Aviation/Dispute Resolution Briefing

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The mortgagee's duty of care on the exercise of a power of sale

Introduction

Under English and common law legal systems, a secured lender is usually given the right, in a default situation, to sell the distressed asset. In other words, the secured lender may step in to arrange and conduct the sale itself, as seller. This right of 'self-help' is largely unknown to codified civil law systems, which require any such sale to take place through a formal court process, in which the court arranges the sale and acts as seller.

In aircraft, ship and property finance, whether or not self-help rights are included is an important consideration for a lender in evaluating its risk. So, for example, in ship finance, mortgage registration in countries which recognise self-help rights (or otherwise permit registration of English law mortgages) will give this advantage, whereas registration in most Continental European and Latin American countries will not. In both ship finance and aircraft finance, successful resort to self-help in the enforcement context will also of course depend on the laws of the country where the asset is located at the time of enforcement.

The exercise of self-help is, however, by no means an unfettered right, because mortgagees, whether of aircraft, ships or land must have regard to and preserve their borrowers' 'equity of redemption, in other words the possibility that there may be 'equity' in the asset to be returned to the borrower from the sale proceeds after full repayment of the loan.

A mortgagee who fails to have due regard to its borrower's equity of redemption, risks having any sale which the mortgagee arranges using its 'power of sale' challenged by the borrower and set aside by the court.

A recent English judicial decision in relation to an aircraft financing, *Alpstream AG & Ors v PK Airfinance Sarl & Anr*[1], offers a salutary warning to those lenders who fail to take their duties sufficiently seriously.

1 [2013] EWHC 2370 (Comm)

This decision has general application to all mortgagees, whether of aircraft, ships or land, but is of particular relevance to aircraft and ship mortgagees, who operate in much smaller markets in which assets are, on occasion, sold on terms which do not properly test the market, or sold to other customers on what may appear 'cosy' terms to a judge, or which form part of a wider transaction, often with a 'warehousing' dimension, where the purchaser is associated with the lender, or the asset otherwise remains accounted for in the lender's books.

The mortgagee's duty of good faith

English and 'common law' mortgage deeds and other security documents will typically give the mortgagee or security trustee a broad power to take possession of and to sell the security. Provided that the terms of such agreements are sufficiently clear, the courts will generally not stand in the way of that enforcement.

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Nevertheless, a mortgagee's powers are not completely unrestricted. Historically, a mortgage transferred title to the mortgagee, with only a 'right to redeem' being left to the borrower, a right which only the courts of equity, but not the common law courts, would enforce. In the late 19th Century, the jurisdiction of these two courts was merged, although some of the nomenclature has survived. So, to protect a borrower's 'equity of redemption', English courts today still impose an 'equitable' duty on mortgagees to exercise their powers of sale in good faith for proper purposes. Thus the mortgagee must take proper account of the interests of the mortgagor, and others interested in the equity of redemption, when it exercises its power of sale.

That duty is somewhat limited. For example, the courts have held that it is not necessary for the mortgagee to have "purity of purpose", and thus, provided that one of the mortgagee's motives in exercising its power of sale is the genuine purpose of recovering, in whole or in part, the amount secured by the mortgage, the fact that the mortgagee has other motives will not invalidate the power. Further, the duty of good faith does not operate when the mortgagee is determining whether and when to exercise its power to sell, and instead the mortgagee is free to act in its own interest.

However, the duty of good faith remains significant, and a particularly important aspect for mortgagees to bear in mind is the duty to take reasonable care to obtain the "true market value" for the mortgaged property *(Cuckmere Brick Co v Mutual Finance[2])* - a mortgagee cannot simply sell an asset at a price which is sufficient to discharge the debt owed to it. Where the sale is to a third party buyer, the borrower will have the evidential burden of proving that the mortgagee breached its duty.

