Failure of Substratum in Commercial Trusts

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This article explores the doctrine of failure of substratum as it applies to commercial trusts, and particularly, public unit trusts. The analysis is conducted with reference to public unit trusts. In this context, the substratum is the underlying nature of the trust, or alternatively, the purpose for which it was formed.

Public unit trusts are collective investment schemes which offer securities to the general public. They have a large number of members and invest predominantly in marketable assets. Public unit trusts fall under the statutory definition of 'managed investment scheme',[1] thereby being regulated by Chapter 5C of the *Corporations Law*[2]. In addition to the legislation, they are further regulated by their scheme constitution and the general law of trusts and fiduciary obligations. Common examples include cash management trusts which provide access to high-yielding money market securities, equity trusts investing in company shares, and both listed and unlisted property trusts.[3] The two primary organs of a managed investment scheme are the responsible entity, being a trustee of the scheme assets,[4] and the scheme members, being the beneficiaries under the trust.

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1 *Corporations Law*, s9. Unless otherwise stated, all legislative references are references to the *Corporations Law*. For convenience, the term 'managed investment scheme' is used as a reference to public unit trusts regulated as managed investment schemes in accordance with Chapter 5C. Whilst the public unit trust is the most common and significant form of managed investment scheme, it is not the only one: other forms include time share schemes and trustee common funds.

2 The *Corporations Law* was amended by the *Managed Investments Act* 1998 (Cth), inserting the new Chapter 5C dedicated to the regulation of managed investment schemes. The amending legislation commenced operation on 1 July 1998.

3 H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law*, 9th ed (Butterworths, 1999) p 924.

4 Section 601FC(2).

A failure of substratum occurs where some event results in a fundamental alteration to the nature or underlying purpose of the scheme. The occurrence may be an external event, such as:[5]

- An amendment to taxation legislation where the scheme is tax driven;
- The enactment of a law prohibiting investment in a particular country which the scheme is targeting;
- New technologies ceasing to be viable where a specialised scheme is formed to exploit opportunities in that technology; or
- The winding up of the responsible entity where the qualities of the responsible entity are crucial to the scheme.

In such situations, as is the case in company law, the scheme may be wound up by the court on just and equitable grounds.[6] An application can be made for a winding up order by the responsible entity, a director of the responsible entity, a scheme member, or the Australian Securities and Investment Commission ('ASIC').[7]

However, of greater interest is where the failure of substratum occurs as a result of an action by the responsible entity rather than an external event. For instance, the responsible entity may purport to amend either the constitution or the scheme's investment strategy in a manner which fundamentally alters the nature of the scheme. In such cases, winding up the scheme may be a drastic and unnecessary remedy where the scheme is a going concern.

The issue to be explored is therefore whether there are any inherent restraints or limitations on exercises of power by the responsible entity where the action may result in a failure of substratum. Unlike shareholders in a corporation, no statutory remedy is available to members in a managed investment scheme.[8] Therefore, at a glance, there would seem to be little protection afforded to investors when faced with an event which results in a fundamental change to the

5 See K F Sin, *The Legal Nature of the Unit Trust* (Clarendon Press Oxford, 1997) p 120 where some of the situations listed are discussed with reference to the contractual doctrine of frustration.

6 Section 601ND(1). In relation to companies, see s461(1)(k).

7 Section 601ND(2).

8 In the case of corporations, see s246AA. Note that the Australian Law Reform Commission and the Companies and Securities Advisory Committee recommended that an oppression remedy be available: *Collective Investments: Other People's Money* Vol 1, Report No. 65, June 1993, p127. However, this recommendation was not implemented in the *Managed Investment Act* 1998 (Cth).

scheme.[9] As such, the general law, and in particular, the doctrine of substratum as it applies to 'traditional' trusts, must be relied on. If limitations do exist, purported exercises of power which result in failure of the substratum of the scheme will be void, there being no need to wind up the scheme.

This article commences with an analysis of the doctrine of failure of substratum as it applies to general trust law in Australia. The doctrine is then applied to a managed investment scheme context, with an examination of how the substratum of a scheme may be identified. The final part of the article considers specific selected actions by the responsible entity purporting to alter the investment strategy or constitutional investment powers of the scheme.

Failure of Substratum in Trust Law

An early line of trust law authorities, illustrated the jurisdiction of courts to limit the scope of powers to amend trust deeds granted in apparently unrestricted terms such that the power cannot be exercised in a manner which fundamentally alters the nature of the trust. However, since the New South Wales Court of Appeal decision of *Kearns v Hill*,[10] it would seem that this jurisdiction has been substantially limited. It is therefore necessary, after surveying the earlier line of authorities, to analyse whether this restraint on trust deed amendments still remains in light of that decision.

