The incorporation of the English doctrine of fiduciaries into Chinese law

by John McGhee QC[1]

The story of how the doctrine of fiduciaries became part of the English law in a very curious one.[2] It was not introduced by a statute which clearly marked its origin. Like much of English law it grew out of litigation before the courts to resolve disputes over transactions created by individuals.

Long before the Norman conquest of England in the 11th century it had been common for property to be conveyed to be held on behalf of another. So we find examples of men conveying land to a bishop for the use of the church; and in the early 13th century, when the new Franciscan orders of monks came to England with a vow of poverty, land would be conveyed to the borough community for the monks' use. But there was at that stage no formal institution of trust.

That changed in the 14th century. At that time land could not be left by will. If a landowner died leaving an heir, a tax would become payable to the lord and, if there was no heir, the ownership of the land passed to the lord. Landowners started to try and get round these problems by conveying land to friends to be held for the landowner during his lifetime and thereafter for such other persons as he should choose. The Chancellor stepped in to support these arrangements, exercising his power in equity to supplement the common law by enforcing these "*uses, trusts or confidences*" against the persons to whom the land had been conveyed. Furthermore the Chancellor treated the persons for whom the land was being held as having rights analogous to proprietary interests in the land and so began to enforce those rights against third parties who had wrongly been conveyed the land. The popularity of this device grew despite the attempt by Henry VIII to abolish it in the Statute of Uses in 1535. By the 16th century it was being used not only for family settlements but also to create trusts for charitable or public purposes.

Some of these kinds of public trusts also gave birth to modern company law. The Bubble Act 1720 had prohibited the use of corporations save as created by Royal Charter or Act of Parliament. But deeds of settlement were used to create similar structures which, though formally partnerships, had much in common with corporations. They would designate a company name, vest property in trustees on behalf of certain shareholders, provide for management by a board of directors and give shareholders the right to assign their interests. These so called "deed of settlement companies" became very popular despite the disadvantage that all the trustees had to be joined in for the company to sue or be sued and that the shareholders had unlimited liability. In the 1830s Parliament began to catch up and eventually in 1862 enacted the first modern form of Companies Act establishing companies limited by shares.

The final piece of the jigsaw was the export of English law initially to the overseas possessions and trading posts established by England from the 16th to 18th

[1] Maitland Chambers, London. I am grateful to Professor David Fox for commenting on an earlier draft of this paper and to Duncan McCombe for help with Chinese language materials.
[2] See generally Maitland, *Equity and the Forms of Action at Common Law* (Cambridge 1910); Maitland, *Trust and Corporation* in H A L Fisher (ed), *The Collected Papers of Frederic William Maitland* vol III p321 (Cambridge, 1911)

centuries and later to the British Empire. It is for this reason that other jurisdictions such as Australia, New Zealand, Canada, the United States and, of course, Hong Kong share many of the doctrines and principles of English law.

And so it came about that a device created by landowners in the 14th century to pass their wealth to successive generations gave birth to the two of the most important structures in the modern world for commercial and financial transactions: the trust and the company.

The key to the success of the concept of the trust and of the company as investment and business vehicles lies in the way in which they enable the separation of the management control of assets from the right to the benefits accruing from those assets. This requires two things: first, that those in control of the assets have the ability to deal with the assets without the participation of those entitled to the benefit; and secondly, that those with the benefit have an ability to ensure that those in control will deal with the assets for their benefit. In English law the trust vests management control in the trustees by requiring that the trustees have ownership of the assets. The interests of the beneficiaries are secured by requiring that the trustees not only comply with the terms of the trust and exercise reasonable care and skill but also that they act in good faith in the interests of the beneficiaries.[3] Moreover the trustees are required, save as specifically authorised by the beneficiaries or by the terms of the trust, not to put themselves in a position where their obligations to the beneficiaries may be in conflict with their personal interests or with their obligations to others, and not to profit personally from their position. In the case of a company the assets are vested in a new entity with legal personality subject to the control of directors. The directors are regarded as being in a position analogous to that of trustees and so they too owe obligations to act in good faith in the interests of the company and are also subject to the no-conflict and no-profit rules.[4] Both trustees and directors are said to be "fiduciaries" and to owe "fiduciary obligations". Others in a fiduciary position owe similar obligations.

