

WHERE THERE'S A WILL, THERE'S A TRUST ON THE WAY

A case analysis of the first testamentary trust judgment in China

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ABSTRACT

- *In mid-2019, the first publicly searchable testamentary trust judgment in China, Lee A v Qin & Lee B,¹ was published by the Shanghai No.2 Intermediate People's Court.²*
- *This judgment, both from a trust perspective and from the viewpoints of various judicial opinions and treatment, is extremely fruitful in its uniqueness, exploration and perception around creating a trust through a will for the first time.*
- *This article will analyse those judicial opinions and treatments regarding testamentary trust issues in this case, assessing both progress made and drawbacks.*

¹ For the purposes of this article, the terms 'China' and 'PRC' refer to Mainland China only, excluding Taiwan, Hong Kong and Macau.
² Lee A v Qin & Lee B Case No.: (2019) Hu 02 Min Zhong No. 1307.
The complete text (Chinese version only) of the judgment is available at bit.ly/3imUDba

Due to its complex circumstances, the case involves not only testamentary trusts, but also the deceased's ex-wife's divorce property dispute, a posthumous asset change and confirmation of rights and the scope of the estate not covered in the testamentary trust for legal succession and other circumstances. In the interests of clarity and brevity, this article will mainly focus on the facts of the case directly related to the legal issues of testamentary trust. The relationships of the parties involved in this case are relatively diverse, as shown in Table 1.

FACTS OF THE CASE: LEE A v QIN & LEE B

On 11 August 2015, Lee D passed away in Shanghai Ruijin Hospital due to illness. Before his death, Lee D wrote a handwritten will on 1 August 2015, which read as follows:

TOTAL PROPERTY

- Yuanpu Investment (a monthly revenue financial product) under custody of China Merchants Securities worth about RMB5 million;

Table 1: Relationship table of Lee A v Qin & Lee B

Parties	Identity and relationship	Notes
Lee D	Testator and settlor of the testamentary trust	Deceased before this case
Qin	Current wife of Lee D; one of the trustees	Qin was deprived of her qualification as trustee by the Shanghai No.2 Intermediate People's Court
Lee C	Ex-wife of Lee D; mother of Lee A	Lee C had a divorce property dispute with Lee D
Lee A	Daughter of Lee D and his ex-wife Lee C	One of the beneficiaries
Lee B	Daughter of Lee D and his current wife Qin	One of the beneficiaries
Lee E, Lee F and Lee G	Siblings of Lee D	All are trustees

- Yijingling (a financial product) from the Bank of Shanghai and China Merchants Securities worth about RMB5 million; and
- Real estate: one apartment at Jinjia Lane, one apartment at Qingpu Liantang Qianjin Street and one apartment in Haikou.

DISPOSITION OF PROPERTY

- The trustees will purchase another duplex apartment with three bedrooms and two living rooms in Shanghai, the purchase price of which is about RMB6.5 million, and such apartment will be permanently prohibited from being sold and is only for utilisation by the next generation. There are currently three apartments available for sale, the proceeds or rents of which will be incorporated into the ‘Lee D Family Foundation’.
- The remaining RMB3.5 million of capital and property sale proceeds of about RMB4 million and RMB6.5 million of apartments and other assets, totalling about RMB14 million, will be established and managed by the Lee D Family Foundation.

UTILISATION OF PROPERTY

- Monthly living expenses of RMB10,000 will be allocated to Lee D’s wife, Qin, and daughter, Lee B, with all of their medical expenses reimbursed and all of Lee B’s domestic tuition fees reimbursed. Each year, Qin, Lee E, Lee F and Lee G are entitled to receive management fees of RMB10,000 from the fund. Half of the self-borne medical expenses of serious illness in hospital for three of the siblings (Lee E, Lee F and Lee G) will be reimbursed.

