

## TRUSTS AS INSTITUTIONS IN CHINA'S FINANCIAL MARKETS

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*Eric Linge\**

### Abstract

*China passed a law of trusts in 2001 intending it to be useful to financial market participants. Drawing heavily from literature on economic institutions and economic development, this article assesses the potential success of the trust's becoming institutionalized in China. The conclusion is that a legislature's passing of a trust law does not alone make the trust an institution. A law is not an institution until it functions to predictably incentivize and constrain human behavior. A number of provisions in China's Trust Law are unclear, and this prevents the law from functioning with predictability. Further, there is some question whether conditions in China are hospitable to the institutionalization of the trust, and whether the Trust Law can be a catalyst for the development of financial markets.*

### I. INTRODUCTION

Individuals in England first created the legal arrangement called the trust and the rest of the world has since discovered the institution's usefulness. While it was individuals who first conceived of the idea, it took the blessing of the English courts of equity to let it stand as a formal legal institution. The United States' legal system long ago inherited the trust with the rest of the English common law, so that nowadays, trust law is often deemed a product of Anglo-American law. The trust is an institution constituted by a standardized bundle of legal rules arranging the *in personam* and *in rem* rights and duties of the parties inside the trust arrangement with respect to some trust property. In the arrangement, the settlor, an owner of some certain property, transfers that property to someone he considers trustworthy, a trustee; that trustworthy individual then manages it and makes distributions to a third party, called the beneficiary or beneficiaries. The arrangement was originally used in England to circumvent feudal inheritance laws and can still be used today to circumvent undesirable laws, like laws of taxation.<sup>1</sup> Since its inception the arrangement has proven a useful means for a property owner to exploit another party's comparative advantage in property management. Throughout history, individuals in other cultures have created arrangements

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<sup>1</sup> See GEORGE T. BOGERT ET AL., *BOGERT'S TRUSTS AND TRUSTEES* § 2 (3d ed. 2009); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U.L. REV. 434, 439-40, 446-47 (1998).

similar to the trust, including the so-called “lineage trust,” or *tang* (堂) in pre-communist China,<sup>2</sup> but only the Anglo-American trust has been so widely and successfully exported. Today the Anglo-American trust is incorporated into the modern, formal legal systems of many countries, even countries outside of the common law tradition, like China.

In passing the *Trust Law* of the People’s Republic of China<sup>3</sup> (hereinafter “*Trust Law*”), the Chinese legislature was quite self-conscious in its decision to attempt a transplant<sup>4</sup> of the Anglo-American trust into its formal legal system. Observing how the modern trust plays an important role in other countries’ financial markets, the Chinese legislature hoped the trust could grow to also play an equally important role in the Chinese financial markets.<sup>5</sup> The trust in the modern U.S. and U.K. has become a widely used organizational form for some types of institutional investors.<sup>6</sup> Institutional investors have become very important to the stability and efficiency of financial markets in the U.S. and the U.K. Believing the development of the institutional investor sector to be a means of infusing the Chinese financial markets with stronger liquidity, rationality, stability, and efficiency,<sup>7</sup> the Chinese legislature passed the *Trust Law* as a catalyst for the rise of institutional investment funds.

The trust’s role in financial markets extends beyond merely providing an organizational form for some types of institutional investors. The trust is also an organizational form for the management of household wealth. When the trust form was first created, it provided a means for landowners to manage their ownership of real property. Since then financial assets have become a larger and larger component of household wealth in the

<sup>2</sup> See DAVID FAURE, CHINA AND CAPITALISM: A HISTORY OF BUSINESS ENTERPRISE IN MODERN CHINA 37-40 (2006); Madeleine Zelin, Informal Law and the Firm in Early Modern China (Feb. 23-24, 2007) (unpublished conference article) (on file with the University of South California), available at [http://www.usc.edu/schools/college/crcr/private/ierc/conference\\_registration/papers/Zelin.pdf](http://www.usc.edu/schools/college/crcr/private/ierc/conference_registration/papers/Zelin.pdf).

<sup>3</sup> See Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT’L PEOPLE’S CONG. GAZ. 311.

<sup>4</sup> Alan Watson famously popularized the concept of the legal transplant, which he described as “the moving of a rule or a system of law from one country to another, or from one people to another.” ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW 21 (1974).

<sup>5</sup> LUSINA HO, TRUST LAW IN CHINA 10 (2003) (H.K.); Charles Zhen Qu, *The Doctrinal Basis of the Trust Principles in China’s Trust Law*, 38 REAL PROP. PROB. & TR. J. 345, 348-53 (2003).

<sup>6</sup> John Langbein, *Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997). See also A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 764-73 (2008).

<sup>7</sup> The financial markets are so far lacking in these characteristics. See Benjamin Liebman & Curtis Milhaupt, *Reputational Sanctions in China’s Securities Market*, 108 COLUM. L. REV. 929, 934-40 (2008). See also BARRY NAUGHTON, THE CHINESE ECONOMY: TRANSITIONS AND GROWTH 19 (2007).

U.S. and other wealthy countries, although real property is still the largest component of household wealth, even in wealthy countries.<sup>8</sup> Paralleling this change in household wealth, the trust in the U.S. and U.K. has become increasingly important as a means for managing household ownership of financial assets.<sup>9</sup> Financial institutions earn fees for managing this wealth, and the trust is a common form used by households to hold this wealth. Real property as a component of household wealth is comparatively larger in China than in wealthier countries, but the proportion of wealth in financial assets is increasing.<sup>10</sup> Meanwhile, household savings rates in China are extremely high, and households' options for investing this wealth are limited.<sup>11</sup> The wealth management industry in China is anxiously awaiting the day when these households put this savings into financial assets; the industry is expected to boom.<sup>12</sup> At the moment, however, the development of the wealth management industry and the institutional investor sector is constrained by a number of factors including law. Further regulation could play a role in rationalizing financial markets, but it is arguable that the weakness in the underlying institutions is a more fundamental concern.

This paper will examine one of these underlying institutions, the trust, which is itself a collection of rules from contract and property institutions. The rules of any country's trust law, including China's, seek to solve a fundamental problem in the trust arrangement: the beneficiary's interest in the trust property must be protected from the trustee's mismanagement, but the trustee must be given an adequate degree of freedom to make investment decisions. A country's trust law, China's included, will also provide rules for trust parties to arrange a pattern of creditors' rights that could not be achieved by contract and property rules alone. China's Trust Law provides rules whose goal it is to solve these fundamental problems, but some provisions are unclear as written. It is incumbent on the courts, a regulator, or the legislature to finally settle these uncertainties. In defining the trust as an institution, we will refer to the U.S. version of the trust as a point of departure. This is not to suggest that the development of the trust institution in China should follow the U.S. model. The concept of legal transplant implies that

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<sup>8</sup> James B. Davies & Susanna Sandström & Anthony Shorrocks & Edward Wolff, *The Global Pattern of Household Wealth*, 21 J. INT'L DEV'T 1111, 1118 (2009).

<sup>9</sup> John Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995).

<sup>10</sup> Davies et al., *supra* note 8, at 1118.

<sup>11</sup> Franklin Allen, Jun Qian & Meijun Qian, *China's Financial System: Past, Present, and Future*, in CHINA'S GREAT ECONOMIC TRANSFORMATION 506 (Loren Brandt & Thomas Rawski eds., 2008).

<sup>12</sup> See, e.g., Bee Ong, *Fledgling Asian Wealth Industry Finds Feet*, FIN. TIMES, June 27, 2010.

rules are not simply exported and imported. Rather, a rule is first transplanted, and the transplant can only be deemed a success once the rule functions in the recipient country as if it were always part of the system. Only when all market participants and trust parties share a common understanding of the provisions in the *Trust Law* can the *Trust Law* become an integral part of China's legal system. Until its uncertainties are resolved, the Trust Law will be a weak link in the development of the institutional investor sector in China.

## II. INSTITUTIONS

Before evaluating the success of the trust as a transplanted institution, we must first define "institution." Institutions are the formal and informal norms, rules, practices, and attendant enforcement mechanisms by which members of a group abide and expect others to abide.<sup>13</sup> The group could be relatively small or large and need not be formal. For instance, a group could be composed of all the participants in the diamond market<sup>14</sup> or the participants in the cotton trade.<sup>15</sup> So long as all members abide by the rules, cooperation is fostered, and their costs of transacting are lowered. Parties' promises are credible. Disputes can be resolved predictably. Institutions give entrepreneurs confidence that they will be able to capture gains from their investments without sharing them with expropriators. In short, institutions create a system that constrains some human behaviors while incentivizing others, and this makes transactions less costly to make.

