

A Trust for Commercial Use in Japan: An Unexpected Winner in the Race among Organizational Forms

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INTRODUCTION

While a trust is a widely used legal form for commercial arrangements in many developed countries, many questions about trusts remain unanswered. For instance, why is the trust form so popular, compared with other competing legal forms? Why is a trust used for certain commercial arrangements, and not for others?

In Japan, trusts are often used for a variety of commercial arrangements. But the most popular types of commercial trust used in Japan -- loan trusts and money trusts, as described hereafter -- do not exist, or at least are not in common use, in the United States or the United Kingdom. Why is this?

This short essay examines this puzzle. Two tentative arguments are submitted. First, the advantage of using the trust form for a particular commercial arrangement depends on the costs of private law and regulation associated with using other distinctive legal forms, such as a corporation, and while many of the legal and regulatory attributes ascribed to trusts exist in corporations and other rivals, those other forms are often subject to additional (and sometimes stricter) laws and regulations, so that a trust is often an unexpected winner in the race among organizational forms.

Secondly, developments in general trust law reflect this race. More specifically, developments in trust law in recent years show a departure from the traditional model of a family trust. They reveal a trend toward recognizing more flexibility that makes the trust form more attractive in the competition with corporate and other organizational forms for commercial use.

Section I briefly describes trust business in Japan, and shows the popularity of trusts in areas where trusts are not commonly used in the United States or the United Kingdom. Section II examines the private law aspects of trusts and other legal forms, while Section III focuses on the regulatory aspects of trust business in Japan. Section IV overviews recent developments in the general trust law. Conclusion follows.

I TRUST BUSINESS IN JAPAN

In Japan, trust business can only be carried out by entities licensed under the Trust Business Act (Act No. 154 of 2004, as amended) and financial institutions licensed under the Act for Financial Institutions' Trust Business (Act No. 43 of 1943, as amended). Until the early 1990s, trust business was monopolized by eight financial institutions, of which seven were known as trust banks. Following the reform of the financial system in recent years, today over 200 financial institutions and entities are licensed to carry out trust business in Japan.

In Japan today, individuals own financial assets totalling over 1,700 trillion yen (about 13 trillion euro), with corporate entities owning another 700 trillion yen (about 5.3

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trillion euro). Among these financial assets, assets in the amount of over 900 trillion yen, or 37.5%, in the form of trust assets are in the hands of commercial trustees.¹

One of the surprising facts about trust business in Japan is the popularity of loan trusts and money trusts (as described hereafter), although loan trusts were popular in the 20th century but are no longer popular today. Generally speaking, loan trusts do not exist in the US or the UK, and the inevitable question arises as to why this is.

A) *LOAN TRUSTS*

A loan trust is an arrangement where the trustee, typically a trust bank, accepts money from the general public and uses it to extend loans to business borrowers. The law permits the trustee to guarantee repayment of the “principal”, and the practice is for the trustee to announce expected “interest” payments when accepting money as the principal. When interest rates were controlled by banking regulations, this expected interest payment was likewise under regulatory control, as was the term of the trust: either two or five years. There was no single case in which the trustee failed to meet the interest payment it had announced or to repay the principal. Moreover, deposit insurance is available to cover repayment of the principal amount under the Deposit Insurance Act. In short, a loan trust is almost identical to a bank deposit, although legally the investor’s claim is a beneficial interest in the trust property (i.e. loans) rather than a mere creditor’s claim against the debtor bank.

B) *MONEY TRUSTS*

A money trust is similar to a loan trust except for some important aspects. The trustee usually invests the trust assets in securities, such as shares and bonds. Deposit insurance does not apply, and the trustee usually does not guarantee repayment of the principal. Also, distribution of dividends out of the profits rather than a pre-announced “interest” payment is the normal practice. There are several types of money trust. One is a trust where the trustee accepts money from numerous general public investors and manages it (as a pool) with wide discretion, but subject to portfolio regulation; for example, it is not permitted to spend all the money to purchase land. A second type of money trust is where the trustee accepts money from one entity – typically an institutional investor – and manages it with wide discretion without pooling it with other money. A third type is a trust where an institution as the settlor-beneficiary retains investment discretion and the trustee manages money in accordance with the beneficiary’s instructions.

C) *SECURITIES INVESTMENT TRUSTS*

The securities investment trust is modelled on the unit trust in the UK and regulated in the Japanese Investment Trust Act (Act No. 198 of 1951, as amended). A corporate form, which is popular in US mutual funds, was not permitted in Japan until 1998. Today, all open-ended funds organized under this Act for securities investments take the trust form. The trust structure is heavily regulated in this type of trust. The settlor must be a special-purpose registered institution which used to be prohibited from engaging in any activity

¹ See Trust Companies Association of Japan, *Trusts in Japan 2015* (July 2015) (in Japanese).

other than managing these investment funds. Today, the settlor company may serve as a securities investment adviser as well. The role of the trustee, typically a trust bank, is quite limited: it merely holds the trust asset. The regulator must be notified of any trust deed signed between the settlor and the trustee. Asset management is ensured by the settlor company, and the units of the trust (representing beneficial interests in the trust) are marketed to public investors through a network of securities brokers.

