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CASE UPDATE

A question of discretion – 'substratum rule' does not form part of Jersey trusts law

In *Representation of Rysaffe Fiduciaries SARL*, the Royal Court considered the so-called substratum rule and determined that it did not form part of Jersey trusts law. That is not to say, the Court clarified, that a trustee may use such powers entirely as it pleases; rather it must satisfy itself that the exercise of the power meets the three-stage test previously set out by the Supreme Court in *Pitt v Holt* [2013] 2 AC 108.

Rysaffe is also an interesting case because of the Court's willingness to accept extrinsic evidence of the settlor's intentions as to how he would have wished the trusts to be administered after his death.

What is the substratum rule?

The 'substratum rule' is a restriction on the typically wide powers vested in the trustees of discretionary trusts to add or exclude beneficiaries subject to the terms of the trust as they see fit. At its simplest, the substratum rule prevents a trustee from using a power to add or exclude beneficiaries in a way which would have been beyond the contemplation of the parties at the time that the trust was established. To quote from Lewin (at 33-079): "*Another way of expressing the point is that an amendment must not change the whole substratum of the trust or its basic purpose*".

The facts in *Rysaffe*

In *Rysaffe*, the substratum rule was considered in the context of the trustee's application for the blessing of its proposed course of action under Article 51 of the Trusts (Jersey) Law 1984 (as amended) (the "**Law**"). Interestingly, the substratum rule only arose because of a passing reference to it by Leading Counsel, albeit he had concluded that such a rule, if it applied, presented no impediment to the trustee exercising its powers in the manner proposed.

The trustee's blessing application concerned two discretionary trusts settled in 2000 and 2008, respectively the G 2000 Settlement and the G 2008 Settlement, as to how the trusts should be administered in light of the settlor's unexpected death in 2015. The trustee's proposed course of action was the result of several years of discussions between the family as to how best to divide the assets of the settlor between them. Although the settlor had executed Letters of Wishes in respect of both trusts, these had not been updated since then to reflect a number of changes in the underlying assets owned by the trusts.

As to the G 2000 Settlement, the Letter of Wishes requested that after the settlor's death, the trustee should treat the settlor's wife should as the principal beneficiary with their children becoming beneficiaries on the death of the wife. As an aside, it is noteworthy that the trustee interpreted the reference to "*our children*" as including the wife's issue from a previous marriage, which approach the Court expressly endorsed as being the natural interpretation of the wording in the Letter of Wishes.

The Letter of Wishes in respect of the G 2008 Settlement requested that upon the settlor's death, the trustee should treat "*his children*" as the beneficiaries. Thus, neither the wife nor her child from her previous relationship fell within the class of beneficiaries of the G 2008 Settlement.

Over the course of the trusts' lifetime, the trustee of the G 2008 Settlement had extended a number of loans to the settlor to fund property purchases and cover certain of his personal expenses. As the Royal Court noted, this is a tax-efficient (and relatively common) manner for beneficiaries to receive assets from a trust. Following his death, these loans were repayable by the settlor's estate to the trustee of the G 2008 Settlement. The trustee considered that it would be more appropriate for these loans to be waived or forgiven such that the settlor's wife could remain in the UK property; however that could only properly happen if the wife was a beneficiary of the G 2008 Settlement (which she was not, and the settlor's Letter of Wishes did not identify her as being someone that he had wished to benefit from this particular trust).

The trustee's proposal, endorsed by the family, was to add the settlor's widow as a beneficiary of the G 2008 Settlement with a view to her being provided for going forwards including, ultimately, by being permitted to continue living in the matrimonial home she had shared with the settlor. Given the G 2008 Settlement did not envisage the settlor's wife deriving benefit from it, the question therefore arose whether her addition to the class of beneficiaries would destroy the "*substratum"* of the trust (i.e. to benefit the settlor's children) or not.