Empirical studies and economic theory claim to demonstrate that institutions are of primary importance as a determinant of economic growth.<sup>16</sup> High quality institutions will allow for high economic growth, while low quality institutions will hinder economic growth. Often identified as the most important institutions are those that protect property rights from expropriation, those that support private

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<sup>13</sup> AVNER GREIF, INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE 1-29 (2006); Douglass C. North, Economic Performance Through Time, 84 AM. ECON. REV. 359 (1994); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE [hereinafter NORTH, INSTITUTIONS] (1990).

<sup>14</sup> Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J.L. STUD. 115 (1992).

<sup>15</sup> Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001).

<sup>16</sup> DOUGLASS NORTH, GROWTH AND WELFARE IN THE AMERICAN PAST: A NEW ECONOMIC HISTORY (3d ed. 1983); Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001); Dani Rodrik & Arvind Subramanian & Francesco Trebbi, *Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development*, 9 J. ECON. GROWTH 131 (2004).

contracts,<sup>17</sup> and the tribunals that enforce property and contractual rights.<sup>18</sup> Writers often emphasize the importance of formal, state-supplied laws and adjudicative mechanisms.<sup>19</sup>

China's experience over the past three decades has posed a problem for the hypothesis that strong, formal institutions are necessary for high rates of economic growth. China has been perceived to have weak institutions, yet its economy has grown fast and substantially.<sup>20</sup> China lacked a systematic law governing private rights of property ownership until the *Property Law*<sup>21</sup> came into effect in 2007. Understanding which laws will apply to specific disputes remains confusing because there is no good system for authoritatively resolving conflicts between different rules.<sup>22</sup> Contrary to the processes prescribed in the *Constitution*<sup>23</sup> and the *Legislation Law*,<sup>24</sup> regulations from lower-level government agencies often trump the laws and legislation that should technically provide the rules of decision.<sup>25</sup> Meanwhile, a "bewildering array" of bodies has power to make rules of binding effect, and it is not uncommon for rules to contradict.<sup>26</sup> State courts have low status and have inconsistently enforced laws.<sup>27</sup> In short, China's formal legal system cannot be said to provide a secure system of property rights.<sup>28</sup>

According to Professor Clarke, the institutional economic theorists may be correct that secure property and contract rights are important for economic growth, but they are incorrect in claiming that rights and their attendant enforcement mechanisms must be part of a system of state-supplied and state-enforced laws.<sup>29</sup> Institutions

<sup>17</sup> Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 J. POL. ECON. 949 (2005) (seeking to differentiate the contractual and property rights institutions, a distinction that is often not made in the literature, which often simply lumps the two together as simply "institutions").

<sup>18</sup> NORTH, INSTITUTIONS, *supra* note 13, at 35.

<sup>19</sup> *Id.*

<sup>20</sup> Donald Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 AM. J. COMP. L. 89, 91 (2003).

<sup>21</sup> Wuquan Fa (物权法) [Property Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 19, 2007, effective Oct. 1, 2007) 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 291.

<sup>22</sup> Donald Clarke et al., *The Role of Law in China's Economic Development*, in CHINA'S GREAT ECONOMIC TRANSFORMATION 375, 392-403 (Loren Brandt & Thomas Rawski eds., 2008).

<sup>23</sup> XIANFA (1982) (China).

<sup>24</sup> Lifa Fa (立法法) [Legislation Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 2000, effective Jul. 1, 2000) 2000 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 112 (2000).

<sup>25</sup> Clarke et al., *supra* note 22.

<sup>26</sup> *Id.* at 394, 399-400.

<sup>27</sup> Jianfu Chen, CHINESE LAW: CONTEXT AND TRANSFORMATION 653-99 (2008).

<sup>28</sup> Donald Clarke, *Law without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT'L L. & BUS. 131 [hereinafter Clarke, *Law without Order*] (2010); Clarke et al., *supra* note 22, at 399-400.

<sup>29</sup> Clarke, *Rights Hypothesis*, *supra* note 20; Clarke et al., *supra* note 22.

are important because they create an economic environment where the behavior of actors is reasonably predictable. Certain behaviors are predictably incentivized and other behaviors are predictably constrained. During China's growth period, informal mechanisms have existed that provided substitutes for state enforcement of property rights, state creation of property rights, and state enforcement of contract rights.<sup>30</sup> Local officials are promoted to higher levels in part based on the economic performance of their region; they therefore have had an incentive to not expropriate the property rights of enterprises and hamper their growth.<sup>31</sup> Indeed, officials had an incentive to do everything in their power to facilitate economic growth.

Informal contract enforcement mechanisms may have also provided an adequate substitute, though there is evidence that courts are becoming more authoritative in resolving disputes. The *guānxì* (关系) (or, relationship and reputation) between contracting parties may provide an adequate enforcement mechanism.<sup>32</sup> When parties have an existing relationship and plan to do business repeatedly in the future, parties may trust each other to keep their promises.<sup>33</sup> A mechanism founded on *guānxì* would seem, however, to be less effective when the parties do not have or do not expect to have a long-term relationship. Furthermore, as economies grow and markets become larger and more competitive, the cost of breaking a relationship falls. More substitutes become available in the market, and competition drives down prices. As enterprises grow, new relationships will be of a less personal variety and may be made over greater distances.<sup>34</sup> An empirical study conducted in Eastern Europe showed that parties with no prior dealings were willing to start and develop new relationships when courts were reliable in enforcing promises.<sup>35</sup> Trust was fostered because of the availability

<sup>30</sup> Franklin Allen & Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57 (2005) (identifying reputation and relationships as substitutes for formal law in firms' participation in the capital markets); Clarke, *supra* note 20, *Rights Hypothesis*, at 100-09; Clarke et al., *supra* note 22, at 400-03; Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184 (2005).

<sup>31</sup> Allen et al., *supra* note 30, at 98-99; Clarke, *Rights Hypothesis*, *supra* note 20, at 100-09; Clarke et al., *supra* note 22, at 400-03; Pistor & Xu, *supra* note 30.

<sup>32</sup> Allen et al., *supra* note 30, at 97.

<sup>33</sup> On "guanxi", see Carol A. G. Jones, *Capitalism, Globalization, and Rule of Law: An Alternative Trajectory of Legal Change in China*, 3 SOCIAL & LEG. STUD. 195 (1994).

<sup>34</sup> Avinash Dixit, *Trade Expansion and Contract Enforcement*, 111 J. POL. ECON. 1293 (2003); Avinash Dixit, *Two-tier Market Institutions*, 5 CHI. J. INT'L L. 139 (2004); John McMillan & Christopher Woodruff, *The Central Role of Entrepreneurs in Transition Economies*, 16 J. ECON. PERSP. 153, 163-64 (2002).

<sup>35</sup> Simon Johnson & John McMillan & Christopher Woodruff, *Courts and Relational Contracts*, 18 J.L. ECON. & ORGAN. 221 (2002).

of courts. What this means is that while *guānxì* may have played an important role during China's growth period as an institution protecting contractual rights, *guānxì* hinders the efficiency of enterprises in a more developed economy. *Guānxì* limits potential contracting partners to the set of parties already known, and in their quest for more profitable transactions, parties will want to choose from a larger set of partners. As China's market economy becomes more developed, we would expect courts to become more important. Indeed there is now quantitative evidence that parties are more frequently relying on state courts to resolve their disputes.<sup>36</sup> Courts' decisions may not always be perceived as just and fair, but their decisions are increasingly seen as authoritative.<sup>37</sup> Judgments provide final solutions to disputes and have a reasonably high rate of implementation.<sup>38</sup>

Since the start of economic reforms, reams of economic legislation have been passed in China, and now an objective of policy makers is to create through legislation the legal institutions for a rules-based market economy.<sup>39</sup> For this policy to provide an optimally efficient economic environment, all the rules provided by the state would have to be efficient, and the state would have to be able to weed out inefficient rules. China's policy ignores market participants' ability to identify problems in the law and to spontaneously adopt rules to solve these problems. China is lacking a good process by which the state can adopt the institutions created by market participants,<sup>40</sup> and policy makers have a strong preference for favoring state-created, formal institutions to market-created, informal institutions.<sup>41</sup>

Market participants have an advantaged position compared to the state in identifying barriers to efficient markets and creating rules-based solutions to problems. The state may choose to adopt the informal, market-created rule (as the common law judges are theorized to have done),<sup>42</sup> creating a formal rule. Otherwise, the rule may function by spontaneous force in the market. These informal rules can arise spontaneously when people who repeatedly

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<sup>36</sup> Clarke et al., *supra* note 22, at 408-15.

<sup>37</sup> *Id.* at 414.

