

# Drafting a Bill of the Commercial Trust Law in Japan

## I. Introduction

The drafting work of the Commercial Trust Law in Japan dates back to 1986, when 10 legal scholars, including ourselves, and 8 trust bankers gathered to undertake research on the law of commercial trusts. Over the last three years, in particular, we have focused on drafting a Bill to modernize and reform the law of trusts in Japan, at least in commercial fields. We are here very much pleased to present our Draft Bill to the annual meeting of the Trust Law Society in Japan for discussion to improve its contents and to finalize it.

## II. The current state of the Japanese law of trusts

Japan is a Civil Code country. Yet it has had a statutory law of trusts since 1922. This Trust Act was produced under the influence of U.K. law, but some scholars still describe it as a drop of water on a sea of oil.

Why was the Trust Act introduced into Japan in 1922? The process began with the commercial aspects of trusts. Our parliament (the Diet) had already enacted the Secured Bond Trust Act in 1905. To issue secured bonds, an issuer was required to make a contract with a trust company, which would keep the collateral in custody for investors. That was the first time that trust schemes were introduced into Japan. Legislators took the view that a great number of investors would be involved in these transactions and that their membership would often change, which conditions would require a trustee company to protect and keep the collateral for bonds. What we see here is that, in Japan, from the beginning, the trust was introduced as a commercial vehicle. A little

later in the 1920s, our parliament felt the need to enact the Trust Act as a response to some scandals involving trust companies which had misappropriated investors' money or collateral.

Some of the unique characteristics of the Japanese law of trusts become clear from this background. In particular, they have not used the trust as a will substitute, and in most cases trustees have been limited to trust companies or trust banks. If we limit our focus to the commercial aspects of trusts in Japan, another interesting aspect emerges. In spite of the numerous and wide-ranging changes in business and investment activities over the last eighty years, Japan's Trust Act has scarcely been reformed or amended. As a result, trust bankers, government regulators, and legal scholars now agree that some of the provisions in the Act are outdated.

Let us enumerate at least four problems with the Act.

First, a basic tenet of the Trust Act in Japan has been that its provisions are understood as being mandatory. Although classified as part of private law, most scholars regard the Act's key provisions as being mandatory, including section 22, the duty of loyalty. Section 22 of the Act states that self-dealing by a trustee is strictly prohibited, and it is permitted only if both of the following two conditions are met: (i) where the circumstance is so urgent as to require the self-dealing and (ii) the court expressly authorizes it. Consent by the beneficiaries or settlors by itself is insufficient. Perhaps this strict interpretation becomes more understandable if we take into account both the background to the enactment of the 1922 Act and also the tendency on the part of Japanese lawyers to stick to the wording of the statutory law.

This approach, however, gave rise to practical problems. For instance, under the Japanese land trust scheme, where a trust bank plans and develops an office building so that beneficiaries may receive rent regularly, it would be desirable and helpful for the trustee's branch to be

included in the building. The trust bank would pay market rent to the trust as a stable tenant. They have never done this, however, for fear of violating section 22!

Second, some of the provisions of the Trust Act are obscure and ambiguous. For instance, section 36 reads that the trustee has a right to reimbursement of expenses against the beneficiary, but adds that the right shall be forfeited if the beneficiary waives beneficial interests. Commentators in Japan differ in their interpretation of this section. Some argue that, as a practical result of this provision, the trustee has no recourse against the beneficiary. Others contend that the trustee can recover from the beneficiary, at least to the extent that the latter benefited from the trust. At any rate this uncertainty presents an obstacle to the reasonable calculation of risk on the part of commercial trustees.

Third, under the Trust Act, the settlor rather than the beneficiary occupies an important place in the trust scheme. If the trust is a vehicle for the beneficiaries, then they should be given a say in, for instance, the modification of the trust or a merger and division of the trust. In Japan, the trust has been regarded as a kind of contract. This is the main reason for the settlor enjoying a large number of powers over the trust. In many commercial trusts, however, beneficiaries should and could be given a primary role in monitoring the on-going administration of the trust.

Fourth, despite the fact that commercial trusts are prevalent in Japan, the Trust Act has not responded to its unique situation. In the usual Japanese trust, the beneficiaries are numerous, which makes for serious problems in practice: How are their beneficial rights enforced? Is each of them able to enforce their rights severally or are they required to act unanimously? In the case where the majority rule applies, how do they decide? The Trust Act has not supplied any answers to these

questions.

In sum, the Japanese Trust Act is now obsolete and far removed from the realities and practical necessities of today.

### III. Drafting the commercial trust law

Against this background, we formed a study group aimed at drafting an appropriate Commercial Trust Law for Japan. It is not intended as a Draft Bill for introduction to Parliament directly, but a sort of Restatement, prepared by a group of scholars with great help from trust bankers. We hope that this Bill can form the basis for drafting a new Japanese trust law in the future.

Here we would like to explain very briefly the basic characteristics of the Draft Bill.

#### 1) Commercial Trust Act as default rules and introduction of disgorgement relief

Two examples will show that the Draft bill is intended to provide default rules, and its provisions are not of a mandatory, regulatory nature. Further, it is intended to give the trustee more freedom to exercise his discretion and expertise.

The first instance is the duty not to delegate. Section 26 of the current Trust Act states that, unless otherwise agreed in the trust instrument, it is only in extreme circumstances that the trustee may delegate his powers. Although this section appears to be, and is in fact, a default rule, trust banks have been much too cautious with delegation as a result.

The Draft Bill changes the rule of non-delegation into a rule of delegation: unless otherwise agreed in the trust instrument, the trustee can delegate his power (section 432).