However, as *Alpstream* re-confirms, if the mortgagee sells to a "company in which he is interested", then the evidential burden shifts to the mortgagee and the onus is a heavy one, requiring the mortgagee to show that he used his "best endeavours to obtain the best price reasonably obtainable" for the mortgaged property *(Tse Kwong Lam v Wong Chit Sen[3])*, which, in practice, will require the mortgagee to give extensive disclosure of documents, to make its officers available for cross-examination as witnesses and allow the court to analyse the mortgagee's discharge of his duty in forensic detail.

The *Alpstream* case

In *Alpstream*, PK Airfinance Sarl, an aviation finance lender and affiliate of GE Capital Aviation Services Limited, had provided finance to two borrowers in the Alpstream group, part of the Russian NRC group controlled by Alexander Lebedev. The finance was for the purchase of a number of Airbus A320s which were leased to a low cost German airline, 'Blue Wings'. Blue Wings ran into financial difficulties and filed for insolvency in

2 [1971] Ch 949
3 [1983] 1 WLR 1349

early 2010, with the result that PK's power of sale under the relevant mortgages arose. PK set about exercising that power, organising a public auction of the "distressed aircraft".

Alpstream contended that in exercising the power of sale, PK failed to perform its duty to take reasonable steps to obtain the best value for the aircraft, or to act in good faith and for proper purposes. In particular, Alpstream referred to the fact that PK had itself purchased the aircraft at auction and then transferred them to GECAS, which was part of the same group, in order that the aircraft could then be leased to 'JetBlue', an American airline. Alpstream argued that the transfer to GECAS and lease to JetBlue were pre-destined, that in setting up the auction PK was simply "going through the motions", and that instead PK should have organised a private sale to achieve the best price reasonably obtainable.

Breach of duty?

As has been stated, where a mortgagee has sold to a third party, the onus of proof will be on the borrower to demonstrate that the mortgagee breached its equitable duty. However, given that in this case the mortgagee, PK, had purchased the aircraft itself, with a back-to-back on-sale to GECAS, the court scrutinised what had happened much more closely. The judge, Mr Justice Burton, was prepared to treat the overall transaction as a sale to a company in which PK was interested. Such cases are likely to be highly fact specific, but in such circumstances it has been held that the facts must show that the desire to obtain the best price is given "absolute preference" over any desire that the connected party obtains a good bargain. Thus, if PK had prioritised the procurement of the A320s for GECAS in order to secure the lease to JetBlue over obtaining the best price reasonably obtainable, then it would be in breach of duty.

In this case, Mr Justice Burton concluded that the auction exercise carried out by PK was, at best, half-hearted. In particular, although PK had carried out an extraordinary US$50 million of repairs and upgrades to the A320s pre-auction, converting them from an 'as is' to an 'as new' condition, there was no trumpeting of the "magnificent" condition of the A320s in the marketing material. Further, although the auction was advertised, there was no targeting of possibly interested parties and no chasing up of or encouraging of such parties that did make enquiries. Mr Justice Burton concluded that this ensured that PK "did not spoil the deal" to JetBlue, an "important strategic customer" of PK, and that, in bidding at the auction, PK bid just enough to be "affordable" but no more than required to beat other offers. Thus PK paid no attention at all to the need to obtain the best price.

In reaching this decision, the judge noted that no independent valuation advice had been obtained. He confirmed earlier judicial decisions that although it is not an "inflexible absolute obligation" *(Saltri III Ltd v MD Mezzanine SA SICAR[4])* for a mortgagee to take independent valuation advice, even in a connected sale situation, the failure to take such advice in *Alpstream* was significant.

The best price reasonably obtainable

The judge then turned to consider whether the price paid by PK was in fact the best price reasonably obtainable. Despite his finding as to the deficiencies in the auction process, on the basis of the expert valuations put forward, Mr Justice Burton concluded that even if an improved auction had taken place, the aircraft would not have achieved a higher price than the figure which was ultimately bid by PK. This was because both parties' experts accepted that, had the A320s been sold at auction, the market price would have been subject to a distress discount of 20%. In relation to the arguments as to a private sale, noting that such an exercise would have taken at least seven months, the judge came to the same conclusion that PK's bid would not have been beaten.