Early Decisions

Duke of Bedford v Marquess of Abercorn[11] involved a marriage settlement in favour of the intended children of the marriage. A power of amendment was granted to the husband and wife to make alterations in such a manner as to them seemed fit. An amendment purported to jointure any future wives of the husband and to charge younger children of any future marriage. The Court examined evidence of the scope and intended purpose of the amendment clause, concluding that the only reasonable construction of the power was that it only permitted variations of the charges created as amongst those who

9 Note that in the case of constitutional amendments, section 601GC(1) does provide limited statutory protection, as discussed further below.

10 (1990) 21 NSWLR 107.

11 (1836) 1 My & CR 311; 40 ER 394.

were intended to benefit by them, and not to introduce new interests in favour of strangers.[12]

Similarly, *Re Dyer*[13] involved a trust settled in order to assist in the establishment and maintenance of a permanent metropolitan orchestra. The deed provided that the settlor, his executors or administrators, may 'from time to time and at any time or times by deed vary all or any part of the trust and powers hereinbefore declared and created'. The settlor executed a deed varying the objects of the trust to include various music societies and associations not originally entitled under the deed, directing the income of the fund to be applied to those organisations in specified amounts. It was held that the alteration was inconsistent with the underlying nature of the trust, Martin J observing that it would appear 'strange' if the donor attempted to reserve a power to change the whole substratum of the gift. His Honour further stated:[14]

> A power to revoke is common in deeds of this nature, and I cannot believe that the draftsman would not have included such a power had it been intended that the donor was to be entitled to benefit an object other than the one nominated in the deed. What are the limits of the power to vary is a very difficult question, which does not call for determination here, but I consider none of the draft deeds submitted falls within those limits...

Therefore, these decisions dictate that unless a power of revocation is reserved by the donee, a power to amend a trust deed cannot be exercised in a manner which will alter the substratum of the trust, such as by allowing for benefits to be directed to non-objects.[15] However,

12 Ibid at 403 per Lord Cottenham.

13 [1935] VLR 273.

14 Ibid at 290-291.

15 Similar principles can be drawn from cases considering the *Variation of Trusts Act* 1958 (UK). The Act grants the court jurisdiction to approve arrangements 'varying' or 'revoking' trusts, but not the resettlement of a new trust. It has been held that if an arrangement changes the whole substratum of the trust, then it cannot be regarded as varying the trust: *Re Ball's Settlement Trust* [1968] 1 WLR 899; *In Re T's Settlement Trusts* [1964] Ch 158; *Re Holt's Settlement* [1969] 1 Ch 100; *Allen v Distillers Co (Biochemicals) Ltd* (1974) 2 All ER 365; *Re Smith* [1975] 1 NZLR 495. See J W Harris, *Variation of Trusts* (Sweet & Maxwell, 1975) pp 66-68, who questions the correctness of these decisions. Harris argues that the preferable view upon a proper construction of the *Variation of Trusts Act* 1958 (UK) is that it allows courts to approve *any* arrangement which benefits the beneficiaries. For the equivalent Australian legislation, see *Trusts Act* 1973 (Qld) s 95; *Trustee Act* 1936 (SA) s 59C; *Variation of Trusts Act* 1994 (Tas) ss 13, 14; *Trustee Act* 1958 (Vic) s 63A; *Trustees Act* 1962 (WA) s 90.

whether this limitation still exists in the light of the decision of *Kearns v Hill*[16] must be explored.[17]

Kearns v Hill

The above authorities were considered more recently by the New South Wales Court of Appeal in *Kearns v Hill*. The case involved the construction of a clause authorising the trustee to revoke any powers conferred on it or to 'vary or amend' any provision of the trust deed other than the declaration of trust or the vesting date.[18] The trustees purported to amend the definition of 'beneficiaries' contained in the deed so as to include a new class of beneficiaries constituted by the children of the existing beneficiaries.

Meagher JA (with whom Mahoney JA and Clarke JA agreed) held that on a proper construction of the clause, the power of variation extended to *any provision* in the deed. His Honour noted that while each deed must be considered in its own particular context, so that no other deed executed in different circumstances and in different language can decide the fate of a given deed, it was impossible to discern from the deed in question any intention that the list of beneficiaries should remain perpetually inviolate.[19]

Counsel for the respondent relied on the decisions discussed above. Meagher JA characterised the *ratio* of *Duke of Bedford v Marquess of Abercorn* as being that the court must consider the scope and evident purpose of a variation clause when determining the validity of a given amendment. However, given that the evident purpose of the clause in question was to ensure maximum flexibility, it was found that such a

16 (1990) 21 NSWLR 107.

17 The substratum cases may be explained as an instance of a fraud on the power being committed, being where a limited power which is designed to achieve one particular purpose is exercised to achieve a different purpose, resulting in the purported action being beyond the scope of the power: see *Vatcher v Paull* [1915] AC 372. As such, actions by the responsible entity which seek to alter the nature or underlying purpose of the trust may be found to be an exercise of power for an impermissable purpose, thereby being a fraud on the power: see for instance the superannuation and pension cases *Lock Banking Corporation* (1991) 25 NSWLR 593 at 606-607; *Re Courage Group's Pension Schemes* [1987] 1 All ER 428 at 537.