- Subsequent amendments are subject to the text with later date.³ The management of the property is jointly undertaken by Qin, Lee E, Lee F and Lee G. As for the newly bought apartment of RMB6.5 million, Qin, Lee A and Lee B have the right to live there, but those who do not live there cannot charge rent to the occupants.

For the estate of Lee D, the court of first instance approved in principle that the estate should be handled in the way of testamentary trust.⁴ A testamentary trust is essentially a trust that is triggered following the death of the testator (the settlor), and the effectiveness of the will may be overturned by a later will or a notarial will. Therefore, the testamentary trust is a retractable and dynamic trust. Qin and Lee B appealed that the inheritance of Lee D’s estate should be divided according to the legal inheritance rules instead of the trust, but Lee A supported the first instance court’s handling of the estate by way of trust. In the second instance, Lee E, Lee F and Lee G agreed to send the case back for retrial, but did not agree to the other appeals of Qin and Lee B. Although the court of second instance adjusted some contents of the judgment of first instance, it maintained the original attitude towards the recognition and arrangement of testator trust involved in the judgment of first instance.

3 This means if there are amendments or new versions of his will, the effect of the latest version shall prevail. And, of course, there was no later version.

4 The actual scope of the estate identified by the Shanghai No.2 Intermediate People’s Court and recognised by all parties in the first instance is slightly different from the scope in Figure 1, but does not affect the evaluation and analysis of the testamentary trust in this case, hence the scope difference is not detailed in this article.

