Trusts

Righting Wrongs

MACFARLANES

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Interpretation; Mistake; Rectification; Rule in Hastings-Bass; Trusts

This article constitutes a thorough up-to-date examination of the complex interaction between interpretation, rectification, equitable mistake and the re-stated rule in Hastings-Bass *in the context of trusts.*

We all make mistakes. Some are more serious than others. One of the great strengths of the courts of equity in England is their flexibility in providing a remedy where justice and fairness demand that there should be one.

It is however remarkable (and no doubt very welcome for settlors, trustees, advisers and others who might otherwise stand to lose out) quite how willing the courts have shown themselves to be in recent years in putting right the wrongs which have been presented to them.

The courts have used a number of key tools to achieve this including:

(1) Interpretation or construction: do the words really mean what they appear to say, particularly in the light of the surrounding facts known to the parties at the relevant time?

(2) Rectification: do the words used fail to carry out the clear intention behind the transaction?

(3) Mistake: was the transaction carried out on the basis of a sufficiently serious mistake so that the transaction should be set aside?

(4) The *Hastings Bass*[1] principle (inadequate deliberation): did the trustee, in breach of duty, fail to take into account relevant considerations so that the act in question should be set aside?

To some extent, these principles overlap. For example, it is not uncommon for construction and rectification to be claimed as alternative remedies. The same is true of rectification and mistake or setting aside on the basis of either mistake or the *Hastings-Bass* principle.

However, each principle has its own requirements and potentially very different consequences. Deciding the basis for any application to the court is important and depends both on the requirements for success but also on the desired remedy. For example, construction or rectification would be appropriate where the claimant wants the transaction to stand but something has gone wrong with the wording so as to prevent it taking effect as intended. However, if the objective is to set aside the transaction completely, an application based on mistake or the rule in *Hastings-Bass* will be necessary.

Given the way in which the law has developed, some of these principles have become more popular and others less so. For example, there was a time when the *Hastings-Bass* principle was routinely relied

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[1] *In re Hastings-Bass decd* [1975] Ch. 25; [1974] 2 W.L.R. 904.

on where mistakes had been made in a trust context. However, since the decision of the Supreme Court in *Pitt v Holt*,[2] there have been no English cases where a transaction has been set aside on the basis of the *Hastings-Bass* principle but a succession (possibly even a tidal wave) of cases where transactions have been set aside on the basis of mistake.

Whilst the courts have warned on a number of occasions that these principles should not be seen as a get-out-of-jail-free card where transactions have taken place which give rise to unexpected tax liabilities,[3] for the most part this appears to be precisely what has happened, with the courts seemingly bending over backwards in their efforts to shoehorn unopposed claims into one or other of the relevant categories.

Before looking in detail at the different remedies, one other point which is worth noting is that the English courts have not shrunk from providing remedies in relation to trusts where the trustees are based overseas and the trusts are not governed by English law.[4] In *Graham v Lynch* Master Kaye accepted that the English court would have jurisdiction if the non-resident trustees submitted to the jurisdiction of the English Court.[5]

One reason for choosing English law is that it might be thought (rightly or wrongly) that HM Revenue & Customs (HMRC) may be more likely to accept that any tax liability should take account of any relief granted by an English court as opposed to an overseas court.[6] However, the author is not aware of HMRC refusing to give effect to a ruling by a foreign court in these sorts of circumstances.

Rectification

Rectification may be available where the court is satisfied that a document does not reflect the true intention of the maker of the document. It is however a discretionary remedy. The courts have said that it "must be cautiously watched and jealously guarded".[7]

Where a claim for rectification is successful, the document will take effect in its rectified form as if that is what the document had always said.[8] This of course enables a party seeking rectification to undo potential tax disadvantages which might have been caused by the failure of the document to reflect the relevant intention.

The key case dealing with rectification in the context of trusts is the decision of the Court of Appeal in *Racal Group Services Limited v Ashmore* which confirms a number of important points.[9]

The critical requirement is that the applicant must establish by clear evidence exactly what the intention was and what the document should have said. The reason for this is that the applicant is, by definition claiming that the written document does not reflect their intention and so the evidence needed to counteract the presumption that the document reflects what was intended is correspondingly higher.

