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Calculating liquidation losses in margin share trading accounts

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General introduction to trust margin trading

From the end of 2014 through the first half of 2015, China's share market soared, attracting large numbers of investors and a rapid expansion of investment capital. This very feast of capital market activity witnessed the springing up of numerous umbrella and other types of structured trusts. Lots of bank wealth management funds and private capital entered the stock market through trusts, and these became the mainstream model for participation in margin account share trading ("trust margin trading"). In April 2015, the CSRC decided that trust margin trading amplified fluctuations in the stock market and should be restricted because it was not beneficial to the healthy development of the market. At the time, the scale of trust margin trading had already reached a considerably high level.

Forced liquidation of trust margin trading accounts has caused controversy

From mid-June 2015, the stock market underwent fierce turbulence when thousands of stocks dropped to the daily limit set by regulation or were suspended from trading. Trust margin trading accounts also suffered heavy blows, the net value of many trust margin products reached or even fell below the stop-loss line. Trust companies had to forcibly liquidate margin accounts, inflicting calamitous losses on investors (mainly inferior-ranked investors). Some investors made claims against trust companies, triggering a variety of disputes.

We have been representing trust companies in dozens of complaints and litigation cases triggered by forced liquidations. Most of the claims have been brought by subordinate investors (margin borrowers) in trust schemes and a few by preferential investors (suppliers of margin funding).

What type of forced liquidation is liable for damages?

The anxiety of investors who have suffered losses is understandable, but many claims for damages we have seen have not been realistic. Extreme market conditions are a severe test of trust company management of margin trading, but also one of the risks all participants have to endure. Trust products are not supposed to guarantee profits and investment in securities by margin trading is inherently risky.

In trust schemes using margin funding, trust companies set clear stop-loss lines to protect the returns for preferential investors and also to control the investment risks for subordinated investors. When the net value of the property held in trust reaches the stop-loss line and subordinate investors fail to deposit additional funds within the agreed time limit, trust companies are entitled to liquidate the property held in trust. Whatever the consequences, a forced liquidation in conformity with the trust agreement is the fulfillment of the trust company's duty as a trustee. In principle, exercise of this function should not incur a liability to beneficiaries whether senior or subordinated investors.

Although there are explicit provisions for forced liquidation in trust agreements, in practice some liquidations are defective because of exceptional circumstances, for instance "erroneous" or "delayed" liquidations. A trust company which takes defective forced liquidation action in violation of its obligations under its trust may be liable in tort for investor losses. Different defective liquidations will trigger different liabilities.

How to calculate losses caused by defective forced liquidations?

The calculation of losses caused by defective forced liquidations is a critical issue in disputes. In terms of the basis for calculation, there are concurrent liabilities; for breach of contract and for tort. In relation to causation, factors like price fluctuation in the securities market and uncertainty of transactions have to be considered and analyzed case-by-case.

There are no explicit legal criteria for calculating losses caused by erroneous or delayed forced liquidations, and a number of views have emerged in the judicial practice.

View 1: a point in time before the liquidation as the base day to calculate losses

In Hu Er Zhong Min Liu (Shang) Zhong Zi No. 170 (2001), the Second Intermediate People's Court of Shanghai held that it is not reasonable to calculate the loss based on the stock price at a point in time after the liquidation, since this would call for the prediction of future prices. Accordingly a loss caused by forced liquidation should be calculated with reference to a base day before the liquidation. The Supreme Court expressed a similar view in respect of the futures market in the case of Min Ti Zi No. 111 (2010).

The calculation of loss should be based on prices at a reasonable point in time before the date of the forced liquidation, and any difference in the net property value between this time and the forced liquidation is deemed to be the loss caused by an erroneous or delayed liquidation.

View 2: no compensation for losses due to stock price fluctuation, but only compensation for loss of interest

The Intermediate People's Court of Changsha found in Chang Zhong Min Zai Shen Chu Zi No. 0101 (2009) that: "erroneous liquidations infringe an individual's right to his or her property and shall be deemed a tort. Given the risks and unpredictability of the securities market, the loss caused by the tort is calculated based on the value of the property when the tort occurred plus the loss of interest on that value."

Accordingly, the value of the property at the time of the erroneous liquidation is treated as the principal amount, and the loss is the interest accrued on this principal amount from the date of the liquidation.

View 3: compensation at the discretion of the court

In the case of Yang Min Wu (Shang) Chu Zi No.979 (2013) a decision of the Shanghai Yangpu District People's Court, the plaintiff lost a trade opportunity because of the defendant bank's action somewhat similar to an erroneous liquidation. The court determined the plaintiff's losses on a discretionary basis, taking into account factors such as the market conditions, the monetary amount in the plaintiff's account, the margins and the fees.

In considering these three views, we are inclined to prefer the first method, because it is more practical and minimizes the impact of market price fluctuation when assessing losses. The other two methods are applicable to special cases, and are not fully compatible with margin share trading through trust companies.

We find reasonable the "tracing-back calculation" method adopted under the first view, namely, that the loss is the difference between the net value of the property held in the trust account at the time of the delayed liquidation and the net value of the property held in the trust account at the agreed time of liquidation.

Possible defenses by trust companies against forced liquidation claims

In our experience investors' claims are almost invariably calculated using a "looking-forward" approach. Fluctuations in share prices cannot be foreseen by any market player, and calculations based on future prices is legally baseless and unreasonable. Basing values on prices that may occur at a future time can even result in an endless chain of losses. Thus a "tracing-back calculation" should be the first consideration when looking at losses.

It should be noted that "erroneous" or "delayed" liquidations will not necessarily lead to losses of property held in a trust account, and any calculation method should be flexible enough to take account of actual circumstances. For example, if the stock price tumbles after an erroneous liquidation or surges before a delayed liquidation, the following questions arise: is there a causal link between the forced liquidation and the losses or the worsening of losses? Would this objectively mitigate the losses? What's the most reasonable base day for loss calculation in different situations? How to reasonably exclude other factors that might influence the calculation of losses?

In general, whether there is any defect in the forced liquidation of a trust margin account, and how to calculate the losses caused by defective forced liquidations are hugely complex and case-specific questions. In this article, we have summarized judicial practice in the calculation of losses caused by defective forced liquidations. We hope this article will help all players to find suitable resolutions for the disputes they may face.

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