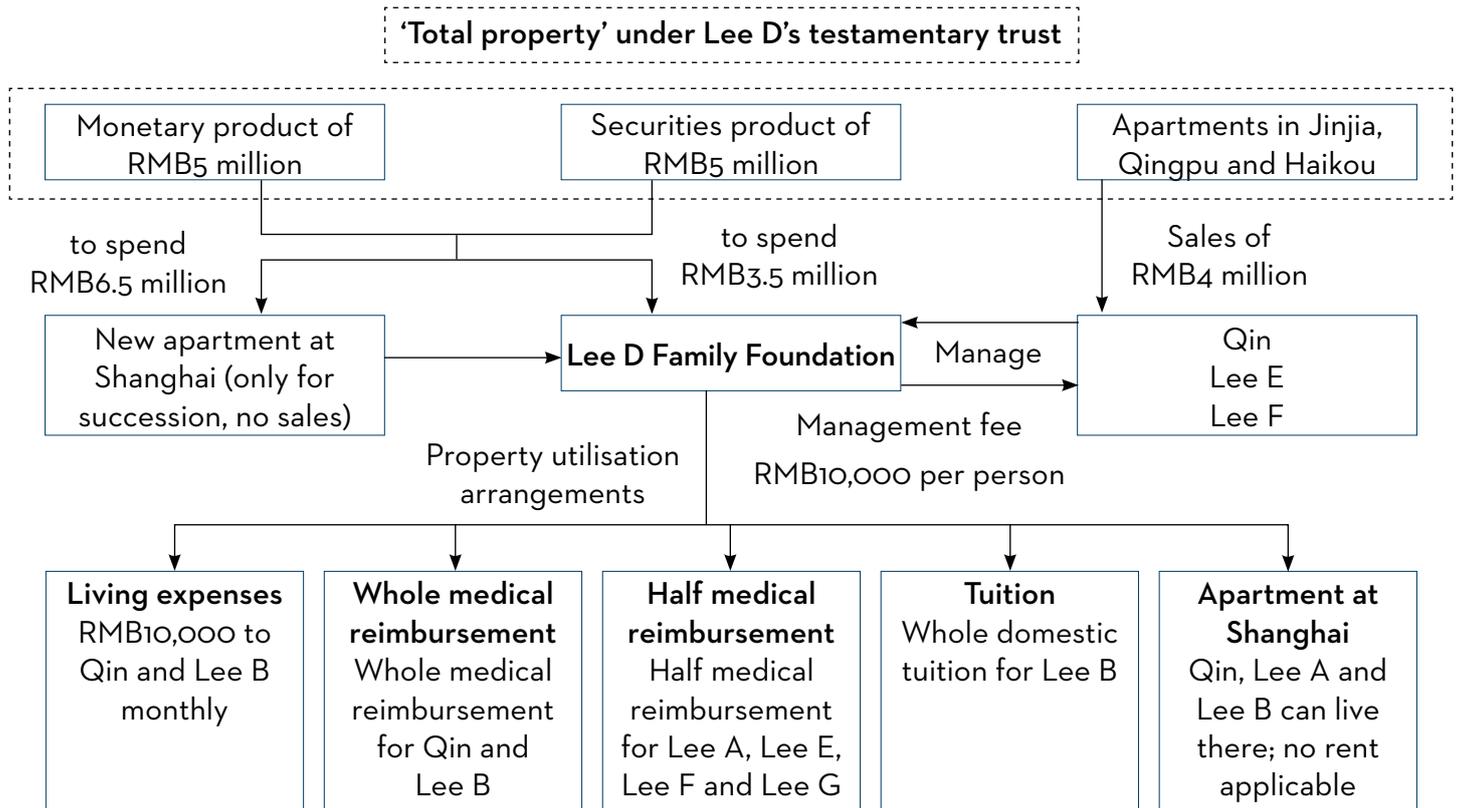


Figure 1: Arrangements of Lee D's testamentary trust

THE PROGRESS OF THE TESTAMENTARY TRUST CASE

PAYING RESPECT TO THE TRUE MEANING OF TESTATOR, PARTLY RESOLVING THE EFFECTIVENESS ISSUE

In this case, the written will by the testator Lee D did not appear to use the term 'trust' and designated the establishment of the Lee D Family Foundation to manage the estate. Such expression is actually contrary to that of a trust, as the foundation legislation in China has gone through a long process (see Table 2 below) and, according to the *Regulations for the Management of Foundations* (the Regulations) currently in force, the term 'foundation' in China only refers to non-profit legal persons engaged in public welfare undertakings. Foundations for private benefit purposes are not recognised by China at present. The purpose of the will in this case was not to donate the estate to charity but to serve the family members' private living. Further, Lee D entrusted his wife and siblings as trustees, who, as natural persons entrusted, cannot be considered legal persons and would certainly not be registered in the civil affairs department as non-profit legal persons.

Nevertheless, the Shanghai No.2 Intermediate People's Court (the Shanghai Court) ultimately determined that Lee D essentially wanted to establish a trust, rather than a foundation or an ordinary inheritance, from the true viewpoint of the testator. The Shanghai Court interpreted such idea in its judgment as follows:

'From the context of the will, the meaning expressed by Lee D is not to divide the estate, but to manage the estate as a whole through a third party named "Lee D Family Foundation" ... Lee D also specified the utilisation purpose of part of the property, designated the beneficiaries, clarified the remuneration of the managers [author note: i.e. trustees], and further clarified the purpose of the purchase of the apartment - "only for succession to the next generation, not for sale forever", which refers to the separation of ownership and usufruct. The above meaning of Lee D indicates that, in line with the legal characteristics of the trust, it should be identified as Lee D's wish to establish the trust by way of will to realise the inheritance of family wealth.' (emphasis added)

During the Shanghai Court’s hearing, Lee A argued that the apartment to be bought by Lee D’s estate, as stated in his will, ‘only for succession to the next generation, not for sale forever’ was ‘just a wish of Lee D and could not be realised in practice’. Speaking to this matter, the Shanghai Court explained in the judgment that this is not an unattainable wish but, to the contrary, it is the embodiment of the characteristics of the perpetual inheritance of the entrusted property of the family trust:

‘The purpose “only for succession to the next generation, not for sale forever” in the will is not legally impossible to achieve, but is exactly one of the functions of the trust system.’
(emphasis added)

To a great extent, this judicial opinion makes up for the deficiencies of trust law in current Chinese society and shows that the Shanghai Court adopts a supportive and effective judicial attitude towards the validity determination of a private trust. The trust itself is a kind of independent property collection by consensus with specific purposes, a fact that has been gradually recognised as the underlying legal logic of the asset management industry.⁵ As long as the testator’s true intention conforms to the characteristics of the trust, even if the wording is not standard, the judicial confirmation of the establishment of the trust can still be obtained, rather than checking the specific wording to determine the effectiveness of the trust documents.