18 However, the amendment power provided the following restriction: '...PROVIDED However that no such release revocation variation or amendment shall be valid if such release revocation or amendment would have the effect of infringing any rule against perpetuities or directing or requiring any excessive accumulation of income or would entitle the settlor or the trustee or any person who has been a trustee of the settled fund to receive any of the income or corpus of the settled fund.'

19 (1990) 21 NSWLR 107 at 111.

consideration was of little assistance.[20] Furthermore, in relation to *Re Dyer*, his Honour stated that the restriction on amendments destroying the substratum is similarly of little help in the case at hand, given the relevant substratum was to benefit the descendants of the beneficiaries, and that purpose was achieved rather than destroyed by the purported amendment.[21] Mahoney JA was more explicit in his disapproval of the above authorities, stating:[22]

> In earlier times, the view was taken in some cases that ... the intention of the settlor was that the alterations to be made should not alter the main structure of the trust or the beneficial entitlements under it. I doubt that would be seen as the intention of such a clause at the present time. As the precedent books show, discretionary trusts have in more recent times been used to provide to the settlor or the person having the benefit of the power of variation the power to make fundamental changes in the structure of the trust document and the entitlements under it... And these are reasons why, in Australia, a power of variation of greater rather than lessor extent has been seen as desirable. Therefore I do not think that any limitation should be placed upon the generality of the power of variation by reason of the factors referred to in the cases cited.

It could be argued that, as a result of this decision, the doctrine of failure of substratum has little or no application to trust law, at least in New South Wales. However, this is unlikely to be the case. Five points may be offered in support of the assertion that failure of substratum is still of relevance to trust law. *First*, Meagher JA stated that it was impossible to locate a substratum in the trust at hand. This observation seems odd in the context of his Honour's decision. He acknowledged that the trust was designed to deal with the disposal of family assets to the descendants of the settlor.[23] This in itself is the relevant substratum, being the underlying intention or purpose for which the trust was formed.

Secondly, Mahoney JA stated that while the earlier decisions promoted the view that the settlor intended amendments not to alter the main structure or beneficial entitlements under the trust, no such intention is evident in modern times. With respect, it would appear that this is a misinterpretation of the early authorities. The intention of the set-

20 Ibid at 110.

21 Ibid at 110.

22 Ibid at 108. In a similar vein, Meagher JA stated at 111: 'I also put to one side the equally obvious consideration that the conditions which existed in England in 1850 are not necessarily the same as those which existed in New South Wales in 1970'.

23 Ibid at 109.

tlor is not that the structure and beneficial entitlements are to remain intact, but rather that the *underlying purpose* is to remain intact. If, as is shown by the facts of *Kearns v Hill*, the underlying purpose can be maintained upon a change to the constituent objects of the trust, the amendment is valid. If the amendment fundamentally changes the nature of the trust such that it no longer achieves or is no longer likely to achieve the objects for which it was originally settled, the amendment is invalid.

Thirdly, Meagher JA stated that there is little utility in investigating the scope and evident purpose of an amendment clause when the purpose is merely to ensure maximum flexibility. It is submitted that this once again would seem to be in conflict with the substance of his Honour's decision, as an investigation of the terms of the deed was undertaken in order to determine the intended scope of the amendment power.[24] The scope and evident purpose of the amendment power, the subject of *Kearns v Hill*, was to ensure maximum flexibility in the management and administration of the trust, provided that such amendments did not depart from the underlying substratum upon which the trust was created, being to benefit the descendants of the settlor.[25]

Fourthly, the restraint on trust deed amendments which result in a failure of substratum was accepted in *Re Courage Group's Pension Schemes*[26] and by the Supreme Court of New South Wales in *Lock v Westpac Banking Corporation*,[27] the latter decision having been handed down after *Kearns v Hill* and having cited *Re Dyer* to support the proposition.

Finally, the issue would seem to be merely one of characterisation of the substratum. In *Kearns v Hill*, Meagher JA determined the purpose to be to benefit the descendants of the settlor.[28] The purported amendment sought to add further descendants as objects of the trust, and was therefore within the ambit of the substratum. This may be contrasted with *Re Dyer*, where the substratum was narrowly charac-

24 At first instance, Young J examined the terms of the deed, finding the repeated reference to persons who are 'capable' of becoming beneficiaries as consistent with giving the variation power the width which the appellant contended. The analysis was accepted by Meagher JA on appeal: Ibid at 110.

25 Ibid.

26 [1987] 1 All ER 528 at 537 per Millett J.

27 (1991) 25 NSWLR 593 at 601 per Waddell CJ. See also at 603 where his Honour states: 'It is true that in some cases a power to vary a trust deed may be held not to extend to a variation which would alter the substratum of the trust'.