<sup>38</sup> *Id.*

<sup>39</sup> Donald Clarke, *Legislating for a Market Economy*, 191 CHINA Q. 567 (2007).

<sup>40</sup> *Id.* at 584.

<sup>41</sup> *Id.*

<sup>42</sup> Robert Cooter, *Market Modernization of Law: Economic Development through Decentralized Law*, in ECONOMIC DIMENSIONS IN INTERNATIONAL LAW 275, 278-80 (Jagdeep S. Bhandari & Alan O. Sykes eds., 1997); see also Paul H. Rubin, *Why is the Common Law Efficient*, 6 J.L. STUD. 51 (1977); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J.L. STUD. 65 (1977).



deal with each other develop a pattern of cooperation because they have determined the gains from cooperation outweigh the gains from opportunistically seeking profit at the expense of each other.<sup>43</sup> In order for a rule, be it formal or informal, to actually become a binding constraint on actors, the actors must internalize the norm.<sup>44</sup> That is, in making their decisions they must actually choose to abide by the rule, and once a critical mass of market participants can be expected to abide by the rule – or, at least, signal as if they intend to abide by it – there is predictability of behavior. A rule has been institutionalized.

A state can declare a rule binding on economic actors, but the common understanding of the rule among economic actors and enforcing agents (such as judges or regulators) will determine what the substance of the rule actually is. The *Trust Law* in China provides a set of rules, but problems, gaps, and uncertainties exist in the law. For the trust to be useful in reducing parties' transaction costs, it must constrain and incentivize parties' behavior in a predictable manner. When rules from the *Trust Law* do not provide a clear solution to trust-related problems, there must be other rules (be they formal or informal) to solve the problems. All parties – judges, users of trusts, those dealing with trust users – would have to know what this rule is and would have to share similar, if not the same, understanding of the rule.

Next, we will consider the trust as an institution. We will determine what are the problems that arise in forming a trust relationship, and we will consider the *Trust Law*'s effectiveness in providing rules to solve these problems.

### III. THE TRUST INSTITUTION

If the general use of the trust form creates predictability in the behavior of the parties inside the trust (the settlor, trustee, and beneficiaries) and outside the trust (all parties who deal with any of the trust insiders), then the trust is a socially beneficial institution. As a socially beneficial institution, it lowers the transaction costs of trust insiders and the transaction costs of the outsiders who deal with the trust. To test this hypothesis – that the trust is a socially beneficial institution – we must first consider the human behaviors it constrains and incentivizes. Then, we can consider the trust in China.

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<sup>43</sup> This pattern of cooperation is a typical result of players in a repeated game context. See Cooter, *supra* note 42, at 288-304.

<sup>44</sup> *Id.* at 292-95.

Fundamentally, the trust form is an arrangement where the owner of some property, the settlor, retains the right to benefit from the property's income while engaging another person, the trustee, to actually perform the management. When the trust is used as a form to transfer wealth to heirs, the property owner would transfer his beneficial right to a third party or parties, the beneficiaries, as part of the trust's initial founding. As is often the case today when the trust is used as an instrument of commerce, the settlor retains at least part of the beneficial right and would thus be considered a beneficiary as well as a settlor.<sup>45</sup> In either case, ownership and control of the property are separated. The beneficiaries own the right to benefit from the property, while the trustee has the right to control and dispose of the property: legal title to the property is transferred to him. Traditionally, this arrangement separating ownership from control was beneficial because it allowed property owners to circumvent laws that would otherwise limit some potential benefits of ownership. Today, this arrangement is beneficial because it allows a property owner to realize greater benefits from property ownership than he would realize by managing the property himself. He can transfer the property to someone with better management skills while still reaping the benefits.

Separating ownership from control creates two fundamental problems. Firstly, the arrangement necessarily creates a principal-agent problem. The principal, the owner, entrusts an agent, the manager, to manage the property in the best interests of the principal. The principal's problem is that the agent cannot always be trusted to put the principal's interests before the agent's own self-interest.<sup>46</sup> Monitoring the agent is costly for the principal.<sup>47</sup> In addition, the arrangement creates a verification problem. Outside parties wishing to deal with the manager or owner must verify what rights each party has to dispose of the property under management. The property under management can serve to credibly bond promises but only when the party has the right to freely dispose of the property. When the owner or manager commits to perform an undertaking for the benefit of an outsider, he must have assets available to make payment, perform the undertaking, or pay damages in the event of his default. Should the outsider sue, the outsider will want to know

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<sup>45</sup> See Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559 (2003).

<sup>46</sup> Robert Cooter & Bradley Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U.L. REV. 1045, 1046 (1991).

<sup>47</sup> Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976); Eric A. Posner, *Agency Models in Law and Economics*, in CHICAGO LECTURES IN LAW AND ECONOMICS 225 (Eric A. Posner ed., 2000).

there are assets for the court to attach. It is costly for outsiders to investigate and verify whether the property under management is available to bond the owner's contracts, the manager's contracts, or both. This verification problem makes it more expensive for the owner and manager to contract because outsiders will factor their investigation costs into the price term of their contracts.

As we saw above, economic actors cooperate and create institutions when they find themselves facing common problems. An institution provides a rules-based course of action to solve the problems they together face. In this way, parties' behaviors will be predictable when these problems are encountered because all parties can be expected to follow the same rules. Parties breaking the rules will likewise receive predictable punishments that participants accept as efficient and fair.

The rules of trusts developed in order that these two fundamental problems could be predictably solved, and by providing predictable solutions to these problems, the trust institution reduces transaction costs. The rules of trusts are, in fact, nothing more than a bundle of contract and property rules.

#### *A. Contract Aspects*

The trust can be viewed as a standardized form of contractual relationship.<sup>48</sup> In fact, a trust-like arrangement could be achieved by contract without the benefit of a dedicated trust law. Indeed, in countries without trust laws, trust substitutes are privately created.<sup>49</sup> This suggests the extent of societal benefit (*i.e.*, reducing transaction costs) engendered by this organizational form (the form is in such demand, parties even synthesize the form when their laws do not provide it). In the contractual-based substitute, an owner of some property could engage a manager, and the manager could agree to manage the property for the benefit of the owner or a third party beneficiary. This arrangement makes the manager the agent of the property owner. The jurisdiction's agency laws, in addition to its contract laws, would govern the relationship. In the paradigmatic case, legal ownership of the property is actually transferred to the manager, giving the manager freedom to dispose of the property as part of his management strategy.<sup>50</sup> As the owner he is free to use it as security in obtaining credit, transfer it, or otherwise contract for its use in any way.

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<sup>48</sup> Langbein, *Contractarian Basis*, *supra* note 9, at 650-69.

<sup>49</sup> Hansmann & Mattei, *supra* note 1, at 442-45.

<sup>50</sup> *Id.* at 443.

Even when the jurisdiction has a trust law, a trust relationship still corresponds closely to a contractual relationship. By deciding to call their arrangement a trust, the parties are automatically agreeing to incorporate the set of default terms provided by trust law.<sup>51</sup> These default terms have proven highly useful in similar deals throughout generations and have thus become standardized. Standardization saves on *ex-ante* and *ex-post* transaction costs. To the extent parties opt for the default terms by not modifying them in their trust instruments, they save on the costs of bargaining and are unlikely to make costly omissions or include terms with ambiguous meanings. Courts will have seen the terms before and should interpret them with a reasonable degree of predictability. Additionally, outside parties considering whether to transact with the trust can save on information costs, as they already understand the form and the default trust terms.

If the default terms provided by trust law are usually considered efficient by most parties desiring to form a trust, then the existence of trust law's default rules could be justified by the cost savings they provide in aggregate to society.<sup>52</sup> Efficient default rules would provide the terms to which parties would have agreed had bargaining for them been less costly.<sup>53</sup> If we define a rule as a solution to a contracting problem, then an efficient default rule would provide a solution to a common contracting problem that is efficient for most parties.<sup>54</sup> When parties determine a state-supplied default term inefficient for their purposes, they will bargain for a new term if the cost of bargaining for the new term is less than the cost of keeping the state-supplied term. When one party determines a term to be inefficient, the burden is on him to initiate haggling for a more efficient term.<sup>55</sup>

The principal-agent problem is common to all trusts, and trust laws can be expected to provide default rules to address this problem.<sup>56</sup> The trustee cannot be trusted to always act in the best interests of the beneficiaries, so there is a problem between the beneficiaries and trustee. In addition, the trust instrument, written by the settlor, provides the trustee with additional duties by which to abide. This creates a principal-agent problem between the settlor

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<sup>51</sup> *Id.* at 447; Langbein, *Contractarian Basis*, *supra* note 9, at 650-69.

