

# Legal Analysis on Rigid Payment of Commercial Trust

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## ABSTRACT

This paper analyzes the causes of formation of rigid payment from the business perspective and the non-commercial perspective. In the first place, rigid payment is the competitive means in the early development of trust, when trust companies won investors' trust with rigid payment agreement. Secondly, the reasons for rigid payment also include avoiding mass disturbances. Administrative organs often force the trust institutions to pay by administrative instruction. The harm of rigid payment mainly lies in causing systemic financial risks and the happening of "bad money driving out good money" in which bad trust runs on good trust, making it impossible for normal trust market to establish its order. As for the legal consequences of rigid payment, according to the Normative Purpose Theory of Germany's Civil Law in regard to invalidity of legal acts, the legal prohibition against rigid payment should be considered as Content Prohibition. The invalidity of rigid payment should be deemed as invalid, if it is illegal, while the payment that does not violate the normative purpose of legal prohibitions should not be judged as invalid.

**Keywords:** Trust Relationship, Rigid Payment, Illegal and Invalid, Normative Purpose Theory

## 1. INTRODUCTION

On April 27, 2018, the People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission, and the State Administration of Foreign Exchange jointly promulgated the Guidance on Standardizing Asset Management Business of Financial Institutions (hereinafter referred to as the New Regulations on Asset Management). After the Measures for Management of Trust Companies and Measures for Management of Trust Companies' Assembled Funds Trust Plan, this regulation clearly points out that asset management products shall not make rigid payment. The Article 19 of this document defines rigid payment from the perspective of specific behavior, and stipulates the penalty measures of rigid payment. As a competitive means, rigid payment has been adopted by many trust companies since the trust industry started in China. Now, the situation of rigid payment is gradually changed. By 2021, more and more trust companies, such as Citic Trust and Yunnan International Trust have chosen to stop issuing fixed income products, that is, to terminate the use of rigid payment in trust. This paper discusses the causes and adverse effects of rigid payment, and the legal consequences of rigid payment as well.

## 2. CONCEPT OF RIGID PAYMENT

The rigid payment in trust is a kind of economic phenomenon, reflecting the balance of returns and risk in financial life. [1] The word "payment" originally refers to the obligation of liabilities settlement of financing institutions' liabilities. According to that, bank's obligation of repaying capital and interest to customers only exists in case that debtor-creditor relationship is similar to bank and its customer.[2] In a trust, the trustee only has the obligation to pay to the beneficiary for the trust interests arising from managing the trust property and handling the trust affairs, and there is no the so-called payment obligation. Rigid payment in a trust generally means that after the maturity of the trust product, the trustee must allocate the capital and the agreed benefits to the investor when the payment cannot be made as scheduled or it is difficult to make the payment, except for the case where the actual benefits are greater than the agreed benefits. The definitions of rigid payment by regulators and judicial organs are exactly not the same. Regulators defines it from the specific form. Rigid payment consists of four cases (as referred in Article 19 of the Regulations for Asset Management): 1. The issuer or manager of asset management products violates the principle of "real, fair and confirmed net", capital

preservation and income preservation are guaranteed. 2. The form of rolling release and other methods are done, transferring the capital, income and risk of asset management products among different investors, so as to guarantee the product's capital and income. 3. If the asset management products cannot be redeemed as scheduled or are difficult to be redeemed, the financial institution that issues or manages the products shall raise funds by itself or entrust another institutions to make the payment on its behalf. 4. Other circumstances identified by the financial regulatory department. Judicial organs start from the meaning of rigid payment--The Minutes of the National Civil and Commercial Trial Conference of Courts (hereinafter referred to as the Minutes) defines "rigid payment" as "Contract containing articles guaranteeing fixed return of capital and interest and guaranteeing the capital will not be damaged, and other provisions for minimum guarantee, that is signed by trust companies, commercial banks and other financial institutions (serving as the trustees of asset management products) with the beneficiary of the asset management products."

### **3. CAUSE AND HARM OF RIGID PAYMENT**

#### ***3.1. Cause of Rigid Payment***

When it comes to rigid payment, the cause of rigid payment has always been a topic that scholars cannot get rid of. Some scholars, starting from the explanation of reputation mechanism, proposed that trust companies would establish reputation through "rigid payment" in the early stage, in order to obtain future earnings.[3] From the perspective of legal theory, some scholars thought that rigid payment is the result of capitalist' pursuit of maximum interests in the era of large capital management. It is also the disease caused by the imperfect trust legal system and the lack of strict supervision in China.[4] The author believes that the cause of rigid payment can be discussed from both commercial and non-commercial perspectives. From a business perspective, in the early stage of trust in China, investors did not believe trust from the Anglo-American law system and they were skeptical to the core concept of trust—trust property are transferred to the trustee from the investor, thus making investors becoming more and more skeptical to the trustee' s credit and ability of managing trust estate. Therefore, in order to eliminate investors' doubts and choose trust business, trust companies agree with investors in advance on the "rigid payment" clause that the capital and income of trust products shall be guaranteed. Conventional rigid payment methods include issuing commitment letters, signing differential compensation agreements, repurchase contracts, etc., while unconventional methods include rolling release, etc.[5] Making up for