28 (1990) 21 NSWLR 107 at 109.

terised as providing a benefit to the immediate objects of the trust as originally settled. In that case, if the Court had characterised the substratum broadly so as to benefit the promotion of music generally, the purported amendment would have been within its scope and therefore valid. Therefore, the divergence in findings in these two decisions may merely be one of characterisation of the relevant arrangement rather than a doctrinal divergence. It is submitted that if the trustees in *Kearns v Hill* purported to include third persons as beneficiaries who were in no way concerned with the family and therefore not within the scope of the class of intended beneficiaries, a different finding would likely have resulted.

Therefore, *Kearns v Hill* does not overturn the doctrine of failure of substratum as applied to amendments to trust deeds. The case does, however, provide authority for the proposition that a power to vary a trust will be construed according to its natural meaning and in such a way as to give it the most ample operation.[29] The judgments in *Kearns v Hill* clearly promulgate a wider and more literal construction of trust deed amendment clauses than did the earlier courts. The judgments also put forth a wider characterisation of the underlying purpose or substratum of the trust. However, the decision *does not* negate the underlying principle that a power of amendment cannot be exercised in a manner which disturbs the substratum of the trust. This begs the question of whether and to what extent the doctrine is applicable to managed investment schemes.

Application to Managed Investment Schemes

Where a purported exercise of power by the responsible entity may have the effect of changing the inherent nature of a managed investment scheme, members have several options. If a right to withdraw is provided in the constitution, a member may redeem their units. However, a withdrawal power may not be available in the constitution.[30] Furthermore, where the scheme is not liquid, a member may only withdraw in accordance with the statutory regime for redemption offers.[31] If the scheme is listed on the Australian Stock Exchange ('ASX'), members who do not agree with the change can sell their unit holdings on the secondary market. If a majority of members disagree with the changes, they may either seek to have the scheme

29 See G E Dal Pont and D R C Chalmers, *Equity and Trusts in Australia and New Zealand* (LBC Information Services, 1996) p 448.

30 Section 601KA(1).

31 Section 601KB.

wound up under s601NB, resolve to re-amend the constitution,[32] or remove the responsible entity.[33]

However, where the scheme is not listed, there is no right to withdraw or the scheme is not liquid, and only a minority of members disagree with the changes, the dissenting members must rely on there being a failure of substratum and seek to have the purported action by the responsible entity set aside. Alternatively, as is the case in company law, a failure of substratum may provide grounds for a member to apply for the winding up of the scheme on 'just and equitable' grounds in accordance with s601ND(1). Winding up may, however, seem a harsh remedy where the scheme is a going concern and the member would prefer simply to have the exercise of power invalidated.

It must therefore be queried whether exercises of power by the responsible entity in managed investment schemes are subject to the failure of substratum limitation. The managed investment scheme is a trust, so presumably the doctrine applies equally to a scheme as it does to 'traditional' trust structures.[34] However, two arguments can be offered in support of the proposition that whilst applicable to traditional trusts, the doctrine has no relevance to managed investment schemes. Each argument will be canvassed and discussed in turn:

> Failure of substratum only applies to closely-held organisations and therefore not to large entities such as managed investment schemes;

With regards to purported amendments to the scheme constitution, as the statutory amendment power in section 601GC allows for the *repeal* and *replacement* of the constitution, the substratum doctrine has no application.

(a) Application to Large Entities

From the company law decisions, it would seem that the doctrine of failure of substratum is only applicable to small quasi-partnerships in which it is possible to ascertain some explicit objective upon formation of the company. The policy basis of the doctrine is that shareholders should not be forced to maintain their investment in a

32 This latter course of action may lead to a dead-lock situation and ultimately result in the scheme being wound up.

33 Section 601FM.

34 See for instance *Eagle Star Trustees Ltd v Heine Management Ltd* (1990) 3 ACSR 232 at 238 where the application of the doctrine to amendments to a unit trust deed was alluded to by Phillips J.

company where the underlying nature of that investment has substantially altered. However, in public companies, this logic does not hold, as members who are not content with the manner in which the business of the company is being managed have the option of exiting the company through the secondary markets. This would result in the doctrine having limited application to large managed investment schemes, being more analogous in economic terms to public rather than private companies.

However, in *Re Tivoli Freeholds Ltd*, Menhennitt J stated that failure of substratum:[35]

> ... is not, it appears to me, confined to cases of 'partnership' companies or 'main object' companies. Whilst it may be easier to find the general intention and common understanding in those cases I can see no reason in principle why it should be confined to such cases and I am not aware of any decision that it is so confined.

Therefore, as a matter of law, a failure of substratum can be found to have occurred in a large public company, and thus also in a managed investment scheme. However, as an evidentiary issue, establishing a common understanding between *all* the members may be difficult. Nonetheless, where there is a stated objective which is publicised to members generally in the prospectus, or some other means of establishing a common understanding between members, such a finding may be possible.