<sup>52</sup> Cf. Alan Schwartz & Robert Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003) (making the same point but in relation to contract law's default rules),

<sup>53</sup> *Id.* at 596.

<sup>54</sup> *Id.*

<sup>55</sup> These inefficient default terms are the so-called penalty defaults. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

<sup>56</sup> See Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

and trustee as well. In so far as the trust instrument's terms are a subset of what is in the best interest of the beneficiaries, the settlor's problem is also the problem of the beneficiaries.

In the modern trust, where the trust property is a portfolio of financial assets, the trustee requires a degree of decision-making independence in order to properly manage the trust property.<sup>57</sup> Changing market forces require timely decisions, and it is impractical for the trustee to consult with the beneficiaries or settlor regarding each of his investment decisions. Instead of constantly seeking permission, the modern trustee is expected to transform the initial trust property into a diversified portfolio balancing overall risk and potential return.<sup>58</sup> Modern default rules, found in statutes such as the Uniform Trustees' Powers Act of the U.S., "empower trustees to engage in every conceivable transaction that might wrest market advantage or enhance the value of trust assets."<sup>59</sup>

Fiduciary law provides the modern trustee with vast managerial discretion to manage the trust property yet provides beneficiaries and the settlor with protection from trustee malfeasance. When the settlor has hired the trustee for his expertise in managing assets, and given that the task is complex and to be carried out over a long period of time, it is impossible that the settlor could provide for every conceivable contingency in the terms of the trust instrument.<sup>60</sup> Nor would the average settlor or beneficiary want to incur the high costs of monitoring a trustee. Trust law in the U.S. and U.K. regulates the trustee's exercise of discretion by imposing on him a broad fiduciary duty that includes the duties of care and loyalty. The duty of loyalty obliges the trustee "to administer the trust solely in the interest of the beneficiary."<sup>61</sup> The duty of care places the trustee "under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."<sup>62</sup>

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<sup>57</sup> See John Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641 (1996).

<sup>58</sup> RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(a) (1992); Sitkoff, *supra* note 56, at 652-53.

<sup>59</sup> Langbein, *Contractarian Basis*, *supra* note 9, at 641.

<sup>60</sup> Cooter & Freedman, *supra* note 46, at 1045-47 (1991); Frank Easterbrook & Daniel Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426-27 (1993).

<sup>61</sup> RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959), continued in RESTATEMENT (THIRD) OF TRUSTS § 170(1) (1992).

<sup>62</sup> RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). When the trustee is managing an investment portfolio, instead of a "prudent man" standard, he is under a "prudent investor" standard. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992).

The enforcement mechanisms for breaches of fiduciary duty provide trustees with incentives to not breach.<sup>63</sup> A fiduciary relationship is one where one party, a principal, trusts another, a fiduciary, to act only on the principal's behalf (*i.e.*, to not act with self-interest) even while the fiduciary is granted broad discretion in which to act. When a fiduciary controls some of the principal's property and has broad discretion to dispose of it, the fiduciary's potential gain from appropriating the property or employing the property for his own self-interest is high. Such self-interested behavior would be a breach of the duty of loyalty. U.S. courts will infer that a fiduciary has breached his duty of loyalty when he has committed an action that has the appearance of being self-interested. It is very profitable to breach the duty, and proving actual breach is difficult because monitoring is costly to the principal and may require expert knowledge to uncover wrongdoing. For these reasons, the standard of proof required to prove breach is relaxed. If he breaches, the fiduciary will be liable to the principal to disgorge all of his ill-gotten gains. By relaxing the standard of proof that would give rise to this remedy, the U.S. law incentivizes the fiduciary to not breach his duty of loyalty. With the fiduciary law in force, it is more profitable for a trustee to carefully adhere to his duty and collect his professional compensation than to breach his duty or to not carefully adhere to it.

U.S. law also provides the fiduciary with incentives to make his managerial decisions without negligence and to not engage in the shirking that may be in his self-interest.<sup>64</sup> Such negligent decision-making would be a breach of the duty of care. The principal can more easily observe negligence in managerial decision-making when the property under management is a portfolio of financial assets. When the fiduciary is generating risk-weighted returns that appear out of line with market returns, the principal may suspect a breach of the duty of care. The fiduciary can rebut this by showing his decision-making process was reasonable. If his decision-making process is unreasonable, he will be liable to the principal to compensate for the loss in value to the assets. By this enforcement mechanism, it is in the fiduciary's best interest to maintain a reasonable decision-making process. So long as he does maintain one, he will not be liable to compensate for losses in asset value.

In sum, state-provided default terms can provide a solution to the principal-agent problem that reduces transaction costs. By incentivizing trustees to manage the trust property only in the interest

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<sup>63</sup> Cooter & Freedman, *supra* note 46, at 1048-64.

<sup>64</sup> *Id.* at 1056-64.

of the beneficiaries, the default fiduciary duty terms should induce trustees to predictably manage the trust property in the best interests of the beneficiaries. In so far as this is what settlors desire in initially creating a trust, they can forego transaction costs by adopting the state-supplied fiduciary duties rather than crafting their own. The more that parties incorporate those fiduciary duties into their trust agreements, and the more comfortable courts become with interpreting them, the more predictable they will be as a regulator of human behaviors.

### B. *Property Aspects*

As addressed above, a trust-like arrangement can be formed by contract. Agency law imposes a set of default fiduciary duties on the “trustee,” or parties can agree to their own set of fiduciary duties. However, to form a true trust, property rules are needed in addition to contract rules.<sup>65</sup> The trust parties and those parties dealing with the trust are all potential claimants against each other’s property and the trust property. Property rules order the priority of their claims.<sup>66</sup> The property rules of organizational law – the law that establishes legal entities including partnerships, corporations, and trusts – allows parties to create patterns of creditors’ rights that cannot be duplicated by contractual terms alone.<sup>67</sup> This pattern of creditors’ rights is rigid and highly standardized, and it solves the verification problem identified above.<sup>68</sup>

Trust law, a branch of organizational law, allows parties to create an entity, a trust, capable of holding property in a partition separate from the property of the settlor, trustee, and beneficiaries. The trust is an entity without legal personality.<sup>69</sup> In most cases a trust cannot sue, be sued, or transact in its own name. The trustee, in his capacity as trustee, can sue, be sued, or transact on behalf of the trust.<sup>70</sup> Effectively the trustee is two distinct legal persons: a natural person contracting on behalf of himself with his own assets to satisfy his creditors, and an artificial person contracting on behalf of the beneficiaries with the trust’s assets to satisfy creditors of the

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<sup>65</sup> Even Professor Langbein recognizes this in his attempt to define trusts as special types of contracts: Langbein, *Contractarian Basis*, *supra* note 9, at 669.

<sup>66</sup> See Henry Hansmann & Ugo Mattei, *Trust Law in the United States: A Basic Study of Its Special Contribution*, 46 AM. J. COMP. L. SUPP. 133 (1998).

<sup>67</sup> Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 406-23 (2000).

<sup>68</sup> On the verification problem, see text accompanying note 47, *ff.*

<sup>69</sup> JESSE DUKEMINIER & ROBERT SITKOFF & JAMES LINDGREN, *WILLS, TRUSTS, AND ESTATES* 549-50 (8th ed. 2009).

<sup>70</sup> *Id.*

trust.<sup>71</sup> Trust creditors may be parties actually extending credit to the trustee as he executes his management strategy, or trust creditors may simply be contractual partners who may someday be owed money from the trust. For instance, the trustee, in his capacity as trustee, may someday receive a margin call from his derivatives broker, or he may lose a lawsuit against a contractual partner.

The pattern of creditors rights arranges the expectations of all parties who deal with the trust parties. A person or enterprise that enters into contracts must have assets available to credibly bond those contracts: that is, a pool of assets to satisfy obligations.<sup>72</sup> The property rules from trust law clearly delineate whose contracts are bonded by the trust property. By resorting to the rules, parties can verify who owns what, and this solves the verification problem. The trust property serves to bond the contracts the trustee makes in the pursuit of trust business.<sup>73</sup> The trust property is not available to bond the personal contracts of the trustee or the settlor (so long as the settlor is not also a beneficiary).<sup>74</sup> A beneficiary's right in the trust is considered to be just one more asset in his overall wealth, so the beneficiary's right, along with all of his wealth, serves to bond all of his personal contracts.<sup>75</sup> The order provided by these rules simplifies and makes predictable the contracting environment for all parties involved.

