

## The substratum rule: does it matter?

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Over the past few years, offshore courts have been grappling with whether an overarching equitable concept known as the "substratum principle" exists. The substratum principle is explored further below, however the essence of the principle is that absent special circumstances, a trustee is precluded from making changes to how a trust operates if doing so will change the very fabric of the trust.

The first of these judgments made in *Wong v Grand View* [2019] Bda LR 41 (**Wong**) suggested that the law of equity had created the "substratum principle" as a freestanding rule of law. However more recent judgments in Jersey (*Representation of Rysaffe Fiduciaries Sarl* [2021] JRC 230 (**Rysaffe**)), Cayman (*In the Matter of the Poulton Family Trust* (unreported, FSD 0121 of 2016 (IKJ), 18 February 2022) (**Poulton**) and a subsequent appeal following *Wong* in Bermuda (*Grand View v Wong* (Civil Appeal No. 5A of 2019) (**Grand View**) indicate that the *Wong* decision was wrong, sounding the death knell for the substratum principle.

That said, the Judicial Committee of the Privy Council has considered the *Grand View* decision and judgment is awaited. In the interim, this article explores whether the existence of the substratum principle as a freestanding rule of law matters anyway, given longstanding equitable principles precluding trustees from exercising their powers for improper purpose, which has a similar effect to that of the purported substratum principle.

Given the clarity with which the Courts in Bermuda, Jersey and Cayman have treated the existence of such a rule, it may be thought that the matter has been decided and the "substratum rule" dead. However, the eulogy for the rule may not yet be written as the Judicial Committee of the Privy Council (the **Privy Council**) recently heard an appeal of the Court of Appeal of Bermuda's decision in *Grand View* between the 8th and 10th of March 2022 and has reserved judgment.

It may well be that the Privy Council resurrects the rule in its full glory or in some diminished way. However, even if it does, it is arguable that, properly understood, the existence of the rule

will not make any substantive difference to the way in which trustees view the exercise of their powers. Accordingly, and despite the uncertainty of the Privy Council's determination of the appeal in *Grand View*, this article seeks to ask a broader question: whether the substratum principle did exist as a freestanding rule of equity, or merely as an iteration of the doctrine of fraud on a power, does it make a difference?

## The so-called substratum rule

The substratum of a trust has been variously described with perhaps the most straightforward explanation derives from the first instance decision in *Wong* [at ¶91], citing Master Teverson in *Duke of Somerset v Fitzgerald* [1] that: "The substratum of the trust refers to its beneficial core".

In turn, the substratum rule [2] itself has been defined in various ways but can be distilled into a simple proposition: "if an arrangement changes the whole substratum of the trust, then it may well be said that it cannot be regarded merely as varying that trust" [3] with the consequence that a purported exercise of a power of amendment or variation is rendered ineffective. Instead, in order to effect the proposed "variation", what would instead be required is a resettlement of the trust on new terms.

In *Grand View*, the principal issue was whether the trustee of an irrevocable discretionary family trust (the **Global Resource Trust** or **GRT**) acted appropriately when it changed the trust's beneficial objects from natural person family members of the settlors, to a Bermuda law mixed purpose and charitable trust (the **Wang Family Trust**), which was settled by the founders of a lucrative group of Taiwanese companies (the **Founders**, who are also settlors of the GRT) to hold shares in the same, and to meet the various purposes of the Founders, including their admirable ethos that the rich do not own their wealth but are merely custodians with a duty to give it back to society. For that reason, the natural person beneficiaries of the GRT could expressly not benefit from the Wang Family Trust. Following the aforementioned change of beneficiaries, the trustee of the GRT would appoint all trust assets to the Wang Family Trust, thereafter terminating the GRT.

Various members of the Founders' family challenged the trustee's decision and at first instance the Supreme Court of Bermuda (Kawaley, AJ) found, inter alia, that "it is now settled law that a general power of amendment may not be exercised in a way which results in what amounts to a revocation and resettlement of the original trusts" [at ¶72], that "a general discretionary fiduciary power of amendment of any kind may not be used to alter the substratum of the trust instrument from which the power derives its existence" [at ¶74] and that "any transaction which effectively revoked the [GRT] and resettled the assets on new trusts would prima facie involve changing the substratum of the [GRT]" [at ¶111], granting declaratory relief that the trustee's exercises of power were invalid.