(b) The Repeal and Replacement of the Constitution

The second issue relates only to purported amendments to the scheme constitution. The amendment power conferred on the responsible entity by s601GC is not limited to *modifications* to the scheme constitution, but also extends to the *repeal* and *replacement* of the constitution. From this, it could be argued that the statutory provision reserves a power of revocation in the responsible entity, allowing fundamental amendments which result in a failure of substratum being permissible.

This point is also rebuttable. The repeal and replacement of the scheme constitution does not *in itself* result in a revocation of the trust, as would be the case with a traditional trust deed, as both the trust settlement and various core powers and duties of the trustee are

35 [1972] VR 445 at 469.

contained in Chapter 5C.[36] The trust may thereby remain intact upon the repeal or replacement of the constitution. Furthermore, revocation and replacement of the constitution by virtue of s601GC(1) does not result in a new *scheme* as such, as there is no need to re-register the scheme with ASIC but merely to lodge a copy of the new constitution.[37]

Following from this, the mere fact that the amendment power extends to the repeal and replacement of the scheme's constitutive document does not *necessarily* result in fundamental amendments which amount to a revocation or resettlement of the trust being permitted. Only where the new constitution fundamentally alters the nature of the duties and obligations of the trust will a resettlement occur. The question is one of the extent to which the amendment effectively varies the nature of the trust.[38] It follows that as a power to repeal and replace the constitution does not in itself permit a revocation and resettlement of the trust, this power does not in itself permit changes to the constitution that would otherwise result in a failure of substratum.

Therefore, actions by the responsible entity which purport to alter the substratum of the scheme will be invalid. However, this proposition is tempered by one proviso: the evidentiary burden in establishing a failure of substratum will be difficult due to both the flexible and large nature of managed investment schemes, as well as the fact that members may have other means of avoiding an oppressive outcome, such as withdrawal by way of a buy-back provision or exit through the secondary market.

Identifying the Substratum in Managed Investment Schemes

As it has been established that an exercise of power by the responsible entity which results in a total failure of substratum may be grounds for the invalidity of the exercise, it is necessary to explore the scope of the substratum concept.

36 From the wording of s 601FC(1), it is arguable that the provision actually settles the trust. As such, there would be no need for the scheme constitution to contain a trust settlement provision.

37 Section 601GC(2).

38 Furthermore, the *Variation of Trusts Act* 1958 (UK) and related Australian legislation, discussed above, at n15, similarly extends beyond *variations* and encapsulates the *revocation* of a trust. Irrespective of this provision, the courts still found that they did not have jurisdiction to approve resettlements.

In this regard, assistance may be sought from company law cases relating to the 'just and equitable' ground for winding up a corporation.[39] A common basis upon which a winding up order under the provision is sought is where the company engages in acts which are entirely outside what can fairly be regarded as having been within the general intention and common understanding of the members when they became members.[40] What is required is that the conduct of business within the objects of incorporation has become impossible, at least in a practical sense.[41] There must be an abandonment of the primary objects of the company, such that the shareholders who have taken up contributing shares are being asked to leave their money in a venture which is different altogether from what they originally subscribed to.[42]

The main source for obtaining the common understanding of members upon incorporation is the company constitution, particularly if the constitution contains the stated objects of the company.[43] The courts may also look to the prospectus, the company's name and any circulars issued to shareholders.[44] The company's course of conduct may also be relevant.

In relation to managed investment schemes, the investigation as to the underlying substratum may differ from the company law approach. The basis of the divergence may be extracted from the pension law decision of *Re Courage Group's Pension Schemes*.[45] Millett J (as he then was) noted that in determining whether an amendment results in a disturbance of the substratum, the amendment must be judged at the time it is intended to take effect rather than when the trust is first created. A fluid approach to the purpose of the trust was

39 Section 461(1)(k).

40 *Re National Portland Cement Co Ltd* [1930] NZLR 564; *HA Stephenson & Sons Ltd (In Liq) v Gillanders, Arbuthnot & Co* (1931) 45 CLR 476 at 487; *Re Kitson & Co Ltd* [1946] 1 All ER 435; *Re Taldua Rubber Co Ltd* [1946] 2 All ER 763; *Re Eastern Telegraph Co Ltd* [1947] 2 All ER 104; *Galbraith v Merito Shipping Co* [1947] SC 446; *Re Wondoflex Textiles Pty Ltd* [1951] VLR 458 at 468; *Re Tivoli Freeholds Ltd* [1972] VR 445. The doctrine of failure of substratum is different to the doctrine of *ultra vires* which has been abandoned by virtue of s125(2): see *Re Tivoli Freeholds Ltd, supra* at 470 per Menhennitt J.

41 *Galbraith v Merito Shipping Co*, supra at 456 per Lord Moncrieff.

42 *Re National Portland Cement Co Ltd*, supra at 572 per Myers CJ; *Re Eastern Telegraph Co Ltd*, supra at 109 per Jenkins J.

43 *Re Tivoli Freehold*, supra at 471 per Menhennitt J. Note that it is no longer necessary to state the company's objectives in the constitution: s125(2).

44 *Re Crown Bank Ltd* (1890) 44 Ch D 634 at 643.