The order established by the property rules cause the cost of credit to be lowered for all parties inside and outside of the trust. Creditors of the trust and the personal creditors of the trust parties can simply verify the priority of their claims in relation to each other by recognizing the trust as a standard organizational form. The pattern is predictable because it has been standardized.<sup>76</sup> In his public accounts a trustee can identify which of his assets are held in trust for others. By virtue of the trust law, potential creditors will immediately know the pattern of creditors rights that run with those assets and which assets will therefore be available as security.

<sup>71</sup> Hansmann & Kraakman, *Organizational Law*, *supra* note 67, at 416.

<sup>72</sup> Hansmann & Kraakman, *Organizational Law*, *supra* note 67, at 392.

<sup>73</sup> RESTATEMENT (SECOND) OF TRUSTS §§ 261-62 (1959).

<sup>74</sup> For an explanation of potential claims by the settlor's creditors, *see* Hansmann & Mattei, *supra* note 1, at 454; *Pottorff v. Dean*, 77 F.2d 893,895 (1st Cir. 1935) (holding settlor who transferred stock in good faith to trustees not personally liable for assessment on stock). For an explanation of potential claims by the trustee's personal creditors, *See, e.g., American Serv. Co. v. Henderson*, 120 F.2d 525,530 (4th Cir. 1941); *Todd v. Pettit (In re Elliott)*, 108 F.2d 139, 140 (5th Cir. 1939); *In re Tate-Jones & Co.*, 85 F. Supp. 971, 981 (W.D. Pa. 1949); 11 U.S.C. § 541(a)(1), (d) (1994); RESTATEMENT (SECOND) OF TRUSTS §§ 221, 306-08 (1959).

<sup>75</sup> Hansmann & Mattei, *supra* note 1, at 451-52.

<sup>76</sup> Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J.L. STUD. S373, S405-07 (2002); Hansmann & Mattei, *supra* note 1, at 451-63.



Creditors of the trust will know which assets will be available as security to them. Likewise, personal creditors of the trust parties will know the assets available to them as security. Clearly by verifying which assets are available, all creditors can accordingly adjust the terms of their credit.

The verification mechanism lowers the cost of credit to the trustee as he pursues trust business, and cheaper credit means less trust income is needed to repay creditors. In considering whether to deal with the trust, trust creditors do not have to investigate the solvency of the trustee or settlor. The personal creditors of the trustee or settlor will generally have no claims against trust property in the event of the trustee's or the settlor's insolvency.<sup>77</sup> Trust creditors can generally not levy against beneficiaries' personal wealth,<sup>78</sup> so in considering whether to extend credit to the trust, they need not investigate the beneficiaries' solvency. Trust creditors need only investigate the solvency of the trust itself, and this task is facilitated by the property rule that partitions trust assets into a discrete pool separate from the parties' personal wealth.

The verification mechanism also reduces a beneficiary's personal cost of credit. A beneficiary's personal creditors can claim against his interest in the trust,<sup>79</sup> but trust creditors have no claim against a beneficiary's wealth held outside the trust.<sup>80</sup> Therefore, to assess a beneficiary's potential to become insolvent, potential creditors need not investigate the dealings of the trust but only the beneficiary's personal wealth, which includes his interest in the trust.

The boundary of the partition that separates the personal property of the trustee from the trust property does suffer from a weakness as it can be difficult to police. A trustee approaching insolvency could declare his remaining assets to be part of trust property, and then his personal creditors would not have a claim against it. Similarly, when a trust is approaching insolvency, the beneficiaries have an incentive to transfer the remaining property to themselves. This would eliminate the trust's creditors prior claim to that property. These economic slights of hand, however, have become more difficult to accomplish as accounting procedures and credit rating agencies have become more advanced. In addition, as legal institutions grow stronger, the gains from rule breaking become less profitable, and these slights of hand become less of a problem.

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<sup>77</sup> The settlor's creditors may have a claim, however, when the settlor is also the beneficiary. See *supra* note 74.

<sup>78</sup> RESTATEMENT (SECOND) OF TRUSTS §§ 274-77 (1959).

<sup>79</sup> RESTATEMENT (SECOND) OF TRUSTS § 147 (1959).

<sup>80</sup> RESTATEMENT (SECOND) OF TRUSTS §§ 274-77 (1959).

In a jurisdiction without a law of trusts, beneficiaries are not protected from the trustee's insolvency. Without trust law, a settlor would have to transfer by contract some of his property to a trustee to manage on behalf of a beneficiary. Were the trustee to become insolvent while holding this property in his possession, the trust assets would be thrown into a pool with the rest of the trustee's assets and generally made available to satisfy the outstanding claims of his personal creditors.<sup>81</sup> Beneficiaries would have only a contractual claim to that property, equal in priority to the trustee's other personal creditors.

In principle the trust's protection from the trustee's insolvency could be achieved with contract alone, but the transaction costs would be prohibitively high.<sup>82</sup> To render the trust protected from the trustee's insolvency, the trustee could insert into all his contracts with his personal creditors terms providing that creditors forswear any claims against the managed property in the event of the trustee's breach. In the trustee-settlor deal, the trustee could promise the settlor to put such terms into each of his personal contracts. When the outside parties with whom the trustee deals use standard contractual forms, it is possible that these outside parties would overlook the term regarding some specific property being managed on another's behalf. There is also a continuing risk that the trustee will forget to include the term in some of his personal contracts. It would be difficult for the settlor and beneficiary to constantly monitor the trustee. In countries without trust law, settlors would likely hire only large institutions, which are unlikely to become insolvent, to manage assets.<sup>83</sup> Indeed, this is what happens in these countries.<sup>84</sup>

A law of trusts, and the property rules it provides, is therefore necessary in order to create a trust entity with its particular pattern of creditors' rights. A trust law makes this pattern predictable for trust insiders and outsiders, and a trust law allows the pattern to be created at low cost.

#### IV. TRUST LAW IN CHINA

As Chinese legislators were consciously attempting a transplant of the Anglo-American trust institution, the similarities between the prototypical Anglo-American trust and the Chinese version of it are

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<sup>81</sup> Hansmann & Mattei, *supra* note 1, at 456.

<sup>82</sup> *Id.* at 456-57; see also Hansmann & Kraakman, *Organizational Law*, *supra* note 67, at 414-23.

<sup>83</sup> Hansmann & Mattei, *supra* note 1, at 458.

<sup>84</sup> *Id.* at 458.

unsurprising. China's *Trust Law*<sup>85</sup> includes rules that organize creditors' rights in the same pattern as the prototypical U.S. and U.K. trust laws. The *Trust Law* also provides a set of default duties that provide a trustee with decision-making latitude while protecting beneficiaries from his potential malfeasance.

Transplanting a bundle of rules to a new jurisdiction does not automatically make those rules an institution. The rules have to be institutionalized. Individual parties across the economy must take account of the rules when making their decisions, and they all must choose to abide by the rules. The rules are successfully institutionalized when they create predictability in the behaviors governed by the rules. First, however, individual parties across the economy must share common understandings of what the rules mean, what behaviors they constrain, and what behaviors they incentivize. The Trust Law rules that provide organization of creditors' rights are straightforward in some respects (less so in others), so there should be fewer barriers to the building of a common understanding of their meanings. On the other hand, the trustee's default fiduciary duties, provided by the Trust Law, are broadly defined. It will take time and experience before a common understanding of these rules can be built among market participants. Most problematic is the lack of clear remedies provided by the Trust Law for breaches of both sets of rules.

#### A. Rules to Solve the Verification Problem

The trust property for all trusts in China must be held in a partition separate from the personal property of the settlor and trustee.<sup>86</sup> The trust property is available to satisfy the claims of neither a trustee's personal creditors<sup>87</sup> nor a settlor's personal creditors.<sup>88</sup>

There is an incomplete menu of remedies available to the settlor and beneficiaries when the trustee uses the trust property to satisfy the claims of his personal creditors.<sup>89</sup> Settlers and beneficiaries have a cause of action to seek the return of trust property that the trustee has improperly transferred to trust outsiders, but this remedy is only available when the outsider has received the property while having knowledge (*mingzhi* 明知) that the trustee has transferred it

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<sup>85</sup> See *Xintuo Fa* (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311.

<sup>86</sup> *Id.*, art. 15, 16, & 18.

<sup>87</sup> *Id.*, art. 16 & 18.

<sup>88</sup> *Id.*, art. 15 & 18.