The reader should remember that the purported outcome of a breach of the substratum principle was that the purported exercise of power in breach of the principle is void, which is relevant when one considers the doctrine of fraud on a power addressed below.

The trustee of the GRT appealed the decision. Sir Christopher Clarke, President of the Bermuda Court of Appeal gave the leading judgment which found that there was no “absolute rule which, whatever the terms of the power or the circumstances of the trust, prohibits the exercise of specific powers of addition and exclusion of beneficiaries from altering the substratum of the trust” [at ¶85].

The Bermuda Court of Appeal confirmed that the principles relevant to the consideration of an exercise of trust powers are those expressed in the English Supreme Court decision in *Pitt v Holt*. [4] The relevant questions for the Court of Appeal as to the exercise of the trustee's powers were therefore [at ¶168]:

- whether the way in which it has been exercised is not within, or contrary to, the express or implied terms of the power (the scope of the power rule)
- whether the trustee has given adequate deliberation as to whether and how he should exercise the power; and
- whether the use of the power by the GRT Trustee, although within its scope, was for an improper purpose, in other words, a purpose other than the one for which it was conferred (the improper purpose rule) [5]

President Clarke saw the “substratum rule” as falling within the improper purpose limb of these questions, finding [at ¶185] that the substratum rule “is only another way of expressing, or synonymous with, the basic principle it adds nothing”. Further, he found that this “basic principle” meant that “[a] power of amendment must ... be used only for the purpose for which it was given...Another way of expressing the point is that an amendment must not change the whole substratum of the trust or its basic purpose”. [6]

The Bermuda Court of Appeal’s reasoning in *Grand View* was accepted and followed by the Royal Court of Jersey in *Rysaffe*, in which the Deputy Bailiff ultimately found that “[t]here is no substratum rule. It is unnecessary for such a rule to be adopted” [at ¶49]. In fact, the Royal Court too saw the “substratum” rule as a manifestation of the improper purpose rule and confirmed that similar cases should be considered as ones concerning limitations to the exercise of trustee powers under the relevant trust instrument and would therefore be treated as an issue of construction, including as to the relevant power’s purported purpose.

It is considered that this treatment of the “substratum rule” is the prevailing view and one which is likely to be followed in other offshore jurisdictions. For example, in *Poulton*, Mr Justice Kawaley (who now sits as judge of the Grand Court of the Cayman Islands) considered, albeit obiter, [7]

that no reliance could be placed on his first instance decision in *Grand View* that one cannot exercise a (similar) power in a way which is inconsistent with the substratum of the Trust. [8] Instead, he appeared to accept that *Grand View* was correctly decided such that, as a matter of Cayman Islands law, the substratum rule did not exist. [9]

As *Grand View* and *Rysaffe* (as well as *Poulton*) spin a common thread that a trustee's exercise of powers can only be constrained in accordance with the principles set out in *Pitt v Holt*, the balance of this article considers the similarities between the improper purpose rule and the contended for substratum rule, in suggesting an answer to the question of whether, if it does exist, the latter serves any purpose.

## Fraud on a power and the proper purpose rule

Given the approach adopted by the courts in the various offshore jurisdiction, the substratum principle in the context of trust variation or amendment has become inexorably linked with the equitable doctrine of "fraud on a power"; which itself is long established being referred to as early as the eighteenth century. [10]

Of course, fraud in this context does not carry modern connotations of dishonesty or immorality, but indicates that a "power has been exercised for a purpose, or with an intention, beyond the scope or not justified by the instrument creating the power". [11]

It is generally accepted that the doctrine of fraud on a power can broadly be split into three categories [12] and has been considered to manifest where the donee of a power seeks to exercise their power: (a) to benefit someone who was not an object of the power or on the understanding that a non-object would be benefitted thereby; (b) for a corrupt purpose; or (c) for a purpose outside the scope of the power (as explained in the Grand Court of the Cayman Islands in *Q Trusts* [13]).

However, as noted above, it is the third of these (defined by the Bermuda Court of Appeal in *Grand View* as the "proper purpose rule") which is relevant to the consideration of any ongoing role of the "substratum rule" and is the one which this article considers.