45 [1987] 1 All ER 528 per Millett J.

adopted, allowing for the main purpose of the scheme to be changed by degrees.[46] This diverges from the company law cases which require an analysis of the common understanding of the corporators at the time of incorporation.[47] In accordance with Millett J's observations, while a change may be unacceptable if introduced all at once, the change may be legitimately introduced over a long period of time.

Applying these principles to managed investment schemes, in the widest sense, the substratum of a scheme may be characterised as the operation of a collective investment vehicle in order to return financial benefit to members. However, depending on the particular scheme in question, a narrower substratum may be found. To do so, it would need to be shown that the scheme was established for a defined and limited objective, and that that objective will be undermined by the event or purported action. In this regard, the scheme constitution, the scheme name and the prospectus may be relevant.

Furthermore, it is explicitly clear from the provisions of the legislation that a scheme may have a defined *purpose*. Section 601NC provides that where the responsible entity considers that the purpose of a scheme either has been accomplished or cannot be accomplished, it may take steps to have the scheme wound up. This provision may not assist an aggrieved minority scheme member, as the power is vested in the responsible entity. However, it is an express acknowledgment by the legislature that a scheme may be established for a defined purpose or objective, and that the accomplishment of that purpose or objective may be undermined.

Selected Illustrations

What situation may lead to a failure of substratum? *First*, changes to the external environment in which the scheme operates, such as the situations listed at the commencement of this article, may infringe on the underlying purpose of the scheme. *Secondly*, a failure of substra-

46 Ibid at 537. His Honour used as an illustration the case of *Thellusson v Viscount Valentia* [1907] 2 Ch 1. That case involved a club formed for the purpose of providing a ground for pigeon-shooting. From time to time, other activities were introduced without objection from members. The club committee resolved to discontinue pigeon-shooting, and the decision was upheld by the Court of Appeal. The Court observed that although the club was originally formed for the encouragement of pigeon-shooting, it now provided several objects, none being more fundamental than the other.

47 Millett J justified the approach on the basis of a pension scheme being an institution of long duration and gradually changing membership. As such, it is arguably equally applicable to companies: *Ibid*, at 537.

tum may result from an action by the responsible entity. For instance, where the scheme is reliant on the skill and reputation of a particular responsible entity, the underlying purpose of the scheme may be characterised as the operation of a collective investment fund by the responsible entity alone. If this is the case, the retirement of the responsible entity may lead to a failure of substratum.

Similarly, failure may result by way of a purported amendment to the scheme constitution by the responsible entity. In this context, it must be noted that the scope of the constitutional amendment power is limited by the legislation. Section 601GC(1)(b) provides that in order for an amendment to be passed unilaterally by the responsible entity, the responsible entity must 'reasonably consider the change will not adversely affect members' rights'.[48] It is likely that in this context, 'members' rights' is a reference to essential rights such as the right to distributions, withdrawal rights, voting rights, the right to receive information and various rights in respect of the scheme property.[49] As such, there may be situations where although the substantive rights of members are not affected, s601GC(1)(b) thereby not providing protection, the underlying nature of the scheme is nonetheless disturbed. Furthermore, where s601GC(1)(b) is not satisfied, a constitutional amendment may be passed by way of a special resolution of scheme members.[50] A majority of members may thereby veto amendments which affect their substantive rights. Recourse to the general law as a source of protection may therefore still be necessary for aggrieved members.

However, of particular interest to the author is the possibility of a failure to substratum occurring by virtue of an amendment to the investment strategy or constitutional investment powers by the responsibility entity.

The scheme constitution must make adequate provision for the powers of the responsible entity in relation to investments.[51] This requirement may be satisfied by the constitution vesting in the

48 Further restraints may exist in relation to constitutional amendments to listed schemes, as it may be necessary to disclose details of the proposed amendment to the ASX where there is a proposed change to the general character or nature of the scheme: *ASX Listing Rule* 3.1; *ASX Listing Rule* 11.1. Furthermore, the ASX may require the approval of members by way of an ordinary resolution before the change may be effected: *ASX Listing Rule* 11.1.2.

49 See P Hanrahan, *Managed Investment Law* (CCH Australia Ltd, 1998) p 63.

50 Section 601GC(1)(a).

51 Section 601GA(1)(b).

responsible entity all the powers of a natural person in investing the scheme property.[52] The responsible entity would thereby have a broad power to invest in any forms of investments and securities. The constitution may further permit investments in assets which would otherwise result in a breach of trust, such as high risk or speculative securities and derivatives.[53] At the other extreme, the constitution may limit the scope and nature of investments, expressly prescribing the types of investments which may be made in accordance with the purpose of the trust. For instance, the scheme may be specified as a *property trust*, the responsible entity only being able to invest in real property, or alternatively an *equity trust*, where investments are limited to company shares. Similarly, the constitution may prohibit certain investments, such as a mandate against shares in companies which are deemed environmentally unfriendly, or restrict investments to equity in companies operating in a specified industry.