Perhaps surprisingly there is no consensus over the content of fiduciary obligations and different jurisdictions take different approaches about how to categorise and name fiduciary obligations. One approach, which is prevalent in the United States, is to regard all obligations owed by fiduciaries as fiduciary obligations. But such an approach does not usefully distinguish between those obligations and those remedies which are peculiar to fiduciaries and those which apply to non-fiduciaries. Thus there is nothing peculiar about the duty of care which applies to fiduciaries in the same way as it does to others who are not in a fiduciary position and gives rise to the same remedy that is compensation for loss suffered by breach. Contrast this with the no-conflict and no-profit rules which are generally regarded as peculiar to fiduciaries and where breach gives rise to a claim to profit based and proprietary remedies including rescission, remedies which are not generally available in the case of breach of duty by non-fiduciaries.

In an influential judgment in the Court of Appeal in England Millett LJ said:

[3] *Bristol & West Building Society v Mothew* [1998] Ch 1 at 18 per Millett LJ
[4] *Re Smith Fawcett Ltd* [1942] Ch 304 at 306 per Lord Greene MR

"*The expression 'fiduciary duty' is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties*".[5]

As to what duties are peculiar to fiduciaries he said:

"*The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he must not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations.*"

There is a tension inherent in these two passages. The question of what duties are peculiar to fiduciaries in the sense that they are owed only by fiduciaries gives rise to one answer, but the question of what obligations owed by a fiduciaries gives rise to legal consequences different from those consequent upon the breach of other duties give rise to another answer. Professor Conaglen, the contributor to this section of the current edition of *Snell's Equity*[6] and the author of an important monograph on the subject,[7] takes the view that fiduciary obligations are those obligations which are owed only by fiduciaries. He points out that that not only a fiduciary's duty of care and skill but also his duty to perform the tasks which he has undertaken, his duty to act in good faith, and his duty to act for proper purposes are all duties which may be owed by non-fiduciaries. All that is left is the no-conflict and no-profit duty which are the duties owed by fiduciaries alone. These duties are distinctive because of their prophylactic or protective function in seeking to prevent fiduciaries from acting in situations in which they face a temptation to breach their other non-fiduciary duties and it is this distinctive quality which, he asserts, is encapsulated in the concept of "loyalty".

Professor Conaglen's thesis has proved controversial. It valuably highlights the important and distinctive function of the fiduciary's no-conflict and no-profit duties. But these duties are not designed to protect all of the other duties commonly owed by fiduciaries. They do not prevent the fiduciary from being in breach of his duty of care for instance. But they do appear to be designed to protect the fiduciary's duty to act in good faith in the interests of the beneficiary. Professor Lionel Smith identifies this requirement that the fiduciary exercises his judgment in what he perceives to be in the best interests of the beneficiary as being at the heart of the duty of loyalty.[8] This duty of loyalty is directly related to the no-conflict rule since a conflict arises within that rule where a fiduciary is bound by the requirement of loyalty with respect to the exercise of some judgment and that exercise of judgment is liable to be affected by something that the requirement of loyalty requires the fiduciary not to consider (either the fiduciary's own self interest or the interests of some other person). The no-profit rule, he considers, has a different justification. Just as assets lawfully acquired by the fiduciary become

[5] *Bristol & West Building Society v Mothew* [1998] Ch 1 at 18
[6] McGhee (gen ed), *Snell's Equity* 33rd ed (London, 2013) Ch 7
[7] Conaglen, *Fiduciary Loyalty* (Oxford, 2007)
[8] L Smith, '*Can We be Obliged to be Selfless?*' in Gold & Miller (eds), *Philosophical Foundations of Fiduciary law* (Oxford 2014); L Smith, '*Fiduciary relationships: ensuring the loyal exercise of judgement on behalf of another*' [2014] LQR 608

property of the beneficiaries, so assets unlawfully acquired by the fiduciaries for themselves or others out of their position as fiduciaries are also treated as the property of the beneficiaries.