In spite of significant judicial consideration, [14] the classic judicial statement explaining the principle is still considered to emanate from the nineteenth century judgment of Lord Westbury LC in *Duke of Portland v Lady Topham*, [15] that: "... [T]he one, the appointor under the power, shall, at the time of the exercise of that power, and for any purpose for which it is used, act with good faith and sincerity, and with an entire and single view to the real purpose and object of the power, and not for the purpose of accomplishing or carrying into effect any bye or sinister object (I mean sinister in the sense of its being beyond the purpose and intent of the power) which he may desire to effect in the exercise of the power."

In the same case, Lord Justice Turner explained that the “purpose” which is the subject of the proper purpose rule is that contemplated by the author, or donor of a settlement: “The purpose of the author of a settlement, by which a power is created, is to benefit the objects within the range of the power. If the power be exercised beyond that range, his intention is that the property, the subject of the power, shall go to those who are entitled in default of appointment.”

In *Re Dick*, [16] Evershed MR explained that the doctrine required an element of intention or “a deliberate defeating” of the purpose for which the power was granted, and in that way can be differentiated from the aforementioned “scope of the power” rule which sets the constraints for the exercise of trust powers, by reference to the construction of the relevant provisions of the instrument granting them. [17]

The next step, succinctly expressed by Mrs Justice Asplin, [18] is therefore “to decide what is the purpose of the trust and what benefits were intended to be received by the beneficiaries or in their best interest”, or, as expressed extra-judicially by Lord Nicholls, cited with approval in the same judgment: “To define the trustee's obligation in terms of acting in the best interests of the beneficiaries is to do nothing more than formulate in different words a trustee's obligation to promote the purpose for which the trust was created”.

## Ascertaining purpose

The purpose for which a power is conferred by a settlor on a trustee (or other power holder) is a matter of construction and inference from surrounding circumstances, [19] relying upon the same rules of construction as those which apply to the construction of trust documents.

As noted by Lewin, the reason for adopting a similar approach based on well-trodden principles of construction which requires the ascertainment of the objective intention of the document (“the way in which the document is to be understood, not the purpose or motive, desire or other subjective state of mind of the settlor” [20]) is that: “Otherwise no lawyer would be safe in advising on the construction of a written instrument, nor any party in taking under it”.

This will inevitably mean that, in some circumstances, the express terms of a trust can be divorced from the hypothetical or subjective intention of the settlor, and in such circumstances, the Court will not depart from the objective, express wording of the instrument. [21]

But what if the trust doesn't contain express terms about the purpose of a particular power or the express wording of the trust is ambiguous as to purpose? If the express terms of the trust are unclear, the Court is willing to consider the “matrix of fact” [22] when considering a settlement to supplement and assist with the application of express terms of a settlement, however not in circumstances where such information may be considered to contradict, vary or alter the express terms of the trust—though documents created after the settlement of a trust should be treated with caution because they might not be reflective of the purpose for

particular powers of that settlement [23] and for much the same reasons, no regard should be paid to post-settlement conduct. [24]

The factors which the Court will consider as part of that matrix are myriad and will include any mischief arising from the provision deducted from its express terms, an analysis of the effect, and the court's understanding of the term in context. For example, in the context of pension funds, the Court will borrow rules of construction from contract law, that “the question is what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean”, [25] or an objective standard to the usual meaning of the words in context.

In other words, whilst the Court may, like an episode of Countdown, may be required to defer to “dictionary corner” [26] in some situations, the exercise of ascertaining purpose may also well require it to have regard to “any other relevant background material in order to construct the limits of the discretion” [27] as permitted by the standard rules of construction. [28]

Of course, ascertaining the purpose is often easier said than done. As noted above, it is often not a straightforward exercise and its determination may be more art than science. Importantly, and perhaps contrary to instinct, although the purpose of the trust might be to promote the best interests of the beneficial class, this isn't always that case and can make a trustee's duty to ascertain purpose difficult. [29]

## Distinction without a difference?

While it remains to be seen whether the Privy Council will determine that the substratum rule exists as a freestanding rule of equity, it is difficult to envisage a situation in which a trustee might breach the purported substratum rule without also falling foul of the proper purpose rule.

In any event, given the symmetry between the substratum rule (making changes during the life of a trust impacting its substratum analysed at the time of settlement), and the proper purpose rule (using a trust power for improper purpose seen in the context of the powers intended at the time of settlement of a trust), as well as the mirror consequences of breaching both (that the power was exercised improperly and that the purported exercise was void) it might be that trust practitioners are making a distinction without a difference.