The Royal Court's consideration of the substratum rule

The substratum rule had previously been considered by the Royal Court, albeit in a different context, in *Re Osias Settlements* [1987-88] JLR 389. On that occasion, Tomes DB had expressed reservations as to whether the substratum rule formed part of Jersey law given, firstly, the fact there is no mention of substrata in the Trusts (Jersey) Law 1984 ("TJL") (specifically in the context of the variation provisions of what was then Art 43, now Art 47) and, secondly, the practical difficulty of deciding when the substratum of a particular trust has been changed. The only limitation on the court's power to consent pursuant to Art 43 TJL (now Art 47) was that contained in Art 43(2) (now Art 47(2)) i.e. that the relevant transaction is for the benefit of the person on whose behalf the consent of the Court is being given. The Royal Court then considered a recent judgment of the Bermudian Court of Appeal (*Wong Wen-Young v Grand View Private Trust Co Ltd* [2019] SC (Bda) 37 Com) in which that Court had considered whether the substratum rule applied to Bermudian law.

The Royal Court analysed the Bermudian Court of Appeal judgment in significant detail including Clarke P's statement (at paragraph 185 of *Grand View*) that "…*I would reject…the proposition that*

there is some 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 – a metaphorical term the characteristics of which it may be difficult to define, and which may not necessarily exist."

Having considered the Bermudian Court's judgment, the Royal Court concluded categorically (at paragraph 49 of its judgment) "*We adopt these principles as we consider them to be a correct analysis of the law. There is no substratum rule. It is unnecessary for such a rule to be adopted…Powers of addition and exclusion are to be given their natural meaning when considered with the three questions posed by Lord Walker [in Pitt v Holt] in mind*".

The test set out in *Pitt v Holt* requires as follows:

- is the exercise within the scope of the trustee's powers?
- has the trustee given adequate deliberation as to whether and how it should exercise the power?
- is the power being used for an improper purpose?

Ultimately, the Royal Court did not consider it appropriate to identify a substratum for the two trusts, proceeding instead only on the basis of the *Pitt v Holt* test and the well-established Jersey test in *Re S Settlement* [2001] JLR Note 37 (which is similar to the *Pitt v Holt* test but additionally includes consideration of whether the trustee's opinion has been formed in good faith, is reasonable and has not been vitiated by any actual or potential conflict of interest). Having satisfied itself that this was also test met, the Royal Court blessed the trustee's proposal under Article 51 of the Law.

Extrinsic evidence of settlor's intentions

As an interesting aside, it is worth noting that the Royal Court permitted extrinsic evidence of the settlor's intentions of how he would have wished the trusts to have been administered after his death. Whilst the Letters of Wishes in respect of the two trusts had not been updated, the Court accepted evidence given by the trustee that it was convinced from conversations with the settlor that he would have wished for his wife to be able to remain in their matrimonial home and be reasonably provided for during her lifetime. The Court also accepted the trustee's evidence that he would have wished for matters to be resolved in an amicable fashion without the need for any of his family to resort to litigation.

Conclusions

The Royal Court has robustly rejected any suggestion that there is a substratum rule in Jersey. A trustee's powers to add or exclude beneficiaries is therefore not fettered by potentially unclear concepts of what the substratum or main purpose of a trust might be. In each case, it will be for the trustee to ensure that it has complied with the test expounded in *Pitt v Holt* when considering how best to exercise the powers vested in it.

Equally, although the Court was on this occasion willing to accept extrinsic evidence of how the settlor would have wished the trusts to be administered after his demise, it is clear that a counsel of perfection would be for trustees to maintain periodic discussions with settlors and beneficiaries so that their wishes can be updated in light of any events that might have happened after the establishment of the relevant trusts.

Finally, it is worth noting that the Bermudian Court of Appeal's judgment in *Grand View* is being appealed and is due to be heard by the Privy Council in March 2022. Whilst *Rysaffe* represents a robust rejection of the substratum rule in Jersey, it will be interesting to see whether the Privy Council (as the final court of appeal in Jersey as well as in Bermuda) takes a different view to that taken by the Bermudian and Jersey courts to date.

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