Recently English authority appears to provide some support for Professor's Smith's thesis. In *Pitt v Holt*[9] the United Kingdom Supreme Court held that trustees would have been in breach of fiduciary duty and their decision would have been liable to rescission if in exercising their discretion they had knowingly failed to have regard to relevant matters. Since the case has nothing to do with the no-conflict rule or no-profit rule the court cannot have been using "fiduciary duty" in the sense used by Professor Conaglen.

Further Professor Conaglen has himself accepted that fiduciary duty can be used in different senses. In an important paper written jointly with another contributor to *Snell's Equity*, Professor Nolan,[10] he accepts the legitimacy of two alternative approaches:

> "*One approach is to identify the duties that are peculiar to fiduciaries, in the sense that those duties are not owed by other kinds of actors. From that base, one can seek to describe the nature and function of fiduciary duties that mark fiduciaries out from other kinds of actors, or, in other words, the duties that identify fiduciaries. Alternatively, and equally legitimately, one can consider the suite of duties that apply to all fiduciaries, irrespective of whether those duties are of a kind that apply to other kinds of actors.*"

Interestingly this paper reveals further common ground with Professor Smith. Both agree that the no-conflict duty presupposes a requirement for the fiduciary to act in good faith in the interests of the beneficiaries. As Professor Smith puts it:

> "*... the no-profit rule and the no-conflict rules can often be excluded in particular cases, or modified prospectively. The 'duty' of loyalty, however, cannot be excluded without destroying the fiduciary relationship. A trustee who held property, and the corresponding powers, but who could lawfully use the property for his own benefit, would not be called a fiduciary.*"[11]

And as Professors Conaglen and Nolan put it:

> "*To say that a person may not in act in circumstances where some interest or other obligation conflict, or may conflict, with his duties, and yet to allow him to act in bad faith, simply makes no sense.*"[12]

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[9] [2013] UKSC 26 at [70] & [71]
[10] Nolan & Conaglen, '*Good faith: what does it mean for fiduciaries, and what does it tell us about them?*' in Bant & Harding (eds), *Exploring Private Law* (Cambridge, 2010)
[11] L Smith, '*Can We be Obliged to be Selfless?*' in Gold & Miller (eds), *Philosophical Foundations of Fiduciary law* (Oxford 2014) text to fn73.
[12] Nolan & Conaglen, '*Good faith: what does it mean for fiduciaries, and what does it tell us about them?*' in Bant & Harding (eds), *Exploring Private Law* (Cambridge, 2010) at p329

There was no comprehensive legal framework to regulate trusts in the People's Republic of China until the Trust Law promulgated in 2001.[13] This was designed to provide a comprehensive legal framework for regulating trust and investment companies in China; and regulations have since been enacted to apply the trust to investment funds, occupational pension funds, asset securitization, collective capital trusts and real estate investment trusts.[14] The trust industry in China has since experienced exponential growth. The first unified company law was enacted in China in 1993 but it was subject to significant revision and restatement by the Company Law promulgated in 2005.[15]

The 2001 Trust Law and the 2005 Company sought to introduce into Chinese law for the first time the concept of fiduciaries. The purpose in doing so was not only to provide the necessary check and balances on the powers of trustees and of directors, supervisors and managers of companies but also to provide reassurance to potential foreign investors familiar with the laws of England and other English based legal systems. The extent to which the Trust Law and Company Law succeeded in incorporating the fiduciary concept into Chinese law is of critical importance but is also controversial.