In many cases, demonstrating that the document does not reflect the relevant intention is straightforward. For example, there may be contemporaneous correspondence which makes it clear what was intended.[10] However, in other cases it may be more difficult to show what was intended. In *Racal* itself, whilst it was clear that the document in question did not give effect to the donor's intention (which was to obtain tax relief by making a series of covenanted payments to charity for more than three years), the claimant was unable to demonstrate "with the requisite clarity" precisely what was intended in terms of the timing of the covenanted payments. In that case rectification was therefore refused.

[2] *Pitt v Holt* [2013] UKSC 26; [2013] 2 A.C. 108.
[3] See e.g. HH Judge Hodge QC in *Hartogs v Sequent (Schweiz) AG* [2019] EWHC 1915 (Ch); [2020] W.T.L.R. 505 at [37]; *Pitt* [2013] UKSC 26 at [135].
[4] See e.g. *Hartogs* [2019] EWHC 1915 (Ch); *Graham v Lynch* [2020] EWHC 986 (Ch).
[5] *Graham* [2020] EWHC 986 (Ch) at [31].
[6] *Graham* [2020] EWHC 986 (Ch) at [32].
[7] *Whiteside v Whiteside* [1950] Ch. 65 at 71 per Sir Raymond Evershed MR.
[8] *Marley v Rawlings* [2014] UKSC 2; [2015] A.C. 129 at [66].
[9] *Racal Group Services Limited v Ashmore* [1995] S.T.C. 1151.
[10] As was the case in *Giles v RNIB* [2014] EWHC 1373 (Ch); [2014] S.T.C. 1631.

It is important to note that the failure of the document to reflect the relevant intention must relate to the nature of the transaction or the way in which it is carried out rather than the tax consequences. This can be illustrated by the case of *Allnutt v Wilding*.[11] A settlor intended to make a gift into trust which qualified as a potentially exempt transfer. He did not realise that, in order to achieve this, the trust needed to be an interest in possession settlement rather than a discretionary settlement. The gift was therefore made to a discretionary settlement, which was an immediately chargeable transfer for inheritance tax purposes. Rectification was not available, as the settlor had intended to create a discretionary settlement and so the document did reflect the settlor's intention. The fact that it had a different tax consequence to the one which he intended was of no assistance in the claim for rectification.

Another difficulty which frequently arises in relation to claims for rectification results from the principle that "equity will not act in vain".[12] This caused a problem for the claimant in *Whiteside*, where the wording of a covenant by a husband to make annual payments to his ex-wife resulted in more tax being payable than was strictly necessary. However, before the court hearing took place, the husband and his former wife entered into a new deed with the correct wording. As there was no longer an issue between the parties, the court declined to rectify the original covenant.[13] This was the case even though the husband might have had a claim against his lawyer in the absence of rectification, so that there was arguably some relevance to the rectification in terms of the respective rights of the people involved.

The requirement for there to be an issue between the parties has been relaxed over the years. In *Whiteside* the Master of the Rolls suggested that one party must actually be asserting a right against the other in order for rectification to be granted.[14] However, in *Racal* the Court of Appeal accepted that it would be enough if there is an issue which is *capable* of being contested between the parties or (as in that case) between the donor and the person he intended to benefit, and that it does not matter if everybody involved agrees that rectification should be granted.[15] The court was also satisfied that, even if the reason why rectification is sought is to obtain a tax advantage (or to remove a tax disadvantage), that is no bar to rectification being granted. The court did however confirm that rectification would not be granted if the only effect of the order would be to secure a tax benefit.

The most recent case where rectification has been granted in a trust context is *Graham v Lynch*.[16] The settlor had set up several BVI trusts to hold UK property. It was intended that the settlor should be excluded from benefit to avoid any inheritance tax reservation-of-benefit problems. However, although he was not a member of the class of beneficiaries, the trustees had power to add beneficiaries, and the settlor was not specifically excluded from benefiting. The claim was therefore brought to rectify the trusts by inserting the settlor and his spouse as excluded persons.

However, before the application was made, the trust assets were distributed to the settlor's children so that the trustees no longer held any assets. On the face of it therefore, granting rectification would serve no useful purpose other than removing any inheritance tax reservation of benefit risk.

The court had to strain quite hard to satisfy itself that there was an issue between the parties. The court did this by reference to the fact that the documents distributing the assets to the settlor's children contained an indemnity in favour of the trustees (on which basis it was said that the trustees continued to be trustees) and on the basis that, if for some reason further assets were added to the trusts, the trustees would be obliged to deal with those assets in accordance with the terms of the trusts. The question as to whether or not the settlor was able to benefit from the trusts would, in those circumstances, be an issue capable of being contested between the settlor and the trustees.