EMPHASISING THE IMPORTANCE OF FIDUCIARY DUTIES

In addition to the siblings of Lee D, the testamentary trust/will in this case also designated Qin as one of the original trustees. However, as specified in the trial at first instance, Qin declined to act as trustee, before indicating at second instance that she was willing to act as trustee. In response, the Shanghai Court decided Qin ‘should not be listed as executor, manager or trustee of the testamentary trust because her behaviour indicates contrary to

good faith’. In the end, the trustees of this case only include the siblings of Lee D, while Qin was ruled out as a trustee by the Shanghai Court for violating the fiduciary obligations of honesty and credit.⁶

Table 2: Regulatory development of ‘foundations’ in China

Period	Phase	Relevant PRC regulations on foundations
1981 to 1987	Beginning phase	Lack of laws or regulations regarding foundations.
1988 to 1996	Triple regulation phase	On 27 September 1988, the State Council of the People’s Republic of China (the Council) promulgated the <i>Measures for the Administration of Foundations</i> , which includes 14 provisions on the definition of foundations, conditions for their establishment, examination and approval systems and rules for fund preparation, etc.
1997 to 2003	Clean-up and rectification phase	In 1996, the General Office of the Central Committee of the Communist Party of China and the Council jointly issued the <i>Notice on Strengthening the Administration of Social Organisations and Private Non-Enterprise Units</i> , ⁷ beginning to clean up and rectify foundations.
2004 to 2015	Public interest legal person phase	In 2004, the Regulations were issued to encourage the development of public-interest legal person/ corporate foundations for the purpose of public welfare in China.
2016 to present	Philanthropic organisation phase	In 2016, the <i>Charity Law of the People’s Republic of China</i> came into force, making the foundation one of the legitimate forms of philanthropic organisation.

⁶ Namely, that a natural person acting as trustee would be considered as having less credit and exercise less fiduciary duty than a legal person would.
⁷ Since this notice is now invalid, it cannot be found on any web pages of the General Office or the Council. But some local governmental websites have kept the record of such notice (Chinese version only). See e.g. bit.ly/32hlhM4 (accessed September 2020).

‘If real estate becomes trust property in China, from trust establishment to distribution, it will be regarded as two transactions under the framework of China’s current tax law ... which will result in a heavy tax burden’

FIDUCIARY DUTIES IN THE TRUST LAW

The *Trust Law of the People’s Republic of China* (the Trust Law)⁸ outlines the following fiduciary duties for trustees:

- the duty of handling trust affairs as stipulated in the trust documents;⁹
- the duty to handle trust affairs in the best interests of the beneficiary;¹⁰
- the duty of high due diligence;¹¹
- the duty of honesty;¹²
- the duty of credit;¹³
- the duty of caution;¹⁴
- the duty of effective management;¹⁵
- the duty of prohibiting the use of trust for personal gain (other than remuneration);¹⁶
- the duty of prohibiting embezzlement of trust properties;¹⁷
- the duty of prohibiting ‘self-trading’;¹⁸
- the duty of respective management;¹⁹
- the duty of management in person;²⁰
- the duty of record keeping and regular reporting;²¹
- the duty of confidentiality;²²
- the duty to pay trust benefits to beneficiaries;²³ and
- the duty to assist new trustee(s) on handing over.²⁴

Testamentary trusts are often a result of the testator’s personal writing style, and testators are more likely to appoint natural persons from non-professional institutions (such as their relatives

and friends) as trustees. However, the trustee has a series of fiduciary obligations, prescribed in the Trust Law. Although the requirements of the professional management obligations of the natural person trustee may be less strict than those of the professional institution trustee, there is no excuse for not strictly obeying some other obligations such as good faith and diligence. In this case, both Qin being deprived of the qualification of trustee and the active notice of fiduciary duties being given to the remaining trustees in the judgment document show the Shanghai Court’s emphasis on, and importance of, the fiduciary duty when facing natural persons acting as trustees.