Two points of objection may be disposed of at the outset. Unlike in China or in other civil law jurisdictions, English law is primarily based not on a code or system of rules but on principles deduced from decided cases, principles which are continually being clarified, updated and qualified as new cases are decided. In fact even though in England directors duties have recently been codified by the Companies Act 2006 it is nevertheless provided that previous case law is to be used in construing and applying these new statutory duties.[16] It is difficult for an English lawyer to understand how the law concerning fiduciary duties can be applied in a system such as China which does not have a rich heritage of decided cases to draw upon. But the difficulty is only the practical one of working out what are the scope and application of fiduciary duties. It is not, is suggested, something which in itself prevents the import of the concept of fiduciary duties into other systems of law.

Secondly it might be objected that the concept of trust (and thus of fiduciary duties owed by trustees) depends on the notion that in law the trust property is vested in the trustees who hold in equity for the beneficiary. That analysis is not available in China since article 5 of the Chinese Property Law[17] prevents new property rights being created otherwise than as authorised by law. Furthermore article 2 of the Trust Law does not even require the property to be vested in the trustees: it merely requires that the trustee "*entrusts*" his property rights to them. Again this is not a valid objection to

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[13] Order No 50 of the President of the People's Republic of China promulgated on 28 April 2001 and taking effect on 1 October 2001. Citations are from the official translation accessible at http://www.npc.gov.cn/englishnpc/Law/2007-12/10/content_1383444.htm

[14] See generally Lusina Ho: '*Trust laws in China History, ambiguity and beneficiaries' rights*' in Smith (ed), *Re-imagining the Trust* (Cambridge, 2012)

[15] Citation is from the translation of the version as revised on 28 December 2013 taking effect from 1 March 2014 accessible at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html. There have been subsequent revisions which are immaterial for the purposes of this paper.

[16] s170(4) Companies Act 2006

[17] Order No 62 of the President of the People's Republic of China adopted on 16 March 2007 with effect from 1 October 2007. Official translation at http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471118.htm

the introduction of fiduciary duties. The mechanism by which the property is regarded as in law belonging to the trustees and in equity as belonging to the beneficiaries is only one means by which management of the property may be placed in the hands of the trustees and the benefits remain with the beneficiaries.[18] It is not the only means by which this separation between management and benefits can be made. Many fiduciaries (for example a solicitor or agent) do not obtain property in any assets at all and yet owe fiduciary duties.

The debate about the nature of fiduciary duties in England and other similar common law based legal systems both informs and is informed by consideration of the manner in which fiduciary duties have sought to be incorporated into the 2001 Trust law and the 2005 Company Law in China. The nature of the problem in each case is quite different however.

Article 25 of the 2001 Trust Law sets out the primary obligation of trustees as follows:

> "*The trustee shall abide by the provisions in the trust documents and handle trust business for the best interests of the beneficiary.*
>
> *In administering the trust property, the trustee shall be careful in performing his duties and fulfil his obligations with honesty, good faith, prudence and efficiency.*"

This clearly imposes an obligation to act in accordance with the trust documents including, an obligation to exercise due care and an obligation to act in good faith in the interests of the beneficiary. Article 22 confers rights on the settlor if the trustees are not acting for proper purposes and by article 49 this right is extended to the beneficiaries too. Article 22 provides:

> "*Where the trustee disposes of the trust property in breach of the purposes of the trust, or causes losses to the trust property … the settlor shall have the right to apply to the People's Court for annulling such disposition and the right to ask the trustee to restore the property to its former state or make compensation. Where a transferee of the said trust property accepts the property whilst knowing the violation of the purposes of the trust, he shall return the property or make compensation.*"

The no-profit duty is imposed by article 26 which is in the following form:

> "*Except obtaining remuneration according the provisions of this Law, the trustee may not seek interests for himself by using the trust property.*

[18] Note too that the idea that the beneficiaries have a proprietary interest in the assets is far more complex and subject to qualification than at first appears: see the seminal work of another contributor to *Snell's Equity*: McFarlane, *The Structure of Property Law* (Oxford, 2008). See also Maitland's comment in *Equity and the Forms of Action at Common Law* (Cambridge, 1910) at p23 that on the question of the beneficiary's right "*the best answer may be that in history, and probably in ultimate analysis, it is jus in personam; but that it is so treated (and this for many important purposes) that it is very like jus in rem.*"

Where the trustee, in violation of the provisions of the preceding paragraph, seeks interests for himself by using the trust property, the interests gained therefrom shall be integrated into the trust property."

