust assets constitute not only the initial settled sum but also the assets that are obtained as a result of the trustee's administration, disposal, and destruction of trust assets. Thus, when the trustee sells the trust asset to a third party and, in return, receives its price, the money automatically falls into the ambit of trust assets. In a similar vein, if trust assets are damaged, the agreed compensation received by the trustee from the insurance company will automatically become part of the trust assets that are subject to the trust.[67] This consequence is described as the 'substitution'[68] or 'real subrogation'[69] of trust assets.

The trust's substitution rules are conducive to safeguarding the 'independence and integrity'[70] of trust assets. There is no doubt that trustees are persons or entities[71] specifically appointed by settlors for the management of trust assets. Such an appointment entails the settlor's trust and confidence reposed in the trustee. Based on the agency interpretation of the trust, one could reasonably infer that if the trustee becomes incapable of discharging its managerial role, the trust in question should automatically be terminated.[72] Nevertheless, the Trust Law exhibits a departure from this observation. Article 52 of the Trust Law states that unless the trust instrument specifies otherwise, a trust will persist even if its trustee dies, is declared bankrupt, or resigns the trusteeship. This implies that the essential factor for the continuous existence of a Chinese trust lies in the trust assets themselves. As long as these assets can still be identified and utilised to fulfil the trust's purpose, the trust will continue to exist regardless of the trustee's status. Consistent with this line of thought, Chinese legislators have introduced substitution rules to facilitate the protection of trust assets. These rules support the identification of the 'autonomous or self-contained bundle[s] of assets'[73] created under a trust and ensure that these identified assets are always protected from the trustee's personal assets.

The foregoing analysis also accords with the English maxim that 'a trust will not fail for want of a trustee',[74] although the ground that gives effect to this maxim differs between English and Chinese

[64]Henry Hansmann & Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110(3) Yale Law Journal 387, 405.

[65]ibid 416.

[66]This analysis has a similar logic to the separate-patrimony-based approach, which has been extensively explored by lawyers in other mixed and civilian jurisdictions. See Lionel Smith, 'Scottish Trusts in the Common Law' (2013) 17(3) Edinburgh Law Review 283, 285; George L Gretton, 'Trusts Without Equity' (2000) 49(3) International and Comparative Law Quarterly 599, 609; Emile Schmieman, 'Dual Patrimony Dutch Style: The Magic Spell for Introducing the Trust in the Netherlands?', in Remus Valsan (ed), *Trusts and Patrimonies* (Edinburgh University Press 2015) 221, 229–231.

[67]WANG YING 与国民信托有限公司营业信托纠纷 [*Trust Dispute between WANG YING and National Trust Co Ltd*], 北京市高级人民法院 [Beijing Higher People's Court], 京民终 1600 号 [Civil Division, Appealing Ruling, Case No 1600], 6 Aug 2021.

[68]Lusina Ho, Rebecca Lee & Jinping Jin, 'Trust Law in China: A Critical Evaluation of Its Conceptual Foundation', in Lusina Ho & Rebecca Lee (eds), *Trust Law in Asian Civil Law Jurisdiction: A Comparative Analysis* (Cambridge University Press 2013) 80, 88.

[69]Magda Raczynska, 'Parallels between the Civilian Separate Patrimony, Real Subrogation and the Idea of Property in a Trust Fund', in Lionel D Smith (ed), *The Worlds of the Trust* (Cambridge University Press 2013) 454, 465.

[70]*Astor v Scholfield* [1952] Ch 534, 535.

[71]Article 24 of the Trust Law allows both natural and legal persons to function as trustees.

[72]An agency by mandate comes to an end when the agent dies or loses the civil capacity to carry out a juridical act. See Civil Code of the People's Republic of China (n 35) art 173.

[73]Wu, 'Trusts Reimagined' (n 62) 463.

[74]Gretton (n 66) 613.

trust laws. In English law, this maxim is effected via the idea that the courts have an inherent jurisdiction over trusts, so the courts can appoint new trustees to save a trust from failure.[75] By contrast, under Chinese law, this maxim is effected via the idea that the continual existence of a Chinese trust lies in the continuing existence of trust assets rather than the trustees. Therefore, the independence and substitution rules in relation to trust assets lay the foundation for the operation of such a maxim.