Where the responsible entity is vested with a broad investment power, the investments in which it undertakes may similarly be limited by the scheme's investment strategy. Once again by way of example, the investment strategy may provide that only investments into equity securities be undertaken, or in the case of a sectorially defined scheme, only securities in particular industries be invested into.[54]

This poses the question of whether, after the formation of the trust, the responsible entity can seek to either amend the constitution or alter the investment strategy in a manner which alters the nature of the scheme. For illustrative purposes, two specific examples will be explored:

- An alteration changing the scheme from a property to an equity trust;
- An alteration vesting or removing a power to pursue social investments.

52 *ASIC Policy Statement* 134.22.

53 J R F Lehane, 'Delegation of Trustees' Powers and Current Developments in Investment Funds Management' (1995) 7 *Bond LR* 36 at 39.

54 See former reg 7.12.15(6)(bb)(d) which required the manager of a unit trust to inform the trustee of proposed variations to the investment policy of a *prescribed interest* scheme where a member would not reasonably expect such an amendment having regard to the prospectus.

(a) Changing from a property to an equity trust

It is common for schemes to be formed and marketed as being constituted by investments in certain specified categories of assets such as real property or equity. This will be reflected in the name of the scheme, the prospectus and the terms of the constitution. However, upon members contributing to a scheme on this basis, it must be queried whether the responsible entity can subsequently amend the constitution or investment strategy in order to change the scope of investment, thereby changing the nature of the underlying scheme assets into which it has invested.[55]

Such a change may be justified in terms of the interests of scheme members. For instance, where the property market is suppressed, it may be financially beneficial for members that the investment focus be shifted to equities or other forms of more liquid investments. This will satisfy the responsible entity's statutory and equitable obligation to act in the best interests of members.[56] Furthermore, with regard to constitutional investments, the statutory requirement that the responsible entity reasonably consider the change will not adversely affect members' rights may be satisfied,[57] there being no change to the rights vested in scheme members.

The more difficult issue in relation to such amendments is the determination of whether the purported change infringes the underlying substratum of the scheme. Members contribute their capital upon the common understanding that their contributions will be invested in a specified form of property, in this case being real estate. This common understanding is likely founded by the name of the scheme, advertising, the scheme prospectus, and the terms of the scheme constitution as at the date of their membership contracts. An amendment to the nature of the assets undermines this understanding.

55 An illustration is the purported amendment in *Heine Management Ltd v ASC* (1993) 12 ACSR 578, being part of the Aust-Wide litigation. A unit trust was established for the purpose of investing solely in a particular property, being the Grosvenor Place Complex in Sydney. An amendment to the trust deed purported to allow investments in other properties with the purpose of allowing the acquisition of interests in 120 Collins Street Melbourne. Restraints on the amendment power was not in issue in the litigation.

56 Section 601FC(1)(c). In relation to a trustee's equitable obligation to act in the beneficiaries' interests, see *Cowan v Scargill* [1985] 1 Ch 270 at 290 per Megarry VC.

57 Section 601GC(1)(b).

It may be that courts will construe the substratum of a scheme broadly in such a case. In *Kearns v Hill*,[58] for example, the court construed the trust deed in a manner which allowed for its most ample operation, as well as the promulgation of a wider characterisation of the relevant purpose or substratum of the trust. In the current scenario, if the substratum of the scheme is characterised as the provision of a collective investment vehicle investing exclusively in real property, the amendment will infringe this purpose. This is likely in schemes in which the nature of assets invested into are particularly narrow, such as sectorial specific schemes. However, it is possible (and likely) that the substratum will be given a wider interpretation, being simply the provision of a collective investment scheme for the purpose of financial reward to members. If this is the case, the amendment will be valid.

(b) Social Investments

Generally speaking, managed investment schemes are created for the purpose of providing *financial* benefits to members. As such, in exercising its power of investment, the responsible entity must act in the best *financial* interests of scheme members by ensuring their financial return is maximised, given the level of risk and capital appreciation of the investment.[59] The responsible entity cannot base investment decisions on non-financial factors such as moral, ethical, social or political concerns.[60] For instance, the responsible entity cannot pursue a policy that it will not invest in companies which engage in activities considered to be socially or politically undesirable where investment in such companies will be in the best financial interests of members. In this respect, Megarry VC stated in *Cowan v Scargill*:[61]

58 (1990) 21 NSWLR 107. See above under section headed 'Kearns v Hill'.

59 *Cowan v Scargill* [1985] 1 Ch 270 at 287 per Megarry VC; *Harries v Church Commissioners for England* [1993] 2 All ER 300 at 305 per Nicholls VC. See further G E Dal Pont, 'Conflicting Signals for the Trustees' Duty to Invest' (1996) 24 *ABLR* 140; W A Lee, 'Modern Portfolio Theory and the Investment of Pension Funds', in Finn P D (ed), *Equity and Commercial Relationships* (Law Book Company, 1987) p 309.