RESOLVING SEVERAL EXECUTIVE ISSUES²⁵

In this case, when making the will, Lee D mistakenly believed that he had monetary products with a market value of RMB5 million and securities assets with a market value of RMB5 million; hence he arranged for total assets of RMB10 million to purchase an apartment and the rest of the money for the purposes stated in the will. However, as a matter of fact, due to the marital common property share of Qin and the influence of stock market fluctuations after Lee D’s death, such assets could not realise Lee D’s wish to purchase real estate and other designed purposes. In addition, if real estate becomes trust property in China, from trust establishment to distribution, it will be regarded as two transactions under the framework of China’s current tax law (one transaction from trust settlor to trustee and another from trustee to beneficiary), which will result in a heavy tax burden.²⁶ To this

8 Promulgated in 2001

9 art.25(1)

10 art.25(1)

11 art.25(2)

12 art.25(2)

13 art.25(2)

14 art.25(2)

15 art.25(2)

16 art.26(1)

17 art.27

18 art.28(1)

19 art.29

20 art.30(1)

21 art.33(1)

22 art.33(2)

23 art.34

24 arts.39(2) and 41(1)

25 The ‘executive issue’ refers to the difficulty in setting up the trust after the death of Lee D.

26 With regards to the civil-trust property registration issues and double taxation burden issues in China, please see Hao Gao, Jun Luo, ‘Civil Trust Taxation Issues in China: Research and Resolutions from a Legal Viewpoint’, *Taxation Research*, 2020 (05), pp.97-103

end, the Shanghai Court made the following determination in the judgment:

‘Due to the stock market fluctuations and other objective reasons, the total value of the estate of Lee D is less than RMB6.5 million, therefore the content of the will about the purchase of real estate worth RMB6.5 million has been unable to be executed ... However, there are also contents in the will such as the establishment of a trust, with Qin and Lee B receiving trust benefits. There is no causal relationship or pre-requisite relationship between the above contents and the purchase of real estate worth RMB6.5 million. As long as the trust property complies with the legal provisions, it is eligible for execution.’ (emphasis added)

The Shanghai Court took the compromising attitude to liquidate the real estate in the proposed trust property into cash, becoming an operation-friendly monetary trust, which is an expedience considering the drawbacks of the trust property registration system and trust taxation issues in China.

THE FLAWS OF THIS TESTAMENTARY TRUST CASE

TESTAMENTARY TRUSTS WITH INCOMPLETE STIPULATIONS ARE NOT JUDICIALLY RECOGNISED
By comparison, four years earlier than this case, in *Zeng A v Lee*,²⁷ the Fuzhou Intermediate People’s Court (the Fuzhou Court) did not recognise the trust effectiveness of a will intending to establish a testamentary trust, because the content of Zeng’s will was too vague and lacking substantial stipulations such as trust settlor, trustee, beneficiary, purpose of trust and utilisation of trust property. The Fuzhou Court held that:

‘In this case, the testator Zeng Jinsheng’s will was to “found Zen’s Fund using remaining estate, managed and utilised by nephew Zeng A and Zeng B”. From the point of view of the will, the questions of how to establish Zen’s Fund, the purpose of setting up Zen’s Fund, fund operation, and how to allocate property

were not clear without specific requirements, nor were the management and utilisation of the estate by Zeng A.’ (emphasis added)

Article 11 of the Trust Law stipulates that ‘the trust shall be invalid under any of the following circumstances: ... (2) the trust property cannot be determined; ... (5) the beneficiary or the scope of the beneficiary cannot be determined’. Judging from the vague content of the will in Zeng’s case, the testamentary trust does not have enforceability and does not conform to the legal provisions, and so is invalid.