Limited Liabilities of Trustees

The third consequence revolves around the limited liabilities of trustees. The limited liability rules are established under Article 37 of the Trust Law, which suggests that in the absence of breach of trust, trustees are not personally liable for all the obligations of the trust; rather, they are only liable to discharge the trust obligations using trust assets.[76] This rule is set up as a default: unless it is explicitly excluded by the trust instrument, creditors arising in a trustee's due management of the trust affairs can only recoup their debts from trust assets.[77] The limited liability rule is in striking contrast to the default position under English law, where 'the legal personality of a trustee is unitary'[78] and 'all the liabilities which [the trustee incurs], regardless whether affecting a trust or not, are nonetheless fully enforceable against their personal assets'.[79] This departure from the position under English law represents the adjustments made by Chinese legislators in the course of transplanting the trust model into China's domestic law. Such a distinction also demonstrates the Chinese legislators' wish to encourage the general public to accept trustee offices, especially in view of the fact that trusteeship is remarkably onerous, involving the fulfilment of various duties.[80]

In conjunction with the limited liability rule, the Trust Law facilitates the implementation of the TFI regime by according the right of indemnity to trustees. This right allows trustees to pay debts properly incurred as trustees out of trust assets or, if they pay it in the first instance from their own pockets, to be indemnified out of trust assets.[81] The right of indemnity arises as an incident of the trusteeship with regard to the trust assets and is in alignment with the gist of the TFI regime. Underlying the right is the thinking that, since all trust assets are independent of the trustee's personal assets, liabilities associated with the reasonable management of trust assets should be borne by the trust assets themselves.

Question Three

The answer to the foregoing two questions revealed that the implementation of the TFI regime is not a precondition for establishing valid trusts and that the implementation of such a regime can give rise to certain legal consequences. Based on this understanding, let us now turn to the

[75]Richard C Nolan, 'The Execution of a Trust Shall Be under the Control of a Court: A Maxim in Modern Times' (2016) 2 (2) Canadian Journal of Comparative and Contemporary Law 469, 473; Sir Launcelot Henderson, 'The Role of the Courts Today in the Administration of Trusts', in Richard C Nolan, Kelvin F K Low & Tang Hang Wu (eds), *Trusts and Modern Wealth Management* (Cambridge University Press 2018) 19, 26–27.

[76]The Trust Act of Japan also entails the limited liability rule. However, the limited liability rule can only be invoked when the trust is registered as a limited liability trust. See Arai (n 11) 31.

[77]Bian (n 45) 113–114.

[78]*Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* [2019] AC 271, 308.

[79]ibid 318.

[80]In Chinese law, the duty of loyalty is the most important duty imposed on trustees. The duty of loyalty has trust, not self-interest, at its core. See Hui Jing, 'The Duty of Loyalty in Chinese Trust Laws' (2020) 13 Journal of Equity 347, 357.

[81]Chinese law is similar to its English counterpart on this aspect. For an account of the trustee's right of indemnity under English law, see *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* (n 78) 308; *Williams v Simm* [2021] EWHC 121 (Ch) [55]; *Dominion Corporate Trustees Ltd v Capmark Bank Europe plc* [2010] EWHC 1605 (Ch) [31]–[32]; T Cyprian Williams, 'Club Trustees' Right to Indemnity: A Criticism of Wise v Perpetual Trustee Co Ltd' (1903) 19(4) Law Quarterly Review 386, 388.

third question: how can the TFI regime be properly implemented? This question can be divided into two sub-questions: (a) does the valid creation of a trust necessarily entail the due implementation of the TFI regime, and (b) if the answer is no, what steps should a trustee take to properly implement this regime?

A closer scrutiny of the Trust Law shows that the answer to question (a) is negative. Reading articles 8, 10, and 14 of the Trust Law together shows that the creation of a valid trust requires three major components: the settlor must entrust the assets to the trustee, the trustee must accept the trusteeship, and there should be an execution of formalities (if any). The 'entrusting' requirement envisions that, when a trust is validly created, the trust assets will be under the management and control of the trustee and that the trust assets will be segregated from the settlor's personal assets.[82] However, as explained above,[83] the creation of the trust itself does not contemplate the segregation of the trust assets from the trustee's personal assets. The trustee may mix the trust assets with their personal assets, as a result of which the trust assets may lose their identity and become unascertainable. In such 'mixing' situations, a presumption may arise under Chinese law in favour of the trustee: to the extent that they lose their separate identity, the trust assets possessed by the trustee belong to the trustee's personal assets and are thus subject to the claims of their personal creditors.[84] Following this analysis, it can be asserted that the creation of a trust itself does not necessarily entail the due implementation of the TFI regime. This echoes Lianhui Zhao's observation in 'Research on the Independence of Trust Assets':