There is no express no-conflict duty but articles 27 and 28 deal with potential conflicts in two particular situations as follows:

"*27. The trustee may not convert the trust property into his own property. Where the trustee converts the trust property into his own property, he shall restore the trust property into its former state; where losses are caused to the trust property, he shall bear the responsibility to pay compensation.*

28. The trustee may not conduct inter transaction between his own property and trust assets or between the trust assets of different settlors, unless it is otherwise stipulated in the trust documents or is consented by the settlors or beneficiary and the inter transaction is conducted at fair market price.

Where the trustee in violation of the provisions in the preceding paragraph, causes losses to the trust property, he shall bear the responsibility to pay compensation."

Article 27 is recognisable in English law as a particular application of the no-conflict rule known as so called "self dealing rule" that is the rule that if a trustee sells the trust property to himself, the sale is voidable by any beneficiary as of right however fair the transaction.[19]

Article 28 causes some difficulty. At first glance it might appear to be another application of the no-conflict rule that is the so called "fair dealing rule" which provides that if a trustee purchases the beneficial interest of his beneficiary it will be set aside unless he can show that he took no advantage of his position, has made full disclosure, and that the transaction is fair and honest.[20] But in fact it is concerned not with the purchase by the trustee of the beneficiary's interest but with transactions concerning the trust assets and his own property (presumably other than the transfer of trust assets to himself which is dealt with by article 27) and with transactions concerning the trust assets and the assets of other trusts (presumably limited to cases where he is trustee of those other assets too).

These are particular instances of where the no-conflict rule would apply but it does not cover every instance where there is a potential conflict between the interests of the trustee and the beneficiary. What for example if the trustee employed a close relative or a company within his control to carry out services on behalf of the trust in return for remuneration or diverted to himself some business opportunity which came his way by reason of his position as trustee but which he could have exploited for the benefit of the trust? In both cases he would be in breach of the no-conflict rule. Is he in breach of the 2001 Trust Law? If not, what is the consequence for the attempt to incorporate fiduciary duties into Chinese law.

[19] *Tito v Waddell* [1977] Ch 106 at 241
[20] ibid.

The answer to the first question, it is suggested that is that he is not in breach of the Trust Law. It seems clear that those drafting the Trust Law specifically addressed the extent to which they wished to incorporate the no-conflict duty and decided to do so only in specific cases, being those where the trust assets were directly in danger. The answer to the second question in my view is the Trust Law is nevertheless effective to incorporate fiduciary duties into Chinese law although it does not do so to the quite the extent as is usual in an English trust.

That conclusion seems on face of it inconsistent with Professor Conaglen's analysis. If the result of his analysis is that fiduciary obligations necessarily require the application of no-conflict rule then it would seem to follow that the trustees of a Chinese trust do not owe fiduciary obligations and are not fiduciaries. However there is no such problem if Professor Smith's analysis is correct. The duty of loyalty in the form of an obligation to act in good faith in the interests of the beneficiaries is imposed by article 25. Although the no-conflict rule is, on his analysis, derived from duty of loyalty he does not suggest that the duty of loyalty cannot exist without it.