<sup>89</sup> *Id.*, art. 22 (Article 22 could provide this remedy, but this is not clearly so.).

wrongfully.<sup>90</sup> When outsiders receive trust property without knowing it was wrongfully transferred to them, the settlor and beneficiary can still make a claim for substitutionary relief (damages) against the trustee.<sup>91</sup> There are, however, no general causes of action for settlors and beneficiaries to make against trustees when (1) a trustee fails to keep and manage the trust property separately from his own property or the property of another trust,<sup>92</sup> or (2) a trustee uses trust assets to satisfy his personal creditors or the creditors of another trust managed by him.<sup>93</sup>

The exact nature of the beneficiary's right is uncertain, and this is but one example of a gap in the law that must be filled before the law can provide predictable dispute resolution. What is certain is that a beneficiary's personal creditors may levy against his right in the trust.<sup>94</sup> A beneficiary may also transfer his right,<sup>95</sup> so likely he can also pledge his right.<sup>96</sup> There is no provision in the Trust Law stating whether trust creditors<sup>97</sup> may claim against a beneficiary's other wealth when the trust property is exhausted.

The nature and extent of the beneficiary's right is problematic because it does not fit into any of the pre-defined categories of property rights recognized by the law in China. Property rights in China are limited to the categories of property rights recognized by the state.<sup>98</sup> A property right (*wuquan*, 物权) is defined as "the exclusive right of a holder of the right to exercise direct control over a specific thing in accordance with the law, including ownership, usufructuary rights, and security rights."<sup>99</sup> The beneficiary's right,

<sup>90</sup> *Id.*, art. 22; see also Minfa Tongze (民法通则) [General Principles of Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) 1986 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 13, art. 92 (Outside of the trust context, *mingzhi* (明知) [knowledge] is not a necessary element to make a claim for restitutionary relief.).

<sup>91</sup> *Xintuo Fa* (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 22.

<sup>92</sup> He is obliged to by the *Trust Law*, art. 16 & 29.

<sup>93</sup> He is obliged to by the *Trust Law*, art. 18. Again, the cause of action could be found in art. 22, but this is not clearly so.

<sup>94</sup> *Xintuo Fa* (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 47.

<sup>95</sup> *Id.* art. 48.

<sup>96</sup> See *Wuquan Fa* (物权法) [Property Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 19, 2007, effective Oct. 1, 2007) 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 291, art. 208.

<sup>97</sup> A complete explanation of "trust creditor" can be found in the text accompanying note 71.

<sup>98</sup> *Wuquan Fa* (物权法) [Property Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 19, 2007, effective Oct. 1, 2007) 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 291, art. 5. This is the *numerus clausus* principle.

<sup>99</sup> *Id.*, art. 2.

however, is not called a *wuquan*, nor does it fit within the definition of *wuquan*, nor is there any indication that the legislature intended to create a new property right in the *Trust Law*.<sup>100</sup> A beneficiary's right is defined as such: beneficiaries "enjoy the right to benefit from trust profits" (*xiangyou xintuo shouyiquan*; 享有信托受益权).<sup>101</sup> Article 32 of the *Property Law* and Article 117 of the *General Principles of Civil Law (GPCL)* each give the owner of a *wuquan* a cause of action against those who infringe the right, but as the beneficiary's right is not expressly recognized in either of these laws, it is unclear whether a beneficiary's right would be enforceable under either of these laws.<sup>102</sup> A beneficiary's right may be nothing more than a personal right (*zhaiquan*, 债权) against the trustee.<sup>103</sup>

Creditors to the trust and the beneficiaries will have difficulty in assigning a monetary value to a beneficiary's right because the right's legal status and meaning are uncertain. The right's uncertain character causes it to lack liquidity. While the *Trust Law* does guarantee the right's transferability,<sup>104</sup> demand for the right will be patchy as long as the content of the right is uncertain.

Except for the definitional problem of the beneficiary's right, the pattern of creditors' rights is otherwise clear, subject to some caveats. The *Trust Law* does not provide beneficiaries and settlors with causes of action against trustees who do not respect the partition between trust and personal property. To incentivize trustees to faithfully respect the partition (and the partition provides the basis for the predictable organization of creditors' rights), there must be a mechanism to enforce the obligation. In order for the *Trust Law* to actually establish a predictable solution to the verification problem, the courts must uniformly interpret and apply these provisions. When there is no pre-defined enforcement mechanism, they cannot be expected to uniformly interpret and apply the partition rule. Another problem to be addressed below is the extent of the claim that trust creditors will have against a settlor's wealth.<sup>105</sup>

A rules-based solution to the principal-agent problem in trust relationships is bound to be more difficult to effect than a rules-based

<sup>100</sup> Rebecca Lee, *Conceptualizing the Chinese Trust*, 58 INT'L COMP. L.Q. 655, 664 (2009). Lee is of the view that the *Trust Law* does not recognize or create a new property right. *Id.*

<sup>101</sup> *Xintuo Fa* (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 43.

<sup>102</sup> Ho, *supra* note 5, at 70-71.

<sup>103</sup> Lee, *supra* note 100, at 667.

<sup>104</sup> *Xintuo Fa* (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 48.

<sup>105</sup> See *infra* notes 130, ff., and accompanying text.

solution to the verification problem. The verification problem is fairly static. It is solved *ex ante* the formation of the trust by the state's system of property law. The state creates categories of property rights, and the state almost always limits the set of available property right categories. The state purposely keeps the set small because economic actors can save on the costs of gathering information when property rights are easily recognizable as belonging to a certain category with predictable consequences.<sup>106</sup>

### B. Rules to Solve the Principal-Agent Problem

The principal-agent problem is a dynamic problem that cannot be fully solved *ex ante* the formation of a trust. Incidents of the problem are contingent on events that unfold *ex post* the formation of a trust, and these events will continuously unfold until the trust ceases to exist. All that trust parties can do to solve the problem *ex ante* is to define a set of broadly defined duties that provide trustees with an idea of what decisions will be permissible and what will not. In China the traditional principal-agent problem is exacerbated because the Trust Law is, in some relevant places, lacking clarity in expression.

The state, by providing default duties for the use of trust parties, provides the germ from which trustees' decision-making behavior will over time become predictably constrained and incentivized. When all parties inside and outside of the trust share a common understanding of permissible trustee behavior, the trustee's role will become institutionalized.<sup>107</sup> Trustees will also have a better idea of what they can and cannot do. The default duties in the Chinese Trust Law are expressed as broad standards by which trustee decision-making behavior should conform. Broad standards of duty begin to develop more certain meanings as time passes and parties get more and more experience in conforming their behavior to the standards.<sup>108</sup> In the U.S. and U.K. the broad fiduciary standards came to have more certain meaning as courts decided more and more cases where the standards were at issue.<sup>109</sup> The courts developed a body of precedents that gave trustees and other parties a more certain understanding of permissible behavior. It is questionable whether courts in China are competent to fill a similar role. Judicial

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<sup>106</sup> See Hansmann & Kraakman, *Property, Contract, and Verification*, *supra* note 76; Thomas Merrill & Henry Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000).

<sup>107</sup> See Melanie Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 90-94 (2005).

<sup>108</sup> See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

<sup>109</sup> See L.S. Sealy, *Fiduciary Relationships*, 20 CAMBRIDGE L.J. 69 (1962).

precedents do not legally provide judges with rules of decision, and the state seems fully opposed to courts supplementing the meanings of statutes with their own interpretations.<sup>110</sup> It is also unlikely that China would be successful if it were to just simply import the body of Anglo-American fiduciary law and expect it to function equivalently in China.<sup>111</sup>

As there is not yet any systematic exposition of fiduciary duties in China, we cannot understand the term to have equivalent meaning in the U.S., U.K., and China. Nevertheless, the trust relationship in China is a fiduciary one (*i.e.*, it is one of trust). The settlor *entrusts* (*weituo*, 委托) his property to the management of the trustee. The general fiduciary duty is stated in Article 25 of the Trust law; it provides that a trustee should administer the trust in the best interest of the beneficiary. The trustee also has a duty to scrupulously perform his duty of honest and trustworthy management.<sup>112</sup> The principles of honesty and trustworthiness have long been recognized as fundamental principles in the *GPCL*,<sup>113</sup> but they have never been interpreted as fiduciary duties.<sup>114</sup>

The trustee is entrusted to “manage or dispose of the trust property in his own name,”<sup>115</sup> but it is unclear what specific powers the trustee has in managing the trust. May he invest in corporate bonds or equities. May he mortgage real estate, or sell or lease property. It seems to have been in the contemplation of the drafters that the trustee would invest the trust property.<sup>116</sup>

The fiduciary duty in a Chinese trust is complicated – and, in the end, unclear in meaning – because there are more principal-agent problems in a default Chinese trust than in the prototypical Anglo-

<sup>110</sup> Clarke, *Law without Order*, *supra* note 28, at 182-83.