D) OTHER NOTABLE TRUSTS IN JAPAN

Among other commercial trusts in Japan, two are worth mentioning because they have become popular in recent years. One is a securitization trust, in which a trust is used as a vehicle for the securitization of financial assets – typically loans and receivables. This use of a trust is also found in the US, but does not appear to be popular in the UK, where the corporate form seems to dominate as a vehicle for asset securitization.

The other is known as a land trust. In this trust, the trustee accepts land from a land owner, puts up a building, and engages in the management of the property (hiring tenants, and so on). Importantly, the trustee usually draws up a complete plan for the land management and controls the entire property management process (for the benefit of the beneficiary). It often engages in borrowing for the purpose of undertaking the project. Generally speaking, this type of trust is not found in Western countries.

E) PUZZLES

There are various puzzles surrounding the commercial use of trusts in Japan. First of all, why is a typical trust in the US or elsewhere not found in Japan? That is, the maintenance of property for children or estate planning is not the major part of business for commercial trustees in Japan. Secondly, among the popular commercial trusts in Japan, neither loan trusts, money trusts nor land trusts exist in major Western countries, although this may be a bit of a blanket statement and thus somewhat inaccurate. Why? In short, with certain exceptions of course, what we observe in the US or the UK is not popular in Japan, and what we observe in Japan does not exist in the US or the UK. The remaining part of this essay explores these puzzles by examining whether the popularity of trusts comes from law or regulation of legal or organizational forms.

II PRIVATE LAW ASPECTS

In Japan, the private law governing trust arrangements is the Trust Act (Law No. 108 of 2006, as amended). Before the advent of this statute, the old Trust Act (Law No. 62 of 1922) was in place. The Trust Act provides a familiar legal structure for a trust relationship among the settlor, the trustee and the beneficiary.

An important fact, however, is that there was a huge gap between the letter of the old Trust Act and what happened in practice in the Japanese trust business. This gap was narrowed under the current Trust Act, but the following point still applies. The Trust Act states that a trust is created by the settlor when it transfers an interest in certain property to the trustee and asks the trustee to maintain or sell the property for the benefit of the beneficiary in accordance with the purpose of the trust. In practice (with respect to commercial trusts), however, the settlor – and thus the intent of the settlor – is unimportant.

It is often the case that the settlor and the beneficiary are the same, general public investors, property transferred to the trustee is just money, and the trustee's role is something more than, or different from, maintaining or selling trust property as the Trust Act envisages: money or other asset management with wide discretionary power.

Indeed, from a functional perspective, there are four distinctive types of commercial trust in Japan, and applying the basic principles recognized under the Trust Act to any of these types would lead to unwarranted results.

- (1) Trusts similar to deposit taking and lending: e.g., loan trusts.
- (2) Trusts for asset management: e.g., money trusts and securities investment trusts.
- (3) Trusts for securitization: e.g., money claim trusts.
- (4) Trusts for business: e.g., land trusts.

As this essay is hardly the place to explore how this gap between law and practice produced and still produces problems and concerns in commercial trust practice in Japan, suffice it to note that the Trust Act does not prevent the use of trusts for money or land management as observed in money trusts and land trusts.

It has been suggested that a trust has the advantage of creating insolvency-proof assets at low cost.² A corporation, however, can be used for this purpose as well. When an asset owner wishes to separate part of its assets from the reach of its creditors, it can simply place them into a separate corporate box. The question is, which is less expensive, a corporation or a trust? It is often said that a trust offers more flexibility than other legal forms. While this statement is not wrong, flexibility itself does not always mean inexpensiveness.

In general, a corporation offers more certainty in an owner's limited liability than a trust, and there is better-developed case law for corporations than for trusts. Thus, the choice between a corporation and a trust depends on the cost of setting up a new corporation and whether corporate law imposes additional costs with respect to the corporation's governance structure, creditor protection, and so on.

In the US, state corporate laws tend to be generous in respect of mandatory governance structures and mandatory rules for creditor protection, so that creating a corporate box is relatively inexpensive. This suggests that business done through the trust form in Japan, such as loan trust, money trust and land trust arrangements, is done in the corporate form in the US.³ Also, in the US, traditional civil or family trusts which enjoy favourable tax treatment are more popular.

In contrast, corporate law in Japan is much stricter in supplying mandatory rules on corporate governance and creditor protection. Thus, in general, in Japan business can be done in the trust form less expensively than in the corporate form.

It should be noted that this does not suggest that every kind of business done in Japan is in the trust form. First, a large business requires a large amount of capital, and the

² See H.B. HANSMANN and U. MATTEI, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 *New York University Law Review* 434 (1998). See also J.H. LANGBEIN, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 *Yale Law Journal* 165 (1997).