> The validity of a trust relationship does not imply that trust assets are necessarily independent from the assets of a trustee. The word 'trust' is not a magical spell in the mouth of a magician, and a legal relationship labelled 'trust' cannot necessarily produce the effect of the independence of trust assets and the effect of bankruptcy-remoteness.[85]

In line with the paragraph quoted above, a trustee is required to take extra steps to fully implement the TFI regime. These steps constitute the content of the custodial stewardship duty imposed upon trustees. Depending on the type of trust assets, trustees are expected to exercise reasonable care and skill in performing these steps. When trust assets are in the form of chattels, a trustee should, with reference to the reasonable person standard, keep them in a separate location from the trustee's personal chattels and declare that they are part of the trust assets.[86] With respect to money, the trustee should deposit it in a separate bank account and label it as 'trust money'.[87] When it comes to registrable assets, such as land, the trustee must register the assets as trust assets,[88] and the notice on the registration book ought to be clear enough to inform third parties of the separation between the trust assets and the trustee's personal assets.[89] Consistent with the preceding analysis that the creation of a valid trust is not conditional on the implementation of the TFI regime, failure to take such steps would not automatically render an established trust invalid. Rather, such a failure may constitute an improper discharge of the trustee's custodial duty, thereby preventing the legal consequences envisaged by the TFI regime from arising in the first place.

[82]Zhao Lianhui (赵廉慧), '信托财产独立性研究: 以对委托人的独立性为分析对象 [Research on the Independence of Trust Assets: Focus on the Independence Against the Settlor's Assets]' (2021) 2 法学家 [The Jurist] 117, 129.

[83]See the subsection 'Question Two' above.

[84]By contrast, the presumption raised under the *Trust Act of South Korea* is against the trustee: if a trustee mixes the trust assets with his personal assets in an indistinguishable mass, all these assets will be presumed to be part of the trust assets. See Ying-Chieh Wu, 'Trusts in South Korea: Towards an Independent Fund Mechanism', in Ying Khai Liew & Ying-Chieh Wu (eds), *Asia-Pacific Trusts Law: Adaptation in Context* (Hart Publishing 2023) 311.

[85]Zhao, 'Research on the Independence of Trust Assets' (n 82) 129 (author's translation).

[86]Zhou (n 52) 216–217.

[87]Trust Law (n 7) art 29.

[88]ibid art 10.

[89]Hsiao (n 44) 898; Gao (n 14) 359.

The Beneficiary's Right of Rescission

After clarifying the constituent elements of the TFI regime and how it functions, this part discusses the right of rescission granted by Chinese law to beneficiaries. Discussion of this right relates to an understanding of the third-party effect of Chinese trusts: third parties who are not *bona fide* purchasers are subordinate to the interests of the beneficiaries.[90] Similar to the TFI regime, the beneficiary's right of rescission is a mechanism intentionally created by Chinese legislators in the course of transplanting trusts into the local context. This mechanism stems from the functional analysis of legal rules,[91] which aims to replicate an English trust's third-party effect under Chinese law.

As explained earlier, under the influence of Germanic-Roman law, China adopts the dichotomous system in respect of its private law, that is, the law of obligation and that of property.[92] When exploring the function of a right, civil law training prompts one to examine two specific questions related to that right. First, into which heading (ie, obligation or property) should the right in question fall? Second, how can such a right be exercised? The exploration of the two questions plays a vital role in understanding the actions that right holders are eligible to perform and the limitations they can exert on others' behaviours.[93] In this article, the analysis of the beneficiary's right of rescission also centres on examining these two questions.

The Nature of the Right of Rescission

The first question to be addressed concerns the nature of the beneficiary's right of rescission. The analysis in the section 'The Proprietary Regime in English Law' above has shown that an English trust's third-party effect is embedded in the proprietary regime adopted under English trust law. In particular, the justification for the imposition of a constructive trust over the trust or substituted assets in the possession of a third-party recipient lies in the proprietary nature of a beneficiary's right to such assets. However, under Chinese law, when considering the *numerus clausus* principle and the legal prerequisites for creating and transferring property rights, it becomes conceptually challenging to categorise a beneficiary's statutory right as proprietary in nature.[94] In light of Chinese private law's dichotomous classification, a reasonable observation arises: the right of beneficiaries falls into the heading of the law of obligation. This suggests that in the context of Chinese trust law, beneficial interests are categorised as a kind of personal, rather than proprietary, interest.[95] Certainly, the personal nature of beneficiaries' right does not prevent them from playing a proactive role in the trustee's daily management of trust assets. The Trust Law endows beneficiaries with extensive rights, including the right to require trustees to explain the reasons underlying their decision-making[96] and the right to transcribe or obtain a copy of the trust accounts relating to

[90]See the section 'The Proprietary Regime in English Law' above in this article.