60 However, where all the beneficiaries of the trust hold strict views on a certain issue, it may be in their interest for the trustee to pursue those views in its investment policy: *Cowan v Scargill*, ibid at 288. This may occur where, for instance, the scheme constitution specifies that a social investment strategy will be conducted by the responsible entity. In the absence of such a specification, it would be difficult to show that a social investment policy is in the members' interests given the number and fluid nature of members.

61 [1985] 1 Ch 270 at 287-288.

> In considering what investments to make trustees must put on one side their personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views they hold.

However, the right of a trustee to consider non-financial matters in conducting investments may be provided by a direction in the trust instrument.[62] This poses the question of whether the responsible entity can amend the scheme constitution in a manner which provides it with a power to consider non-financial matters in its investment activity, ie, the inclusion of a *social investment* provision.

It is arguable that the insertion of a social investment provision by way of a constitutional amendment may not adversely affect members' rights, therefore not infringing the statutory restraint in s601GC(1)(b). Constitutional rights to distributions, surplus upon winding up, etc, remain intact.[63] However, the amendment may be in breach of the equitable and statutory duty on the responsible entity to act in the best interests of members. Where the social investment clause allows the responsible entity to consider non-financial issues when faced with competing investments which derive the same financial benefit, the best interests requirement may be satisfied, as investments will be equally beneficial to members in financial terms.[64] However, where the provision allows the responsible entity to place non-financial issues *above* the financial interests of members in its investment decisions, the amendment will clearly be against members' best financial interests, therefore being invalid and the responsible entity being liable for breach of its fiduciary and statutory obligations. Although it may be argued that the amendment will benefit members incidentally on the basis of incidental social benefit, it is inconceivable that such an argument will be accepted in the current context. The amendment may also be deemed to be for an improper purpose, as it

62 *Harries v Church Commissioners for England*, note 59 above, at 305 per Nicholls VC; Dal Pont, note 59 above, at 144.

63 However, it could be argued that where the introduction of a social investment power results in a decrease in the revenue of the scheme, distribution rights are adversely affected in substance.

64 See *Cowan v Scargill*, note 59 above, at 287 per Megarry VC.

may be characterised as being for the purpose of promoting the interests of the responsible entity by allowing it to pursue its own social or political agenda.

More importantly in the context of the current discussion, a failure of substratum may result, the underlying purpose of the trust changing from a collective investment for the purpose of promoting the financial interests of members to a scheme in which social or political issues may be promoted through investments at the expense of the financial return to members.

The reverse situation may also be conceived, being where members contribute to a scheme on the basis of its social investment policy, the constitution subsequently being amended in order to remove the ability of the responsible entity to consider such matters. In such a case, the investment policy of the scheme upon formation may constitute its substratum. Members contribute their capital on the common understanding that certain non-financial objectives will be pursued, contracting to forgo the maximisation of financial return in certain situations where it conflicts with non-financial factors. An amendment which alters this fundamental characteristic of the scheme may result in a total failure of substratum, members no longer participating in a scheme with the same purpose for which it was first formed and for which they contributed their capital.

Therefore, amendments which either allow for or remove the ability of the responsible entity to pursue social objectives in its investment policy are unlikely to be valid. The distinction between the scenario explored above in respect of changing from a property to an equity trust and the amendments relating to social investments may perhaps be explained as follows: in the latter, the fundamental purpose for which the scheme was commenced has been changed; in the former, irrespective of whether the investments are in real property or company shares, the underlying purpose of promoting the financial interests of members remains intact. However, this explanation is reliant on the characterisation of the purpose of the scheme by the courts.

Conclusion

The doctrine of failure of substratum is applicable to commercial trusts such as managed investment schemes. The substratum of a scheme may be disturbed by some external event or change to the environment in which the trust operates, rendering the nature and underlying purpose of the scheme substantially different from when the scheme was first formed. As well as external events, a failure of substratum may occur as a result of some action by the responsible en-

tity, such as where it purports to fundamentally change the nature of the assets in which the scheme invests, either by virtue of an amendment to the scheme constitution or by altering the investment strategy of the scheme.

A failure of substratum may allow members to petition to have the scheme wound up. However, where the scheme remains a going concern, seeking a winding up order may be a somewhat harsh remedy. This is particularly so when the failure of substratum is the result of an exercise of power by the responsible entity, and when only a minority of members disapprove of the action. In such a case, aggrieved members may seek to have the action set aside on the basis that it disturbs the substratum of the scheme, thereby being beyond the scope of the relevant power vested in the responsible entity. The action will thereby be void and of no effect.

While clearly available, whether reliance on this general law doctrine is adequate in terms of investor protection is questionable. In the corporate law sphere, the substratum doctrine has been somewhat overtaken by the statutory oppression provisions, providing shareholders with broader grounds for petitioning and a wider scope of remedies. This, in itself, may be indicative of the need to provide comparable recourse to members in managed investment schemes.