Under this new provision the trustee can make a professional judgment as to the efficient administration of trust property. Also

Japanese trust banks are likely to make clear in the trust terms at the inception of the trust what kind of administrative function will be delegated. They feel confident to do so under the new rule, which reads that delegation is the rule, not an exception.

The other example concerns the duty of loyalty. The Trust Act has been both under-inclusive and over-inclusive with regard to the duty of loyalty. Section 22 proscribes the trustee from transferring the trust property into his own property and from otherwise procuring his own rights to the trust property. If such an act is necessary for the benefit of beneficiaries, the trustee must go to court to show that it is a sort of emergency and there is urgent need to do so. It is too strict a prohibition against self-dealing. Even where all the beneficiaries consent, the section still governs. Despite this strictness, however, the provision does not cover other sorts of conflicting situations. If the trustee has nothing to do with owning rights or property on the trust property, the section is not applicable. For instance, he can offer the trust property as security for his own debts. Also there is no section to deal with the conflict of interest between one trust and another.

Our new Draft Bill sets out the general provision of the duty of loyalty. A conflict of interest is prohibited as a general rule against the trustee. It is allowed, however, in three cases: first, when the terms of trust expressly permit it; second, where the trustee acquires informed consent from the beneficiaries with material information furnished to them; or third, where the deal in the conflict of interest itself is fair. As a matter of fact, under the very strict rule against the self-dealing, the trust banks have been allowed to accept the trust property into their account on condition that the interest rate is fair in market terms and they are under control of a regulatory agency. Accordingly, the new Bill will fill the gap between the practice and the law in the books.

An important point is that the no profit rule is made express for the

first time. Under the Japanese Civil Code, which also governs trust relationships, the primary monetary relief for the beneficiary is damages. Since no distinction exists between common law and equity in Japan, an action for damages prevails and the content of damages is the recovery of loss on the part of the trust property. In a case where the trustee gains unjust enrichment in excess of amount of damages, the remedy of damages remains the only available relief apart from other sanctions such as the removal from office, and some form of criminal sanctions, if applicable. The Draft Bill introduces the relief of disgorgement from the enriched trustee.

2) Limited liability

It is a basic rule that the trustee owes personal liability to the third party involved in the transactions for the trust administration. In commercial trusts, however, the trust banks usually wishes to limit their liability to the trust property, and to avoid personal liability. Our Draft Bill makes it clear that if the trustee expressly deals with the third party as trustee, his liability shall be limited to the trust property. To protect the creditor's interests, the limited liability of the trustee shall be forfeited when he distributes the trust property to the beneficiaries with the knowledge that the resulting funds will be insufficient for the creditors.

Under the current Trust Act of Japan, it may be possible for the trust creditor to reach the beneficiaries by subrogation of the trustee's right to reimbursement for those expenses he spent for the trust. As we described earlier there has been arguments about the effect of the beneficiaries' waiver, but this ambiguity has made beneficiaries unsecure or at least uncertain as to their risk. The new Draft Bill makes clear that the beneficiaries are safe. Most commercial trusts are a variety of investment schemes. In such cases, the beneficiaries as investors should

legitimately be able to expect limited liability. To design a better scheme for investment in a trust form, it is desirable to disclose information on the risk of investment and contents of trust property so that it may not be an unfair surprise to every party with interests, including the trustee, the beneficiaries and the creditors.

### 3) Modification, merger, division and termination of trusts

The current Act has no provisions for the modification, merger and division of a trust. In commercial trust practice, this has been a cause of concern. The Draft Bill provides that the modification of a trust can be made by the agreement of the trustee and the beneficiaries. Also a trust can be terminated in the same way. Under the American law of trusts, the settlor's intent has been a primary concern and is as deeply respected as possible. In commercial trusts, however, it is not the settlor's intent, but the investment scheme itself that is important. If the trustee and beneficiaries or investors agree that the trust should be modified or terminated, then there is no need to intervene.

Also the Draft Bill makes stipulations in relation to the merger and division of trusts. Change in economic conditions sometimes makes this desirable. It may be possible to provide for this through the terms of individual trusts, but in the absence of any express provisions, the Bill reads that the trustee can merge or divide the trust with the consent of beneficiaries (sections 821 and 822).

### 4) Provision for multiple beneficiaries

The current Act provides no sections which deal with cases where there is a great number of beneficiaries, as is usual in commercial trusts. The Draft Bill introduces a number of ways to respond to the situation. First, not unanimous consent but that of majority votes is sufficient in most cases where beneficiaries' consent is needed. For instance, the

consent to the transaction by the trustee in conflicting situations can be made with the support of a two-thirds majority. Alternatively, a trust instrument may set up a meeting of beneficiaries in case of need in the future. In that case, the meeting will be held when consent by the beneficiaries is necessary. To protect minority beneficiaries, the Draft Bill introduces a sort of appraisal remedy. They can claim that the trustee should purchase their interest at the market price.

Finally, the Draft Bill invents a representation system for multiple beneficiaries. The beneficiaries can appoint a representative beneficiary to whom they can delegate their powers to a certain extent, and in case no appointment is made, it is still possible to nominate a representative manager for beneficiaries if the trust terms permit. The representative manager will be able to exercise certain powers of beneficiaries.

#### IV Conclusion

As we have seen in this brief overview, the Draft bill for commercial trusts in Japan is unique. It responds to some of the problems inherent in the current Trust Act, and its commercial nature is also clear. It could be argued, however, that the Draft Bill has something in common in its direction with the Uniform Trust Code and other reforms in the law of trust in the United States.

In Japan, our parliament enacted a new law regarding asset-backed securitization this May. In that Act, a trust scheme for securitization was introduced for the first time and some of the provisions in our Draft Bill, such as the beneficiaries' meeting and a representative beneficiary, were already included in the new law. We will hope to go forward toward the establishment of a more general law of commercial trusts in Japan.