[91]The strength of the functional method is its emphasis on similarity, its desire for legal evaluation, and unity. The functional method not only requires comparative jurists to examine the cultures of different jurisdictions, but also enables them to formulate general laws without having to abstract specific situations. See Ralf Michaels, 'The Functional Method of Comparative Law', in Mathias Reimann & Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019) 345, 346.

[92]See the section 'Doctrinal Obstacles to Legal Transplantation' above in this article.

[93]Ori J Herstein, 'A Legal Right to Do Legal Wrong' (2014) 34(1) Oxford Journal of Legal Studies 21, 22; Matthew H Kramer, 'Refining the Interest Theory of Rights' (2010) 55(1) American Journal of Jurisprudence 31, 33; Joseph Raz, 'Hart on Moral Rights and Legal Duties Review Article' (1984) 4(1) Oxford Journal of Legal Studies 123, 125.

[94]See the section 'Doctrinal Obstacles to Legal Transplantation' above in this article.

[95]Linge (n 13) 303; Lusina Ho, 'Trust Laws in China: History, Ambiguity and Beneficiary's Rights', in Lionel Smith (ed), *Re-Imaging the Trust: Trusts in Civil Law* (Cambridge University Press 2012) 183, 185; Lusina Ho, *Trust Law in China* (Sweet & Maxell Asia 2003) 174–175. The beneficiary's interest is also personal in nature in Japan, South Korea, and Taiwan. See Wu, 'Trusts Reimagined' (n 62) 459; Wu, 'East Asian Trusts at the Crossroads' (n 15) 98–99, 106–107.

[96]In contrast, the traditional approach under English law is that trustees are empowered not to disclose the reasons behind their decisions. See *Breakspear v Ackland* (2008) 3 WLR 698 [57]–[58]; *Re Rabaiott's Settlement* [2000] WTLR 953, 933; Alec

the administration of trust assets.[97] With regard to a trust's third-party effect, the right that merits consideration is the beneficiary's right of rescission.

The introduction of the right of rescission enables beneficiaries to act as oversight bodies in transactions involving trust assets. The exercise of this right serves a comparable purpose to that of a beneficiary's constructive trust claim against third-party recipients under English law; that is, to rectify the trustee's misconduct by reclaiming the misapplied trust assets. The beneficiary's right of rescission functions to 'invalidate the disposition vis-à-vis the trustee [and then] compel [the trustee] to make good the trust property'.[98] After a transaction has been rescinded, any assets that were dissipated will be reclaimed and returned to the pool of trust assets, rather than being allocated to the beneficiary's personal pocket. The role of the beneficiary is thus limited to initiate the recovery procedure in regards to any misapplied assets.[99] Such a legislative arrangement has the effect of preserving the independence of trust assets, which is in accordance with the idea that the TFI regime 'turns a bundle of [trust] assets … into a quasi-legal entity'.[100]

The Exercise of the Right of Rescission

After exploring the nature of the beneficiary's right of rescission, let us now turn to the second question: how can the right of rescission be exercised? According to Article 22 of the Trust Law, the effect of the beneficiary's exercise of the right of rescission is that the transaction concluded between the trustee and the third party will be set aside. Thus, to ensure that a third party's legitimate interest is not unfairly prejudiced, a sensible balance must be struck between safeguarding trust assets and ensuring the certainty of the transaction. In this light, Chinese legislators have enumerated conditions for the exercise of the right of rescission by beneficiaries, as elaborated in Articles 22 and 49 of the Trust Law:

> Where the trustee *disposes of trust assets in breach of the trust purpose* or *causes losses to the trust assets due to departure from their administrative duties or improper handling of trust affairs*, the beneficiary shall have the rights to apply to the People's Court for rescinding such disposition and to ask the trustee to restore the assets to their former state or make compensation.
>
> Where a transferee of the said trust assets accepts the assets *with knowledge of the violation of the trust's purpose*, they shall return the assets or make compensation.[101]