[11] *Allnutt v Wilding* [2007] EWCA Civ 412; [2007] W.T.L.R. 941.
[12] See *Pitt* [2013] UKSC 26 at [136].
[13] And see more recently (although not in a trust context) *MV Promotions Ltd v Telegraph Media Group Ltd* [2020] EWHC 1357 (Ch); [2020] S.T.C. 1652.
[14] *MV Promotions* [2020] EWHC 1357 (Ch) at [76].
[15] *Racal* [1995] S.T.C. 1151, 1157d.
[16] *Graham* [2020] EWHC 986 (Ch).

The court also relied on a possible claim for negligence against the lawyers involved in drafting the trusts (noting that this was a factor relied on in *Giles v RNIB*) as well as on the fact that the existence of a possible tax liability represented an issue which might in the future be contested (presumably with HMRC).

It is hard to see how this decision can stand in the light of the Court of Appeal's comments in *Racal* but, for the moment, the environment seems to be very benign for those who wish to rectify mistakes in trust documents.

However, to be on the safe side, counterintuitive as it may seem, if an error is spotted which requires rectification, the temptation to put it right without the involvement of the court should be resisted, as there is a clear risk in light of *Racal* that, if there is no longer any issue between the parties, rectification will not be granted.

Interpretation and construction

A potentially simpler way of dealing with mistakes in trust documents is by interpreting those documents in the light of the relevant factual background. This is the normal way of interpreting contracts. The Supreme Court confirmed in *Marley v Rawlings*[17] that the same principles should be applied to wills and this approach is also taken with respect to family trusts.[18]

The key question is how far it is permissible to go in interpreting a document before this becomes an exercise in rectification.

In the context of wills, Nicholls J said in *Re Williams decd* that the proposed interpretation must not be one "which the word or phrase cannot bear".[19] It is not permissible to vary or contradict the language used, as that amounts to re-writing the document, which should be achieved, if at all, by way of rectification.

The House of Lords however appears to have taken a rather wider view in *Chartbrook Limited v Persimmon Homes Limited* where Lord Hoffmann suggested that:

> "There is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant."[20]

If this is right, there is arguably little difference between an exercise of interpretation and the grant of rectification,[21] which would seem odd given that, as we have seen, rectification is a remedy which is "jealously guarded" and which is in any event discretionary and so could be refused if there has, for example, been a delay, change of position or third-party reliance. In *Marley* Lord Neuberger described the relationship between interpretation and rectification as "a difficult point" but one which, in that case, he did not need to decide.[22]

In the event, recent decisions of the High Court in relation to the interpretation of trusts demonstrate a fairly restrained approach.

Armstrong v Armstrong[23] was a case relating to standard form insurance policy trusts where some of the boxes had not been completed and, in one place where there were two alternatives, one of which should be deleted, both alternatives had been left in place.

[17] *Marley* [2014] UKSC 2 at [20].
[18] See e.g. *Millar v Millar* [2018] EWHC 1926 (Ch); [2018] W.T.L.R. 563 at [17].
[19] *Re Williams decd* [1985] 1 W.L.R. 905 at 911H.
[20] *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38; [2009] 1 A.C. 1101 at [20].
[21] See e.g. "Construction and rectification after Chartbrook" (Case Comment) Richard Buxton C.L.J. 2010, 69(2), 253–262.
[22] *Marley* [2014] UKSC 2 at [41].
[23] *Armstrong v Armstrong* [2019] EWHC 2259 (Ch).

It was clear on the evidence what the settlor intended. Having reviewed the authorities in relation both to interpretation and rectification, the court filled in the blanks and deleted the relevant alternative but did this by way of rectification rather than interpretation.

On the other hand, in *Millar v Millar*,[24] a settlor created a trust for the benefit of his father but which, after his father's death, provided that the income should be paid to the settlor. However, the trust also contained a clause excluding the settlor from taking any benefit.

It was clear that these two clauses were inconsistent and equally clear that the settlor was intended to benefit. The court therefore interpreted the trust on the basis that the clause excluding the settlor from benefit should be ignored.

Whilst this could be criticised as interpreting the document in a way which is contradictory to the wording used, this was a case where the document was itself internally inconsistent and so this seems much more naturally to fall within the category of interpretation rather than rectification.

It seems therefore that, despite Lord Hoffmann's observations in *Chartbrook*, the courts remain conscious of the distinction between interpretation on the one hand and rectification on the other.

