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Undoing Trustee Errors: An update on the Hastings-Bass Principle and the law of mistake

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The principle established in 1974 in the case of Hastings-Bass ([1975] Ch 25 (CA)) has in the past allowed a Court to set aside an action taken by Trustees who have failed to take some important factor (such as tax considerations) into account when deciding to take the action. Effectively, it has allowed Trustees to undo something they have done where the effect is different from that which they intended.

Earlier this month, the English Court of Appeal ("CoA") handed down its much anticipated decision in Pitt v Holt and Futter v Futter ([2011] EWCA Civ 197), both of which concerned the Hastings-Bass principle ("the Principle"), and this has resulted in a re-examination of the Principle and its application.

The Background to the Principle

In order to analyse the consequences of the CoA's judgement, one must briefly look at the development of the Principle, its technical basis and how it was applied by the English High Court in their first instance decisions in the two recent cases.

To many minds, the Principle was best summarised by Lloyd LJ in the case of Sieff v Fox ([2005] EWHC 1312 (Ch)) as follows: "Where trustees act under a discretion given to them by the terms of the trust, in circumstances in which they are free to decide whether or not to exercise that discretion, but the effect of the exercise is different from that which they intended, the Court will interfere with their action if it is clear that they would not have acted as they did had they not failed to take into account considerations which they ought to have taken into account, or taken into account considerations which they ought not to have taken into account".

Moreover, there are a number of different ways of analysing the underlying technical basis of the Principle. Firstly, it has been argued that the Principle is based on the laws of Trustee powers and as such, the relevant question is whether there has been a valid exercise of a Trustee's power. When Trustees are given a power to distribute trust assets to a potential beneficiary, the Trustees are required to consider various factors in order to exercise that power validly. Failure to take all relevant factors into account will mean that the power has not in fact been exercised and as a result any transfer resulting from the purported exercise will never have taken place (in equity). Hence, an unforeseen tax liability resulting from a distribution to a beneficiary from a trust is likely to mean that not all relevant factors were taken into account by the Trustees. Arguably, therefore, no valid exercise of the power to distribute has taken place, thus rendering the transfer as void and undoing the cause of the tax liability.

An alternative legal basis for the Principle was put forward by Lightman J in Abacus v Barr (2003 EWHC 114 Ch), in which he suggested that it was based on the occurrence of a breach of trust by the Trustees. The consequences of this approach is that, if followed, the Principle would not apply where Trustees have taken all reasonable steps to ensure that the effect of their action is known (such as by taking professional tax advice).

Lastly, a further alternative approach, argued primarily by those seeking to contest the Principle and the extent of its application, is that it devolves from the law relating to mistake. The chief consequence of this is the threshold for the operation of the rule is high, so the mistake must be fundamental and must relate to the immediate legal effect of the action and not its mere consequences.

The First Instance Decisions

The initial decision in Pitt v Holt ([2010] EWHC 45 (Ch)) extended the Principle to a Receiver acting in a personal injury compensation matter where the damages were settled into trust leading to an inadvertent tax charge. Although not a Trustee, the Receiver was acting in a fiduciary capacity and therefore the Principle was applicable in that scenario. The High Court ruled that the creation of the trust was void or voidable and should be set aside and declared to be of no effect, thereby undoing the events which led to the tax charge.

Futter v Futter ([2010] EWHC 449 (Ch)), concerned distributions from a trust which again resulted in undesirable tax consequences about which the Trustees had not been advised. The High Court ruled that the advancements should be set aside and declared void so that the events causing the tax charge were again, in effect, undone.

The CoA Decisions

In both cases, the CoA has reversed the High Court's decisions.

When looking at the exercise of a Trustee power, the CoA focused on the distinction between (i) a scenario where the Trustees' purported exercise of a power is outside the scope of such power, so that the purported exercise will be void and (ii) a scenario where the exercise of a Trustee power is within its scope, but there has been a breach of trust.

It was in reference to this second scenario where the CoA's ruling differed from previous analyses of the Principle. The CoA ruled that if Trustees obtained and followed advice from "apparently competent advisors", there will have been no breach of their fiduciary duty where the advice is incorrect because the Trustees have discharged their duties by seeking the advice in the first place.

The actions of the Receiver in Pitt v Holt and the Trustees in Futter v Futter were both within their respective powers and so not void (as in the first scenario). Additionally, they both sought and acted on professional advice and, even though the advice was wrong in both cases, there was no breach of trust because the advice had been sought and so their actions were not voidable. This analysis thus imposes a major limitation on the future application of the Principle.

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Separately, in Pitt v Holt, on the subject of mistake, the CoA reiterated that the mistake must be as to the legal effect of the action rather than as to its consequences. The inadvertent tax liability in this case, as in many other cases where the Principle has been invoked in the past, was a consequence, not a legal effect, of the Trustees' action and so that action could not be set aside as a mistake.

Conclusion

The decision of the CoA is not binding on the Courts in the BVI or the Cayman Islands, but it is a persuasive authority. It puts strict limits on the Principle itself and its future application which are likely to impact the trust industry worldwide. In a new world where Trustees' actions based on incorrect advice result in unforeseen adverse consequences and such actions cannot be set aside by a Court, the most immediate consequence is likely to be an increase in professional negligence claims against Trustees and, probably more frequently, their professional advisers.

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