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[1] [2019] EWHC 726 (Ch), though this metaphor was described as “inapposite” in *Grand View*, at ¶187.

[2] Significant scholarship has considered the history of the purported rule and

contemporaneous jurisprudence suggestive of its possible existence. See for instance “Trustee decision-making: the substratum fallacy and the exercise of discretionary powers”, Machell QC in *Trusts & Trustees*, Issues 8–9, November 2020 (pp. 790–799), “The substratum rule – where to now?” Alexander and Lewis, *Trusts & Trustees*, Issue 10, December 2021, (pp. 999–1005), “The limits of discretionary trusts: have powers of addition and removal been taken a step too far?”, Russell and Graham, *Trusts & Trustees*, Issue 27(4) at (pp. 280–285), et al.

[3] Megarry J in *Re Ball's Settlement Trusts* [1968] 2 All ER at [442–443].

[4] [2013] UKSC 26.

[5] At a high level, the first question is one of construction of a power, by which the trustee must ascertain whether the proposed exercise is within the express scope of that power; the second question relates to the trustee’s deliberations and is the corollary to the *Hastings-Bass* jurisdiction and that of common law mistake.

[6] Lewin at ¶¶30–56.

[7] Kawaley J stating that if he had been required to consider the wrongful exercise of power of exclusion/fraud on a power claim he would have dismissed it [¶593].

[8] *In the Matter of the Poulton Family Trust* (unreported 18 February 2022) [at ¶592].

[9] It should also be noted in this context that Smellie JA, one of the justice hearing the appeal in *Grand View*, is the Chief Justice of the Cayman Islands further suggesting a commonality of approach between the jurisdictions.

[10] See *Lane v Page* (1754) and *Aleyn v Belchier* (1758) I Eden 132 cited in *Eclairs Group Ltd v JKX Oil & Gas plc* [2015] Bus LR (*Eclairs Group*).

[11] Lord Parker of Waddington delivering the advice of the Privy Council in *Vatcher v Paull* [1915] AC 372.

[12] See *Lewin* at ¶30-069.

[13] [2001 CILR 481]

[14] In modern terms, the proper purpose rule is “concerned with the abuse of power, by doing acts which are within its scope but done for an improper reason. It follows that the test is necessarily subjective” per Lord Sumption at ¶15 in *Eclairs Group*.

[15] (1864) 11 H.L.C. 32 at ¶54, included at ¶30-066 of Lewin on Trusts 20th ed.

[16] [1953] Ch 343 at p. 360.

[17] There has, perhaps unsurprisingly, been academic debate surrounding the way in which the proper purpose and scope of the power rules operate: see "Trustee decision-making: the substratum fallacy and the exercise of discretionary powers", Machell QC in *Trusts & Trustees*, Issues 8–9, November 2020 (pp. 790–799). Whilst there is much to commend differing views, the orthodox view remains to be one recognizing a distinction.

[18] *Merchant Navy Ratings Pension Fund Trustees Ltd v Stena Line Ltd & Ors* [2015 EWHC 448] (Ch).

[19] *British Airways Plc v British Airways Pension Scheme Trustee Limited* [2018] EWCA Civ 1533.

[20] ¶7-005, Lewin.

[21] "The settlement is one which I cannot help thinking was never intended by the framer of it to have the effect I am going to attribute to it; but of course, as I very often say, one must consider the meaning of the words used, not what one may guess to be the intention of the parties" per Jessel, M.R. in *Smith v Lucas* (1881) 18 Ch.D. 531 at 542.

[22] A phrase used by Lord Wildberforce in *Prenn v Simmonds* [1971] 1 W.L.R. 1381, HL at ¶1384.

[23] See "Letters of wishes and understanding the purposes of a trust", *Trusts & Trustees*, Vol. 25, No. 3, April 2019, pp. 277–282.

[24] See *Witworth Street Estates (Manchester) Ltd v James Miller & Partners* [1970] A.C. 583.

[25] *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL at ¶14.

[26] See *Marquis Camden v Inland Revenue Commissioners*. [1914] 1 K.B in which the Court referred to "well-known and authoritative dictionaries".

[27] *Supra* at ¶70.

[28] See *Eclairs Group* at [¶¶30–31].

[29] *Merchant Navy Ratings Pension Fund* [2015] EWHC 448 at ¶228.

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