Clearly a claimant will find it easier to make an application based on interpretation as there are less hurdles to overcome, but rectification should always be claimed as an alternative if the changes needed to the document to reflect the relevant intention contradict the wording of the document or require extensive changes.

Mistake

The circumstances in which a voluntary disposition may be set aside for mistake were settled by the Supreme Court in *Pitt*. They were conveniently summarised by the then Chancellor (Sir Terence Etherton) in *Kennedy v Kennedy*.[25] The key features are as follows:

(1) There must be an actual mistake rather than just ignorance without which the transaction would not have been entered into.
(2) The mistake must normally be in relation to the legal nature of the transaction or some matter of fact or law which is basic to the transaction.
(3) There is no requirement for any fault.
(4) The mistake must be sufficiently serious that it is unconscionable or unfair for the mistake not to be corrected.

Over the last few years there have been a succession of cases where transactions relating to trusts have been set aside on the basis of mistake. In all cases, the purpose of the application has been to avoid unwelcome tax consequences. In only one of these cases has the application been unsuccessful.[26]

One aspect where the courts have perhaps on occasion been somewhat lenient is in determining whether there has been a distinct mistake as opposed to just ignorance. In many of the cases dispositions have been made in ignorance of the fact that the disposition gives rise to a significant tax charge. Typically this is on the basis that advice has been taken and the tax charge has not been spotted; i.e. the advice is wrong.

Payne v Tyler is a good example of this.[27] A died and left assets to B. In order to ensure that there would be no inheritance tax on B's death, B executed a deed of variation so that the assets instead went into a

[24] *Millar* [2018] EWHC 1926 (Ch).
[25] *Kennedy v Kennedy* [2014] EWHC 4129 (Ch) at [36].
[26] *MacKay v Wesley* [2020] EWHC 1215 (Ch), a rather unusual case in which the claimant was seeking to set aside her appointment as trustee in the context of an unsuccessful tax avoidance scheme in order to avoid liability for the substantial tax charge which resulted. The claimant succeeded in her appeal from the order of the Deputy Master ([2020] EWHC 3400 (Ch)) but on the basis of undue influence in regard to her *acceptance* of the trusteeship (and after a subtle amendment to her pleading). The judge noted at [13] that the issues raised relating to mistake "are complex and potentially important" but left them to be considered when necessary in the future.
[27] *Payne v Tyler* [2019] EWHC 2347 (Ch); [2019] W.T.L.R. 1221.

discretionary trust of which B was a beneficiary. However, still within two years of A's death, the trustees amended the terms of the trust to give B a life interest. This meant that the assets in the trust were treated as forming part of B's estate when she died a few years later. In this case, the trustees had taken advice which turned out to be wrong. They therefore had a genuine belief that no tax would be due and so there was an actual mistake.

The position in *Van Der Merwe v Goldman* was more nuanced.[28] The claimant set up an interest in possession settlement shortly after the tax rules had changed in the budget on 22 March 2006. He had taken advice in 2005 which (correctly at the time) confirmed there would be no tax charge on creating an interest in possession settlement. However, he did not confirm the advice when he established the trust several months later. The court accepted that the settlor had still made a mistake as his ignorance of the change in the law had resulted in an assumption that the creation of the settlement would not give rise to an immediate inheritance tax liability.

The position in *Hartogs v Sequent*[29] is perhaps even closer to the line. The claimant settled two overseas settlements at a time when he was deemed domiciled in the UK for inheritance tax. He was acting on advice from a firm of advisers in Switzerland, although it was not apparent what expertise that firm had in UK tax. Having been advised that creating the trust was a sensible thing to do, the settlor assumed that there would be no adverse UK tax consequences. This was enough for him to have made a mistake rather than simply being ignorant of the true position.

It is clear then that seeking specific advice which turns out to be wrong is sufficient. However, even vague or out-of-date advice can give rise to what some of the cases have referred to as a tacit assumption which, if incorrect, will be enough on which to base a claim for mistake. This sets the bar relatively low for any such claim.