Samuels, 'Disclosure of Trust Documents' (1965) 28(2) Modern Law Review 220, 222; Mark Pawlowski, 'Confidentiality or Disclosure?' (2008) 96 Trusts and Estates Law & Tax Journal 12, 12. A later set of cases, however, suggests that trustees need to disclose their reasons for preventing adverse inferences being drawn from silence in the face of a case with *prima facie* evidence. See *Scott v National Trust for Places of Historical Interest or Natural Beauty* (1998) 2 All ER 705, 718–719; *Edge v Pensions Ombudsman* [2000] Ch 602, 633.

[97]Trust Law (n 7) arts 20, 49.

[98]Ho, Lee & Jin (n 68) 97.

[99]Some scholarly writings argue that the availability of the right of rescission and the way in which this right is exercised demonstrate the proprietary aspect of the beneficiary's interest. See Zhenting Tan, 'The Chinese Law of Trusts – A Compromise Between Two Legal Systems' (2001) 13(1) Bond Law Review 224, 234–235; Lee, 'Conceptualizing the Chinese Trust' (n 60) 666; Charles Zhen Qu, 'The Doctrinal Basis of the Trust Principles in China's Trust Law' (2003) 38 Real Property, Probate and Trust Journal 345, 373–374; Zhang, 'Trust Law of China and Its Uncertainties' (n 13) 71. This argument cannot withstand closer scrutiny. If a beneficiary's interest in the trust assets is proprietary, the beneficiary can assert their proprietary right directly against the third-party recipient. There is no need for a beneficiary to rely on rescission to vindicate their property rights. See Wu, 'East Asian Trusts at the Crossroads' (n 15) 107.

[100]Wu, 'Trusts Reimagined' (n 62) 463.

[101]Author's translation, emphasis added.

The two articles above bring forward two conditions concerning the exercise of the right of rescission. The first condition relates to the trustee's discharge of its managerial and disposal duties: the threshold regarding rescission can only be met when a trustee's disposition is in contravention of the trust purpose, or if a trustee's improper management has led to losses to the trust assets. This condition is designed to protect the autonomous interest of the trustee in the exercise of their powers. In the absence of mismanagement or improper disposition, beneficiaries should not be allowed to 'unduly intrude into [the trustee's] freedom'[102] with respect to their administration of trust assets.[103] The second condition concerns the subjective mental state of third-party recipients. The 'knowledge'[104] element suggests that the third-party recipient's liability here is fault-based. In particular, they must act in bad faith in receiving the trust assets to be held accountable; mere knowledge of the existence of a trust relationship or of the transferor's capacity as trustee would not taint the validity of the transaction concluded. If the third-party recipient does not have 'knowledge of the violation of the trust's purpose'[105] when entering into transactions with the trustee, the third-party recipient is entitled to retain the trust asset received by virtue of the *bona fide* purchaser defence.[106] Here, the operation of the second condition aligns with the idea of relational justice[107] by balancing the interests of beneficiaries with those of third-party recipients; specifically, a third-party recipient's exercise of autonomy ought not to be protected where it would unduly prejudice the interests of beneficiaries.[108]

Together, the two conditions guide the exercise of the beneficiaries' right of rescission. In circumstances where the two conditions are satisfied, beneficiaries are entitled to invoke the rescinding procedure in relation to misapplied assets. A successful rescission will rend the transaction at issue ineffective *ab initio*, based on which the trustee is allowed to claim the repossession of the dissipated assets. If the misapplied trust assets can no longer be repossessed, the rescission response is transformed to claiming compensation against the third-party recipient when the latter either consumes or sells the assets. Compensation is substitutive in nature, generally taking the form of money, and it is the obligation of the trustee to claim it.[109] As a result of the substitution of trust assets, the compensation money received by the trustee will automatically become part of the trust assets used for the fulfilment of the trust's purpose.[110] Upon recovery of the dissipated assets or receipt of the compensation money, the TFI regime would require the trustee to retake particular steps to ensure the

[102]Liew, 'Justifying Anglo-American Trusts Law' (n 29) 741.

[103]Bian (n 45) 92.