Therefore, if one intends to design a testamentary trust, one should not think that the judicial attitude to the effectiveness of a testamentary trust, due to the judgment of this case, is one of extreme tolerance, so as to design the terms in the will *ad arbitrium*. It is still necessary to design the terms of a testamentary trust strictly, systematically and legally. We would argue that the contents of a testamentary trust file should conform to the provisions in the Trust Law to be considered valid. Therefore, the trust file should indicate the specific purpose of setting up the testamentary trust, the trust testator and trustee, the beneficiary’s name and/or scope, the proposed scope of the entrusted property, the ways and duties for the trustee to perform the function, and the forms and methods for the beneficiary to receive the trust benefits and privileges, etc.

THE TRUSTEES OF A TESTAMENTARY TRUST ARE USUALLY DESIGNATED UNILATERALLY, HENCE THE FIDUCIARY DUTY IS STILL A PENDING ISSUE
In this case, Lee D’s siblings assumed the role of trustees, as Qin had initially refused to act in this role. On the one hand, the natural person trustee usually lacks the professional capability and consciousness of their fiduciary duties. On the other hand, the trustee appointed in the will may give up their fiduciary duties, resulting in a trust encountering trustee deficiency. Regarding this issue, in the case of Lee D’s testamentary trust, the Shanghai Court made a rare prompt on fiduciary duties to the natural person trustees. From the judgment:

‘... The court hereby points out to the trustees Lee E, Lee F and Lee G in this case that all of

²⁷ Case No.: (2015) Fu Min Yi Zhong No. 266. The complete text (Chinese version only) of the judgment is available at bit.ly/2DS5o8o (accessed May 2020).

‘At present, the property types of civil-trust products that have been established in China are relatively limited, and mainly comprise monetary property’

you shall abide by the provisions of the trust documents and handle the trust affairs for the maximum interests of the beneficiaries; as the trustees, you shall fulfil your duties and earnestly perform your obligations of being honest, trustworthy, prudent and effective in managing the trust property. If the trustees dispose of the trust property against the purposes of the trust or violate the management duties or handle the trust affairs improperly, causing the trust property to suffer losses, or the trustees take trust property into their own property or conduct other illegal acts, the beneficiaries may, in accordance with the law, require the trustee to restore, to compensate for the losses and to take other legal responsibilities.’ (emphasis added)

In addition, anti-*Bartlett* provisions²⁸ may be considered in the trust documents for embedding the family office, as well as the consensus design of the trust protector.²⁹ It is not only recommended to design the terms through a professional advisor, but also that the testator/settlor should be encouraged to communicate with the trustee, trust protector/supervisor, family office and other candidates to reach agreement before their death.

²⁸ In offshore trust practice, in order to achieve the purpose for a family office rather than a trustee to manage a private trust company, anti-*Bartlett* provisions can be stipulated to dismiss the management duty of the trustee over trust property. See e.g. *HSBC Trustee CI v Kwong* [2017] JRC 214A

²⁹ Also called a ‘trust supervisor’ in China. The Trust Law only establishes the trust supervisor system for public interest trusts, while there is no explicit regulation as to whether business trusts and civil trusts can adopt the trust supervisor system. The authors would like to argue that, despite no relevant rules governing trust supervisor system for private trusts in China, considering the basic principle ‘an absence of legal prohibition means freedom’ under private law, trust parties should be allowed to establish trust supervisor clauses in their documents through consensus and to freely make arrangements as long as such arrangements do not violate *jus cogens*. Besides, the trust supervisor is usually called trust protector in common-law jurisdictions. See e.g. the British Virgin Islands *Trustee (Amendment) Act, 1993*.