the doubt of investors on trust by means of giving real interests to investors, rigid payment actually become a kind of sharp practice adopted by different trust companies when they compete with each other and when the business of trust competes with other asset management businesses like security and stocks. From non-business perspective, since too many are involved in collection fund trust, mass events may be triggered, if problems occur in the management of trust products and payment risks occur. In order to maintain social stability and maintain political performance, the government and corresponding regulatory agencies will require trust institutions to make rigid payment as remedial measures after the event through administrative orders. In the early practical operation of trust, the regulatory agencies and government often acquiesce in the existence of rigid payment, which also connived at the trust companies to violently agree on rigid payment with the client in asset management products.

#### ***3.2. Harm of Rigid Payment***

Although rigid payment played a certain role in the early development of China' s trust industry, rigid payment in trust products will cause bad influence and harm to the market. Therefore, in the process of continuous development and growth of China' s trust industry, regulatory authorities have clearly stipulated that trust companies shall not make rigid payment in regulatory documents such as Measures for Management of Trust Companies, Measures for Management of Trust Companies' Assembled Funds Trust Plan and New Regulations on Asset Management. There are two main reasons why rigid payment should be restricted. First, rigid payment will disrupt the order of financial market and cause financial systemic risks. When trust products cause risks, trust companies can only use their own funds or other funds that should not be flowing into the trust market to make rigid payment. This huge payment risk, unhealthy capital allocation, and many other problems will eventually bring about systemic risks to the financial market as a whole. When there is a tiny risk, trust companies can also use the way of rolling release and the way of buying the new one to make up for the old, to cover the risk. But, when the risk accumulates and gradually expands, it is likely to form systemic risk, thus damaging the financial market. Secondly, because of the existence of rigid payment, the Gresham's Law will appear in the trust market, forming the status quo of bad trust running on good trust. Therefore, a normal trust market order cannot be formed in China. One of the most basic principles in market economy is the principle of buyer's responsibility, which simply means that buyers should bear the risks or benefits caused by their own investment behavior. However, rigid payment violates this principle and forms an unreasonable resource mismatch. For trust, the

high-yield product in asset management business, investors should bear the risk equal to its earnings. But due to the existence of rigid payment, the trustor and the beneficiary, as the parties of trust legal relationship enjoy trust high yield of trust products without bearing any risk at the same time. Thus, investors often ignore the risk of such trust product while choosing trust products, with the expected yield as the choosing condition. Therefore, the bad trust of high yield runs on good trust of normal earnings. The choosing rate of trust product depends on the expected earnings of trust products. As a result, a trust product with poor quality but high earnings speeds its release, while good trust will be damaged since investors often choose the bad trust. In the long-term market, with the acceleration of issuing of trust products of poor quality, there will be a certain crowding out effect on projects of better quality.[6] The existence of rigid payment makes investors lack the right awareness of risk, misleading investors be sure to get high profits in zero risk in the level of fact, and strengthening the speculative mentality of the investors. Therefore, rigid payment disturbed the establishing of normal order of China's trust market. That is one of the reasons why our country limits rigid payment in trust.

#### **4. LEGAL EFFECT OF RIGID PAYMENT**

##### ***4.1. Analysis on Legal Provisions of Rigid Payment in China***

The legal effect of rigid payment has always been a blind spot in the academic field when discussing rigid payment. When discussing the legal consequences of rigid payment, rigid payment is often recognized on the premise that it is invalid due to the violation of the law, according to the relevant measures of invalid legal acts in the Civil Code. The author believes that in the current theoretical general theory of "illegal  $\neq$  invalid", the problems related to "illegal" and "invalid" need to be explained before discussing what kind of rigid payment needs to be identified as illegal and invalid.

Article 153 of China's Civil Code stipulates that any civil juristic act in violation of the mandatory provisions of laws or administrative regulations shall be invalid. But, such mandatory provision that does not invalidate the civil juristic act is an exception. Civil juristic acts that violate public order and good customs are invalid. It can be seen that China has already differentiated effective compulsory provisions and administrative compulsory provisions at legislative level. And the juristic act shall be invalid only when it violates the effective provisions. Although the legal act violating the administrative provisions is illegal, it shall not be determined as invalid, and it shall still be recognized as valid, and it will only be negatively