[104]The Chinese trust law makes no mention of the meaning of knowledge here. It is unclear whether a third-party recipient's constructive knowledge can suffice; neither is it clear whether an objective or a subjective standard is adopted in the assessment of a third-party recipient's knowledge. By contrast, English law has developed extensive discussions around the mental state of third-party recipients in the context of receipt-based liabilities. See *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246, 306; *Karak Rubber Co Ltd v Burden (No 2)* (1972) 1 WLR 602, 632; *Williams v Central Bank of Nigeria* [2014] AC 1189 [30]–[31]; *Vestergaard Frandsen v Bestnet Europe Ltd* [2013] WLR 1556 [42]; Peter Birks, 'Receipt', in Peter Birks & Arianna Pretto (eds), *Breach of Trust* (Hart Publishing 2002) 213, 226–227; Rohan Havelock, 'The Transformation of Knowing Receipt' (2014) 22 Restitution Law Review 1, 4–6.

[105]Trust Law (n 7) art 22.

[106]Chinese law adopts the principle of *bona fide* acquisition, wherein a purchaser who acts in good faith, pays a reasonable consideration, and takes physical possession of the property or completes the required legal registration for transferring property ownership can acquire valid ownership rights, even if the property was disposed of by an unauthorised individual. See Civil Code of the People's Republic of China (n 35) art 311. For an analysis of this principle in Chinese law, see Lei Chen, 'Land Registration, Property Rights and Institutional Performance in China: Progress Achieved and Challenges Ahead' (2014) 44(3) Hong Kong Law Journal 841, 850; Gebhard M Rehm & Hinrich Julius, 'The New Chinese Property Rights Law: An Evaluation from a Continental Perspective' (2009) 22(2) Columbia Journal of Asian Law 177, 197; Bu (n 35) 203–205; Lin & Jing (n 44).

[107]For the account of relational justice, see the section 'The Proprietary Regime in English Law' above in this article.

[108]Bian (n 45) [92].

[109]Ho, Lee & Jin (n 68) 97.

[110]See the subsection 'Question Two' in the section 'The Regime of Trust Fund Independence' above in this article.

ring-fencing of these assets or money. These steps, as explained earlier,[111] include keeping the chattels separately from their personal assets, depositing the trust money into a separate trust bank account, and re-registering the assets as trust assets in the publicised registration book.

Conclusion

This article has examined the TFI regime and the beneficiary's right of rescission under Chinese trust law. The TFI regime suggests that, instead of creating proprietary rights for beneficiaries under English law, the establishment of Chinese trusts entails creating 'a self-contained bundle of assets'[112] for the interests of certain beneficiaries or for the fulfilment of specific purposes. The proper implementation of the TFI regime has the effect of partitioning off the trust assets from the trustee's and settlor's personal assets when they become bankrupt. Meanwhile, Chinese law accords the right of rescission to beneficiaries to achieve a trust's third-party effect. Exercising this right allows beneficiaries to trigger the recovery procedure in relation to the dissipated assets, thereby protecting trust assets from being misapplied and motivating trustees to properly perform their custodial and managerial duties.

As statutory mechanisms, the TFI regime and the right of rescission are both created by Chinese law to functionally achieve the third-party and bankruptcy effects of an English trust. These examples demonstrate the efforts of Chinese legislators to reconcile the trust model recognised by English law with China's domestic legal rules. In light of the increasing calls to reform Chinese trust law,[113] an analysis of the two mechanisms can provide critical insights into two aspects: first, the TFI regime and a beneficiary's right of rescission run through every type of trust created under Chinese law. Given that they constitute the core characteristics of a Chinese trust, any reform programme that seeks to modify the existing rules or introduce new rules should be based on these core characteristics. Second, the introduction of the two mechanisms suggests that doctrinal obstacles themselves should not be an impediment to the learning or borrowing of English trust law experiences. Functional analysis lies at the core of legal transplantation. When using English law as a reference point for reforming Chinese trust law, one must first identify the function that the rule under examination serves, and then explore what mechanisms can be adopted to perform such a function on Chinese soil. This analytical approach plays a pivotal role in the context of Chinese law, where legal analysis is conceptualised as legal science[114] and nomenclature is crucial in the construction of legal rules and doctrines.

[111]See the section 'The Regime of Trust Fund Independence' above in this article.

[112]Wu, 'Trusts Reimagined' (n 62) 464.

[113]See the introduction of this article.

[114]German legal science and civil law concepts have had a profound influence on Chinese jurists and lawmakers. See Mousourakis & Nicolini (n 33) 240; Zhu (n 33) 6.

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