ENFORCEABILITY ISSUES ARISING FROM TRUST PROPERTY DIVERSITY REMAIN UNRESOLVED
As mentioned above, due to the imperfection of the current trust property registration system in China, when the trustee property is diversified, even the court compromises by setting up a purely monetary trust through the discount of assets.

At present, the property types of civil-trust products that have been established in China are relatively limited, and mainly comprise monetary property. In August 2017, the China Banking and Insurance Regulatory Commission officially issued the *Measures for the Supervision and Administration of China Trust Registration Co., Ltd*. In August 2018, the *Trust Registration Administration Detailed Rules* were officially issued for a China Trust Registration Co, Ltd (CTRC); CTRC provides trust registration and other services. However, for real estate, equity, intellectual property, etc., the lack of clear registration procedures and high tax costs still lead, in practice, to the limited types of Chinese local civil-trust property, making it difficult to absorb real estate, equity, intellectual property, etc., as entrusted property.

From the perspective of practical operation, the judicial department realised the discounted value of the testamentary trust property to turn it into monetary trust in this case, which does not mean that the problems of the registration type and tax burden of civil-trust property in China have been resolved. These problems still need to be resolved by the joint efforts of the legislature, the tax department and the regulatory department.

THE TESTAMENTARY TRUST CANNOT FUNCTION AS A TOOL FOR ISOLATING ASSETS

The authors would argue that, given the testamentary trust’s dynamic nature and the scope of the testator’s estate in uncertain status before death, per art.33 of the *Succession Law of the People’s Republic of China*,³⁰ the estate should not be able to be put into a trust until relevant debts are paid up. Therefore, the authors hold that when the testator of a testamentary trust dies, their estate should still first pay their creditors before they can put it into the testamentary trust. In other words, the testamentary trust does not

³⁰ This Law was promulgated in 1985. The newly passed PRC *Civil Code* will come into effect on 1 January 2021, leading to the PRC Succession Law being abolished, as the succession rules will be incorporated into the *Civil Code*.

have the function of asset isolation or bankruptcy prevention.

If a settlor wishes to establish a trust from the trust property independence, bankruptcy prevention and other risk-control perspectives, they should still consider directly setting up a family trust when alive, in which they should complete the auditing and transfer of the trust property to the trustee before death, rather than in the form of a will to set up a testamentary trust that does not have the trust property independence, so causing risk issues that could have been avoided.

CONCLUSION

The heated discussion around the first testamentary trust case judgment in China continues. This case made judicial affirmation on the form of a will setting up a trust, and such a supportive attitude has positive significance.

First, it endorsed the will as a legal form of trust document, and if the content of a will is consistent with the legal elements of a trust, such will/testamentary trust shall be legally binding without the need for trust product registration.

Second, it recognised the legitimacy of natural persons acting as trustee, though such recognition is accompanied by the court's concern in its active prompt of fiduciary duties.

Third, when the trust property of a testamentary trust does not meet the conditions to establish a trust in the current legal environment, the

reasonability of the compromised scheme of establishing a monetary trust through the way of asset cash realisation is also recognised by the court.

At the same time, however, it should be realised that this case cannot (nor can we ask the organ performing the judicial functions to) resolve the registration and transfer issues of trust property, the double-taxation burden and the lack of fiduciary duty rules considered for natural person trustees in China. In addition, the establishment of a trust in the form of a will is retractable and dynamic and thus cannot play the role of an asset-isolation tool like establishing a family trust and finishing trust property transfer before death, which is also worth noting.

In summary, the authors believe that this case, from the perspective of judicial practice, has added the testamentary trust as an important wealth management tool for the wealth planning industry in China, a significant milestone. However, many problems are still pending and it remains necessary for all relevant departments to jointly push forward for reform in improving the supporting laws and regulations of family trusts in China.

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