evaluated with the nature of punishment. As for rigid payment, there is no detailed regulation on whether it is invalid when it breaks the law in China's current legislation. The Trust Law, which has the highest legal effect level, does not directly specify the legal effect of rigid payment. In 2018, before the introduction of the New Regulations on Asset Management, documents such as Measures for Management of Trust Companies, Measures for Management of Trust Companies' Assembled Funds Trust Plan and so on, only prohibit rigid payment in content, but not specify the concept of rigid payment, i.e. what kind of acts belong to rigid payment and the consequence of violating the prohibitive provisions in the Measures for Management of Trust Companies. The overall provisions are relatively general, and it does not explicitly point out whether the prohibitive provisions in the above-mentioned two kinds of documents are effective compulsory provisions or administrative compulsory provisions. After the introduction of the New Regulations on Asset Management in 2018, the consequences of violating the prohibitions on rigid payment were added. According to the New Regulations on Asset Management, (1) In case of rigid payment, the depository financial institutions should pay the deposit reserve and deposit insurance premium in full and be subject to administrative punishment. (2) Non-deposit licensed financial institutions that make rigid payment shall be deemed to be illegal business operation, and shall be corrected and punished by the financial supervision & regulation department and the People's Bank of China in accordance with the law. The final provisions have not been made on whether the rigid payment is illegal and on the consequences when it is determined as invalid. In conclusion, although the Trust Law does not explicitly stipulate that rigid payment is a prohibited act. But from the view of Measures for Management of Trust Companies issued by the original CBRC in January 2007 January and Measures for Management of Trust Companies' Assembled Funds Trust Plan and the relevant regulations of the recent New Regulations on Asset Management, regulators have clearly defined and regulated the acts of rigid payment of trust investment products with a clear attitude that cannot be questioned from different perspectives, and they specified the illegal properties of rigid payment act.[7] As for whether the rigid payment is invalid when it violates the law, the relevant legal documents only stipulate in Article 92 of the Minutes issued by the Supreme People's Court, that the minimum guarantee or rigid payment promise is invalid.

##### ***4.2. New Thinking of Legal Effect of Rigid Payment***

It can be seen from the above, as the legal effect of rigid payment has not been recognized in our country,

the author thinks that the Normative Purpose Theory in German civil law can be adopted as well. That is, the legal consequence is determined by what purposes of law prohibitions.[8] Here, we analyze rigid payment in reference of Zhu Qingyu's point of view, that legal prohibitions can be divided into content prohibitions, practical prohibitions, and pure order regulation in accordance with the Normative Intent. The reason for China's ban on rigid payment in trust conforms to the content prohibitions, where prohibits the realization of the content of the agreement of the parties and the legal consequences pursued by the parties. To be specific, when rigid payment happens, regulators do not direct at redemption itself. In financial field, redemption is a kind of normal commercial activity. While what regulators prohibit is exactly such agreement stipulated in addition by the trustee and the trustor, on minimum guarantee and income guarantee, in the beginning of development of trust agreement; or, it is difficult for repay of the asset management products issued by trust institutions, trust institutions forcibly make repay with its fund or other means, causing the asset management products that cannot be paid still be paid as scheduled. What should be prohibited is the content itself. Therefore, the legal prohibition against rigid payment shall belong to the content prohibitions. From the Normative Intent Theory, it can be seen that the legal acts violating the content prohibitions are invalid.

Therefore, when our nation's law has not yet specified whether rigid payment is invalid when it violates the law, we need to radically reform and do not determine it as invalid after determining it as illegal. The author thinks that, first, in practice, it seems that the trustor has signed the trust agreement with the trust institution, where minimum guarantee and income guarantee are promised by the trust institution. But in fact, what the trustor signs with the trust institution is credit terms. The actual behavior of lending in the name of trust is different from rigid payment in trust, and it should not be regarded as illegal or invalid. Second, in the process of trust, even if the trustee does not clearly or impliedly say payment, but causes losses to trust property due to its insufficient management ability, the trustee shall bear the responsibility corresponding to the fault, namely the liability for damages. The legal nature of such behavior should be that the trustee bear the civil liability, nothing to do with rigid payment, and should not be regarded as invalid. In the following cases: (1) in the commercial trust, the trustee agrees the minimum guarantee commitment in the agreement or secretly; (2) when the asset management products fail to be paid on time or it is difficult to be paid, the financial institution raises funds by itself to pay or entrusts other institutions to pay on its behalf. All these circumstances shall be invalid. The author believes that the reason why China's regulatory agencies and legislative organs should crack down on rigid payment is that maintaining a good and

stable financial order and preventing from financial systemic dangers. Therefore, the act of credit and loan with the behavior of trust under the guise of rigid payment should be excluded from rigid payment that is prohibited. The reason is that, the act of credit and loan does not violate the social relationship that the law prohibitions against rigid payment aims at. The trustee bears civil liability for compensation in accordance with legal judgment, which is not also contradictory to the purpose of maintaining the good and stable financial order and avoiding financial systematic risks.

## 5. CONCLUSION

Regulatory authorities' opinions and judicial authorities' judgment on rigid payment are not clear. Under this background, there is still some space to explain the force of "rigid payment". By adopting the Normative Purpose Theory in Germany's Civil Law, the force of rigid payment after being regarded as illegal can be clarified. The author thinks that only the rigid payment which really violates the law and conforms to the content prohibitions shall be affirmed as invalid, while other types of "rigid payment" should be regarded case by case.

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