<sup>111</sup> Hideki Kanda & Curtis Milhaupt, *Re-examining Legal Transplants: the Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887 (2003); Katharina Pistor & Chenggang Xu, *Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from Incomplete Law Theory*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 77 (Curtis J. Milhaupt ed., 2003); Lynn Stout, *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?* in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 46 (Curtis J. Milhaupt ed., 2003).

<sup>112</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 25.

<sup>113</sup> Minfa Tongze (民法通则) [General Principles of Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) 1986 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 13, art. 4.

<sup>114</sup> Ho, *supra* note 5, at 101.

<sup>115</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 2.

<sup>116</sup> See, *supra* note 5 (the law was passed, after all, with the idea that the trust would provide a useful organizational form for investors).

American trust. In a Chinese trust there is the central principal-agent problem between the trustee and the beneficiaries, but there are also problems between the settlor and trustee, as well as between the settlor and beneficiaries. The problem between the trustee and beneficiaries should be central because the trustee is, after all, charged with managing the trust property in the best interests of the beneficiaries,<sup>117</sup> not the best interests of the settlor. Yet, the settlor and beneficiaries are granted similar rights to monitor the trustee.<sup>118</sup> The difficulty with the Chinese law is that the settlor is under no express obligation to exercise his monitoring rights in the best interests of the beneficiaries.<sup>119</sup> There is no rule-based solution to the problem between the settlor and beneficiary. The settlor can enforce his interests against the trustee, but the beneficiary has no way to enforce his interests against the settlor.

The default power given to the settlor under the Chinese Trust Law is generally greater than the power given to settlors in the U.S. and U.K.<sup>120</sup> Under the Chinese law, both the settlor and the beneficiaries have rights to request the trustee to modify his management methods,<sup>121</sup> and both have rights to apply to the People's Court to annul a transaction made by the trustee.<sup>122</sup> This essentially allows them to second guess the decisions of the trustee. In the event the views of the settlor and beneficiaries diverge on the monitoring of the trustee, the Trust Law provides no rule to determine which view prevails. The Trust Law only states that application may be made to the People's Court, and the final ruling will be made there.<sup>123</sup> The settlor also has rights to modify or revoke the beneficiaries' rights to enjoy trust profits.<sup>124</sup> This right was granted to the settlor because the Chinese legislators wanted settlors to be able to punish misbehaving beneficiaries.<sup>125</sup>

The beneficiary's ability to manage his problem with the settlor is complicated by the ambiguity of a beneficiary's property right in the

<sup>117</sup> *Id.*, art. 25.

<sup>118</sup> *Id.*, art. 20-23, 49.

<sup>119</sup> Ho, *supra* note 5, at 113-14.

<sup>120</sup> Ho, *supra* note 5, at 112. The Chinese law that empowers the settlor has been argued to be the better law. When beneficiaries are young or incompetent, Foster argues they are better off if the settlor can enforce their rights. Frances Foster, *American Trust Law in a Chinese Mirror*, 94 MINN. L. REV. 602 (2010). The problem with the Chinese law is that the settlor has no duty to enforce in the best interests of the beneficiary.

<sup>121</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 21 & 49.

<sup>122</sup> *Id.*, art. 22 & 49.

<sup>123</sup> *Id.*, art. 49.

<sup>124</sup> *Id.*, art. 51.

<sup>125</sup> Ho, *supra* note 5, at 131.



trust. If the settlor infringes a beneficiary's right, the beneficiary has no cause of action against the settlor. Article 32 of the *Property Law* and Article 117 of the *GPCL* each give the owner of a property right a cause of action against those who infringe the right, but it is unclear whether the right to benefit from trust profits is a right enforceable under either of these laws.<sup>126</sup> The beneficiary's right may be no more than just a personal right against the trustee,<sup>127</sup> which gives him no course of action to enforce his interests against the settlor.

Under the Chinese Trust Law, the settlor has an odd right not available to settlors in the U.S., U.K., or other Asian jurisdictions with trust laws.<sup>128</sup> Under the Trust Law, as written, the settlor is not obliged to transfer (zhuanrang, 转让) legal title to the trust property to the trustee; he is obliged only to entrust (weituo, 委托) management of the property to the trustee.<sup>129</sup> It is unclear whether this means that a settlor can form a trust while retaining ownership of the trust property.<sup>130</sup> The Trust Law does not define *weituo*, but in China an agency relationship is created by the same act: entrusting, *weituo*.<sup>131</sup> Instead of transferring ownership, under the Chinese Trust Law the settlor is obliged only to keep separate (相区别, *xiangqubie*) the trust property from the property he did not put in the trust (weisheli xintuo de qita caichan xiang qubie; 未设立信托的其他财产). The provision seems to be deliberate in not obliging the settlor to transfer ownership to the trustee. Yet the provision remains unclear because the Trust Law defines the trust property as the property *obtained* or *acquired* (qude, 取得) by the trustee.<sup>132</sup> It is unclear whether the settlor could retain ownership of the trust property if a necessary condition for the existence of trust property is its being *obtained* by the trustee.<sup>133</sup> The trustee also must register

<sup>126</sup> Ho, *supra* note 5, at 70-71.

<sup>127</sup> Lee, *supra* note 100, at 667. See discussion, *supra*, notes 98, ff., and accompanying text.

<sup>128</sup> Lusina Ho, *The Reception of Trust in Asia: Emerging Principles of Trust?* 2004 SING. J. LEGAL STUD. 287 (2004).

<sup>129</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 14.

<sup>130</sup> This was a last minute change; in all previous versions of the Trust Law, transfer of ownership was envisioned. Ho, *supra* note 5, at 67; see also Qu, *supra* note 5, at 355-57.

<sup>131</sup> Minfa Tongze (民法通则) [General Principles of Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) 1986 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 13, art. 64 & 65 (referring to agency as "entrustment" (委托)).

<sup>132</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 14.

<sup>133</sup> A necessary condition of forming a trust is the existence of trust property. *Id.*, art. 7.

the trust property where law requires,<sup>134</sup> and he deals with the trust property in his own name.<sup>135</sup> How can he register property in his own name if he does not own it. The answer is unclear. In sum, the only conclusion we can draw is that it is uncertain whether the settlor must transfer title to the trust property to the trustee. It seems that no other jurisdiction in the world, where trust is available as an organizational form, allows the creation of a trust without the settlor transferring the ownership of the trust property.<sup>136</sup>

If the trustee were to manage a trust while the settlor retained ownership of the trust property, it is further uncertain what *de facto* power the settlor could retain over the trustee's management. Could the settlor prevent the trustee from undertaking transactions, and would parties agree to transact with a trustee who did not actually own the property with which he seeks to bond his contracts. In such a situation, the relationship would appear as an agency relationship, but unlike in an agency relationship, creditors would not have recourse against the full extent of the principal/settlor's wealth.<sup>137</sup> Trust creditors have a priority claim against the trust property,<sup>138</sup> but there is no mention made in the law regarding their potential claims to the settlor's other wealth.

The default rules in the Trust Law to deal with the principal-agent problems are, in short, lacking in certainty, and the mechanisms available to enforce them are also unclear. Assuming the rules were clearly defined *ex ante*, the rules can only provide predictable constraints to behavior when there are enforcement mechanisms that punish and incentivize the behaviors governed by the rules. There are many rules and duties in the Trust Law, but the provisions providing remedies for breaches of these rules and duties are scattered and incoherent. Unlike in other civil law countries with trust legislation, there is no Chinese civil code providing remedies.

For breach of the Article 25 fiduciary duty, it is unclear what remedies are available. Article 22 may, however, provide a cause of action to the settlor and beneficiaries for a trustee's breach of his Article 25 duty.<sup>139</sup> Article 25 obliges a trustee to "*handle* the trust

<sup>134</sup> *Id.*, art. 10.

<sup>135</sup> *Id.*, art. 22.

<sup>136</sup> Ho, *supra* note 5, at 67.

<sup>137</sup> Minfa Tongze (民法通则) [General Principles of Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987) 1986 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 13, art. 63 (Where the relationship is one of agency, "the principal shall bear civil liability for the agent's acts of agency.")

<sup>138</sup> Xintuo Fa (信托法) [Trust Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 311, art. 17(2).

<sup>139</sup> *Id.* at 144-45.

affairs in the best interest of the beneficiary.” Article 22 provides remedies for the “improper *handling* of trust affairs,” but makes no mention of handling trust affairs in the best interest of the beneficiary. Both articles use the words *handling of trust affairs* (chuli xintuo shiwu, 处理信托事务). In addition, the duties enumerated in Article 25 (duties of care, honesty, good faith, prudence, and efficiency) are enumerated as part of the trustee’s management (guanli, 管理) of the trust property. Article 22 provides a remedy for “violation of management duties” (yin weibei guanli zhize, 因违背管理职责). For claims arising under Article 22, the People’s Court will order the unwinding of the transaction that caused the breach or, failing that, order the trustee to make a payment of compensatory damages. Whatever profits a trustee makes from engaging in a self-interested transaction would have to be disgorged and added to the trust property.<sup>140</sup> There are no provisions dealing with remedial principles like causation, remoteness, mitigation, or limitation of actions.