Once the hurdle of showing that there has been a mistake has been overcome, it is apparent from the recent cases just referred to that the existence of a significant tax liability if the transaction is not set aside will normally elevate that mistake into one which is sufficiently serious to make it unfair to leave the mistake uncorrected. It should however be remembered in this context that the Supreme Court in *Pitt* warned that:

> "In some cases of artificial tax avoidance the court might think it right to refuse relief, either on the ground that such claimants, acting on supposedly expert advice, must be taken to have accepted the risk that the scheme would prove ineffective, or on the ground that discretionary relief should be refused on grounds of public policy."[30]

There is a suggestion in *Pitt* that a further requirement before a transaction will be set aside on the basis of mistake is that, in the same way as for rectification, there must be a genuine issue which is capable of being contested, even if the parties decide that they will not in fact contest it.[31] This is not mentioned in the Chancellor's summary in *Kennedy*. However, it is a point which has been picked up in later cases such as *Payne*.[32] It is not therefore clear whether there is any requirement for the setting aside of the transaction to have some effect on the rights of one or more persons other than the saving of tax. However, given the nature of the remedy, it would be quite an unusual case where setting aside the transaction did not affect such rights and therefore did not give rise to any issues capable of being contested.

It is tempting to think that setting aside a transaction for mistake is an all or nothing remedy. However, *Kennedy* demonstrates that this need not necessarily be the case. That case related to a deed of appointment which dealt with three separate funds, two of which were to be retained on different trusts but the third

[28] *Van Der Merwe v Goldman* [2016] EWHC 790 (Ch); [2016] 4 W.L.R. 71.
[29] *Hartogs* [2019] EWHC 1915 (Ch).
[30] *Pitt* [2013] UKSC 26 at [135].
[31] *Pitt* [2013] UKSC 26 at [140].
[32] *Payne* [2019] EWHC 2347 (Ch).

was distributed to the claimant outright. Although the general rule in relation to contracts is that the contract may only be set aside on the basis of mistake in its entirety, the Chancellor accepted that a self-contained and severable part of a voluntary transaction could be set aside on the basis of mistake. It was therefore possible to set aside only the outright distribution and to leave the new trusts relating to the other two funds in place.

The fact that there have been subsequent dealings with the trust assets will also not prevent a transaction being set aside on the basis of mistake. In *Rogge v Rogge* various transfers to trusts were set aside on the basis that a property purchased using the settled funds should be transferred to the settlors but on the basis that the settlors compensated the trustees for funds which the trustees had expended in relation to the property in question and which derived from transfers which could not be set aside on the basis of mistake.[33]

Not surprisingly, setting aside a transaction on the basis of mistake has become the remedy of choice in relation to trust transactions which have given rise to unexpected tax liabilities. This is because:

(1) It can be invoked by settlors as well as trustees.
(2) There is no need to show any fault or breach of duty.
(3) Ignorance will often qualify as a mistake as long as some advice has been taken.
(4) The tax liability itself will usually make the mistake sufficiently serious that it should be remedied.
(5) There is a certain amount of flexibility in relation to the way in which any remedy can be structured.

The Hastings-Bass principle

As mentioned earlier, given the advantages of making a claim on the basis of mistake, the *Hastings-Bass* principle has, to a large extent, become redundant.

As a reminder, this allows a transaction to be set aside if a fiduciary has, in breach of duty, failed to take into account relevant considerations before entering into a transaction.

In almost every case the failure to take into account a relevant consideration will be a mistake. If so, it is much better to make the claim on the basis of mistake as there is no need for the trustees to accept that there has been any breach of duty.

There is however still a place for the *Hastings-Bass* principle. If trustees simply give no thought at all to a relevant consideration, such as potential tax liabilities, it is likely that they will be in breach of duty and thus able to invoke the *Hastings-Bass* principle.

It is equally likely that they will not be able to rely on mistake as there will be no basis on which they will be able to say that they had even a tacit assumption that the transaction would not give rise to any tax liabilities, not having turned their minds to it at all. It is however interesting that, as mentioned above, since the decision in *Pitt*, no such claims appear to have been put forward on this basis in the English courts.

Conclusion

The good news for those who are adversely affected where things have gone wrong in relation to trusts is that the English courts are happy to help. What once appeared to be strict conditions have been relaxed. Perhaps this is why HMRC are no longer willing to participate in cases where the effect of relief being granted is to avoid a tax liability. Instead, they simply ask the court to bear in mind some of the older cases where claims have been unsuccessful.

[33] *Rogge v Rogge* [2019] EWHC 1949 (Ch); [2019] W.T.L.R. 1305.

It is however arguable that the pendulum has swung too far in favour of those wishing to correct their mistakes. Unsurprisingly, since most of the cases are uncontested, it is some time since the Court of Appeal has had to consider any of these issues. When they get a chance to do so, it will be interesting to see whether they are prepared to show as much flexibility as the judges in the High Court.