³ For an analysis of trust versus corporate forms in the US, see R. H. SITKOFF, *Trust Law as Fiduciary Governance Plus Asset Partitioning*, in Lionel Smith (ed.), *The Worlds of the Trust* (Cambridge University Press, 2013).

corporate form is much better when it comes to raising substantial capital in that it guarantees free transferability of shares and limited investor liability. Trusts in Japan (or indeed elsewhere) do not have characteristics such as corporate shares which allow for ease of transfer, and a beneficiary's limited liability is not always obvious from the Trust Act.

Secondly, tax law plays an important role. While trusts in Japan are subject to single-tier income tax and corporations are subject to double taxation, the latter is not necessarily worse than the former, because in the corporate form, the owner has control over the timing of dividend distributions and hence, of the second tax. This is particularly true in the case of an active business. In the case of passive investment, income tax is generally unfavourable to the corporate form unless it recognizes pass-through taxation as it does for certain pooled investments and securitization vehicles in the US.

Finally, regulation may not permit use of the trust form for certain types of business. In fact, the Trust Business Act, the Act for Financial Institutions' Trust Business, and other regulatory laws limit the scope of business done in the trust form in Japan.

III REGULATORY ASPECTS

As noted earlier, trust business in Japan is regulated with respect to who may serve as trustee. What can be done in the trust form is likewise regulated. The Trust Business Act and the Act for Financial Institutions' Trust Business regulate the activities of the trustee in each permissible commercial trust.

It might be argued that business or financial regulation should not be different depending on whether the trust or corporate form is used. In countries that adopt such "functional" regulation, the advantage of using a trust depends on private law and other factors. In the US, for instance, the regulation of pooled investment funds generally takes such a functional approach, and the Investment Company Act of 1940 regulates securities investment funds irrespective of whether they take the trust or corporate form. In fact, while the corporate form is popular for mutual funds, the number of funds in this form is smaller than that of business trust funds – although a business trust is not identical to a traditional trust under the relevant US private law.⁴

It is difficult to find a commercial area in Japan where regulation prohibits the use of the corporate form and allows the trust form. This may suggest that regulation is not favourable to Japanese trusts in this respect.

What is important, however, is that in Japan, almost all commercial trustees are financial institutions (most of which are banks licensed to do trust business under the Act for Financial Institutions' Trust Business), and their competitors in the greater part of their business are banks that are not licensed to do trust business. Those other banks ("ordinary banks") are regulated institutions and the scope of their business is quite limited.

Unlike what happens in loan trusts, ordinary banks are not permitted to separate deposits from their own treasury and create a bankruptcy-remote asset pool for lending purposes. The same is true of money trusts: ordinary banks cannot create a structure similar to a money trust. An ordinary bank may, in theory, create a separate corporate box as an insolvency-proof entity, but that entity is prohibited from taking deposits. Having such

⁴ See R.H. SITKOFF, *The American Statutory Business Trust: A Research Agenda*, in H. Tijo (ed.), *Regulation of Wealth Management* 17 (National University of Singapore, 2008).

entity issue securities and other instruments to public investors is understood not to be permitted. Tax law is also unfavourable to the corporate form in passive investment.

Competitors to trustees in land trusts are real estate companies, since ordinary banks are prohibited from engaging in real estate business. Here, it is difficult to show a clear legal advantage to using a trust. The relatively solid reputation of trust banks may explain the growth of land trust arrangements in Japan.

IV RECENT DEVELOPMENTS IN GENERAL TRUST LAW

Recent developments in general trust law are quite remarkable. For instance, in the US and elsewhere, the law tends to recognize wider trustee powers in the investment of trust assets. Also, the traditional focus on trust property has become blurred: a trust has been recognized as a contractual arrangement rather than a property arrangement. In Japan, the dominance of commercial trusts has produced flexible interpretations of relevant provisions of the old Trust Act by which property is unimportant and the entire contractual arrangement is the key. The current Trust Act endorses these interpretations. These developments signal a clear departure from the traditional model of the family trust, and this is understandable as a response on the part of trust law to the competition with corporate and other forms of business organization.

It should be noted that in the US, there is one set of general trust law both for family trusts and commercial trusts. The situation is the same in Japan, where the current Trust Act applies both to family trusts and commercial trusts, and the recent trend toward recognition of more flexibility is found in the law for both. In practice, however, the trust form is becoming more and more popular for small businesses. One possible reason may be that the forces for legal change in the field of commercial trusts are so strong as to affect legal change for family trusts, as well.

CONCLUSION

The advantage of using a trust for business and commercial purposes depends on the advantage of using other competing legal forms. The popularity of certain commercial trusts in Japan as opposed to Western countries may be explained by private law and public regulations which make the use of these competing forms, especially the corporate form, costly. The trust as a vehicle for commerce is thus very much contingent upon historical, political and institutional environments.