If Article 22 does in fact provide a remedy for the trustee’s breach of his Article 25 duties, the Trust Law can be understood to provide a remedy that would make self-interested transactions less profitable than transactions made in the best interest of the beneficiaries. This is notwithstanding the lack of remedial principles useful in determining the contours of enforcement. Whether Article 22 is in fact the appropriate remedy provision, or whether the remedy would be applied in the manner suggested here, is uncertain. Notwithstanding the ambiguities in Trust Law remedies, Chinese courts have in the past shown themselves to be unreliable enforcers of even relatively clear standards.<sup>141</sup>

As for the courts’ track record in deciding cases under the Trust Law, it is short and patchy. There have been few cases where the Trust Law provided the rule of decision, but in the courts’ first trust case, *Huabao Trust and Investment Co. Ltd. v Yanxin Co. Ltd.*,<sup>142</sup> the Shanghai High People’s Court arguably decided the case wrong.<sup>143</sup> The court held that the beneficiary could not transfer its right to receive trust proceeds without the trustee’s consent. Article 48 of the Trust Law provides only that the beneficiary’s right may be transferred and says nothing regarding the necessity of the trustee’s

<sup>140</sup> *Id.*, art. 26.

<sup>141</sup> Clarke, *Law without Order*, *supra* note 28, at 183.

<sup>142</sup> *Yanxin Co. Ltd. v. Huabao Trust and Investment Co. Ltd.*, Shanghai High People’s Court, Mar. 16, 2005, Decision No. 226 of 2004. Nov. 25, 2004, Decision No. 201 of 2004

<sup>143</sup> Lusina Ho, *China: Trust Law and Practice Since 2001*, 16 TRUSTS & TRUSTEES 124, 126-27 (2010); Hao Wang, Lusina Ho & Yi Zhou, *Contract or Trust: Examining the First Trust Decision of the Chinese Courts*, 5 TRUST Q. REV. 11 (2007).

consent. So it is confusing that the court would add this extra restriction to the beneficiary's right instead of adhering solely to the text of the Trust Law.

In conclusion, the contract-like rules of the Trust Law are lacking flesh and clarity and do not provide parties with predictable solutions to their common problems. A trust formed under the Chinese Trust Law will have at least three principal-agent problems, and predictable rules-based solutions to these problems do not yet exist. Furthermore, the procedural institutions through which new, formal, rules-based solutions could develop are limited in their capacity. The Chinese state is opposed to courts' filling this role,<sup>144</sup> and courts may not yet be competent to fill this role anyway. Commentators have urged a Chinese government body to issue supplementary guidelines to add clarity to the Trust Law.<sup>145</sup>

## V. CONCLUSION

This paper set out to determine whether the trust organizational form in China could develop into an institution that creates predictable results for the institutional investors to make use of it. The answer is that the Trust Law as written is significantly unclear. Currently, parties cannot reasonably predict the legal results of their decisions when the Trust Law provides rules governing those decisions.

In addition to the ambiguity in some Trust Law provisions and the lack of private rights of actions to enforce many obligations imposed by the Trust Law, the institutional environment, in which rules-based solutions could be developed, is weak. Courts are becoming more competent to enforce contractual rights, but the legal institutions protecting property rights are chaotic.

Informal institutions have, in the past, provided adequate protection of property and contractual rights in place of the weak formal institutions. These informal substitutes will, arguably, be generally inadequate to support the large and competitive marketplace of institutional investors. In addition, informal substitutes for the protection of parties' rights in a trust relationship will be inadequate when the trust is used to organize a large, modern, and diversified portfolio of financial assets.

A fundamental problem that arises in a trust relationship is the principal-agent problem that exists because ownership is separated from control. To lower transaction costs in a trust relationship there must be a method to predictably solve this problem. Arguably,

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<sup>144</sup> See note 110 and accompanying text; see also note 40 and accompanying text.

<sup>145</sup> Ho, *supra* note 5, at 107; Ho, *China: Trust Law and Practice since 2001*, *supra* note 143, at 127.

informal substitutes could work for trusts when the settlor, trustee, and beneficiaries are all relatively close in personal relationships and distance, but the substitutes work less well in modern financial markets where the sellers and buyers of securities will often share no personal relationship and will be dispersed across the world. U.K. financial markets thrived and ownership became dispersed among many minority shareholders in the 19<sup>th</sup> and early 20<sup>th</sup> centuries. This result was obtained despite there being no legislation protecting minority shareholders' interest against those of managers and directors.<sup>146</sup> The substitute for legislation providing this protection was a high degree of trust<sup>147</sup> between shareholders and company directors, but this trust was dependent on the close physical distance between shareholders and directors. Trust broke down as the 20<sup>th</sup> century progressed because investors in locations further and further away were purchasing shares.<sup>148</sup> Such informal substitutes would likely be inadequate for modern, international financial markets.

In the U.K. financial markets of the 19<sup>th</sup> and 20<sup>th</sup> centuries there was also little question of whether contractual or property rights would be predictably enforced.<sup>149</sup> Investors in China cannot say the same. Evidence from surveys on financial markets in transition economies have suggested that formal legal institutions providing predictable protection of contractual and property rights are important to financial market development.<sup>150</sup> For one, the threat of judicial sanction has been found to create inter-relationship trust (*i.e.*, credibility in commitments), which is useful in dealing with transaction partners with whom there was no pre-established personal relationship.<sup>151</sup> Researchers have suggested that inadequate formal protection of contractual rights in China drives firms to avoid raising capital in the financial markets.<sup>152</sup> This is a signal that the

<sup>146</sup> Julian Franks, Colin Mayer, & Stefan Rossi, *Ownership: Evolution and Regulation*, 22 REV. FIN. STUD. 4009 (2009).

<sup>147</sup> Not the legal institution, but humans' "conformity with accepted norms of behavior in the absence of explicit incentives or penalties to do so." *Id.* at 4040.

<sup>148</sup> *Id.* at 4041-44.

<sup>149</sup> Franks et al. seem to take predictable and accurate contract enforcement as a given during the time period they analyze. *Id.* The competency of the English courts as predictable and accurate enforcers of contracts was established long before the 19<sup>th</sup> century. See Daniel Klerman & Paul Mahoney, *The Value of Judicial Independence: Evidence from Eighteenth Century England*, 7 AM. L. & ECON. REV. 1 (2005).

<sup>150</sup> See notes 34, ff., and accompanying text; see also Rafael La Porta & Florencio Lopez-de-Silanes, & Andrei Shleifer, What Works in Securities Laws? 61 J. FIN. 1 (2006) (identifying laws providing market participants with private remedies against other participants as important for financial market development).

<sup>151</sup> See *supra* notes 34, ff., and accompanying text.

<sup>152</sup> Lu Yi & Zhigang Tao, *Contract Enforcement and Family Control of Business: Evidence from China*, 37 J. COMP. ECON. 597 (2009).

weakness of the judicial institution is retarding financial market development in China.

In China the formal institutional environment is currently inadequate for protecting contractual and property rights with a high degree of predictability, and the development of institutions by which legal solutions could be developed, in order to add degrees of predictability, is stunted itself.<sup>153</sup> The trust institution is essentially just a collection of property and contract rules. If the formal institutions protecting property and contractual rights are weak, then so must the formal institutions protecting the rights of parties to a trust.

In conclusion, the trust institution is but one weak point in the development of an institutional investor market in China. Institutional investors demand financial markets that function with some basic measure of predictability, and once they become a powerful force in markets, their weight and rational decision-making will further add predictability. Arguably, institutional investors demand at least a foundation of basic and well-functioning legal institutions – the lack of which currently impedes the development of the institutional investor industry in China. Enforcement of the rules of corporate governance – whether enforcement is provided by the state, external financial market monitoring, or organizations such as stock markets – are weak in China.<sup>154</sup> This deters firms from using the capital markets to raise capital and thus limits institutional investors' investment opportunities. Other retardants to financial market development include: un-systematic and incomplete regulation of financial markets; a lack of trained accountants, lawyers, and other professionals; and a lack of financial products and innovation.<sup>155</sup>

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<sup>153</sup> See Clarke, *Law without Order*, *supra* note 28.

<sup>154</sup> *Id.*

<sup>155</sup> See Allen et al., *supra* note 11, at 549-52.