Furthermore even Professor Conaglen accepts that fiduciary obligations can be modified by the trust instrument. Of course a point may come where those obligations are so watered down that the relationship between the parties can no longer be regarded as that of trustee and beneficiary at all. The question of what was the minimum necessary for the relationship of trustee and beneficiary to subsist was addressed by Millett LJ in another influential judgment of the Court of Appeal in England as follows:

> "*I accept the submission made on behalf of Paula that there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts. But I do not accept the further submission that these core obligations include the duties of skill and care, prudence and diligence. The duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is sufficient*".[21]

Accordingly, according to Millett LJ, it is sufficient that the trustee has the obligation in article 25 to act in good faith for the benefit of the beneficiaries. Provided that he does so he may be called a trustee and, in my view, it is also correct to regard him as owing fiduciary obligations.

The problem with the 2005 Company Law is not that whether or not it imposes fiduciary obligations but rather as to the content of those obligations. Articles 147 and 148 provide as follows:

> "*147. Directors, supervisors and senior officers shall abide by laws, administrative regulations and the articles of association of the company, and have a fiduciary obligation and obligations of diligence to the company.*

[21] *Armitage v Nurse* [1998] Ch 241 at 253

Directors, supervisors and senior officers may not take advantage of their positions and powers to collect or accept bribes or other illegal income, and may not encroach upon the property of the company.

148. Directors and senior officers may not have the following acts:

(I) misappropriate the funds of the company;

(II) deposit the funds of the company in an account opened in his personal name or in the name of another individual;

(III) in violation of the articles of association of the company, lend the funds of the company to other persons or use the property of the company to provide security for other persons without the consent of the board of shareholders, general meeting or the board of directors;

(IV) enter into a contract or transaction with the company in violation of the articles of association of the company or without the consent of the board of shareholders or general meeting;

(V) take advantage of the convenience of his position to seek for himself or other persons commercial opportunities that belong to the company or to operate by himself or for another person the same type of business as that of his company without the consent of the board or shareholders or general meeting;

(VI) accept as his own the commissions of a transaction between another person and the company;

(VII) disclose the secrets of the company without authorisation;

(VIII) other acts that violate his fiduciary obligation to the company.

The income derived by a director or senior officers from violating the provisions of the preceding paragraph shall belong to the company."

The first sentence of article 147 contains an obligation on directors, supervisors and senior officers amongst other things to abide by the articles of association and so exercise their powers for proper purposes. It also imposes on them a duty of care. The second sentence of article 147 applies the no-profit rule to bribes and illegal income and, it seems, prevents them appropriating the property of the company. Article 148(VI) extends the no-profit rule to other commissions. Article 148(V) prevents directors and senior officers from exploiting business opportunities that rightly belong to the company or from competing with the company and to that extent applies the no-conflict rule and the no-profit rule. But there is no express application of the no-conflict rule or no-profit rule more generally than in these specific instances. Nor is there any express obligation on directors, supervisors or senior officers to act in good faith in the interests of the company. If any of these obligations are imposed this can only because they constitute a "*fiduciary obligation*" within the meaning of article 147 or article 148(VIII).

The question of the extent to which such obligations are imposed again depends on what is meant by fiduciary obligations. If Professor Conaglen is correct then it would appear that the no-conflict rule and the no-profit rule are imposed but not any obligation on the part of directors and others to act in good faith in the interests of the company since he would not regard these as fiduciary obligations. If Professor Smith is correct then there is no doubt that directors and others would have an obligation to act in good faith in the interests of the company but it is uncertain whether or not the no-conflict rule and no-profit rule would also apply.

In my view the answer is that all these obligations are imposed. As Professor Conaglen has acknowledged the no-conflict rule and no-profit rule (which are imposed expressly at least in particular situations) make no sense unless there is an underlying obligation to act in good faith in the interests of the company. As to the wider application of the no-conflict rule and no-profit rule beyond the specific instances expressly dealt with, although these are not absolutely essential for the recognition of fiduciary duties they are commonly a part of a fiduciary's obligations. Accordingly in the absence of any express or implied exclusion they should be regarded as included.

In summary the English doctrine of fiduciaries was effectively incorporated into the Trust Law and the Company Law of the People's Republic of China. Long may it flourish and long may it foster trade and relationships between our two countries.