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4 [2012] EWHC 3025 (Comm)

However, given that this was a sale to a connected party, rather than the more usual case of a borrower needing to prove it had suffered loss as a result of a breach of duty by the mortgagee, the onus of proof was reversed. There was therefore a "heavy onus" on the mortgagee to prove that it had used its best endeavours to obtain the best price reasonably obtainable.

While the judge accepted that it was not necessarily impossible for the A320s to have been purchased by GECAS for the purpose of leasing to JetBlue, PK would need to show that the correct value had been obtained. Because PK had lined up a "special" or "uncommonly motivated purchaser" in GECAS, there would have been no need to conduct either an auction, with the associated "distress" discounts to which bids in such auctions are subject, or a hypothetical private sale exercise, taking at least seven months with all the associated marketing, depreciation and storage costs.

Instead, if PK had been transparent with the borrower that the purpose of the purchase was to implement a lease to JetBlue, there would not have been a need to characterise the sale as a "distressed sale" or to discount the price to incentivise the purchase of all the aircraft, since that was precisely what was wanted. Indeed, the judge considered that PK would in fact have paid (just) more than the market price without the need for any auction. Although no independent valuation had been obtained at the time, a reputable valuation at trial showed that the market price without any discount for distress would have been some US$10 million higher than the price actually paid by PK.

PK was thus held to be in breach of duty, and ordered to pay damages of US$10.175 million plus costs, although it is understood that it is planning to appeal the decision.

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Other recent decisions

The decision in *Alpstream* bears some comparison with the recent decision of the English Admiralty judge, Mr Justice Teare, in *Bank of Scotland plc v The Owners of the Union Gold*[5]. That case concerned an application for the court to approve the judicial sale without auction of four small cargo ships to buyers identified by the mortgagee bank. In such a judicial sale, the court can confer a title free of pre-existing liens and encumbrances, thus increasing the vessels' likely value, and as a result the mortgagee may choose this route to enforcement, rather than by exercising any power of sale it may otherwise have under the terms of the mortgage.

The Admiralty Marshal in England has the power to sell either by auction or by private treaty, and until the *Union Gold* decision, the court had been willing on many occasions to approve direct judicial sales to specific buyers without the need for an auction, provided that it were shown that the price being paid was the "best possible price" that the vessel would achieve. However, in The *Union Gold*, Mr Justice Teare refused to approve 3 of the 4 proposed sales, despite the fact that the mortgagee had provided a number of valuations to support the proposed sale prices. Although the judge accepted that the court may be able to reach a decision on questions of valuation if sufficient evidence were provided, he observed that the Admiralty Marshal has considerable experience in this area, and that it is more appropriate that the Marshal rather than the court should appraise the vessels. Emphasising the importance of ensuring fair treatment for the defendant shipowner and other potential claimants, the judge went on to hold that a judicial sale would only be ordered to a direct buyer without appraisement and auction if there were "special circumstances" to justify such an order.

Although The *Union Gold* related to a sale by the court, and not a sale by a mortgagee, the decision illustrates the approach of the court to determining what steps ought to be taken

5 [2013] EWHC 1696 (Admlty), for further commentary on this decision, see our briefing note, available at http://www.wfw.com/Publications/Publication1283/$File/WFWJudicialSalesOfShipsInEnglandAndSingapore.pdf

to ensure that the sale raise the best price. In The *Union Gold*, despite the fact that the mortgagee had obtained valuations to justify its price proposed for a direct sale, the court nevertheless considered this inferior to an auction process. Interestingly, in *Alpstream*, the court accepted that forced sales typically depress prices by 20%, whereas, in The *Union Gold*, the court considered that the fact that court sales of ships pass title to a purchaser free of maritime liens, unlike private sales (a distinction that would not apply to aircraft sales), was a factor to be weighed against the downwards effect on price of a forced sale.

In the same vein, the Privy Council's decision in *Cukurova Finance International Ltd & Anr v Alfa Telecom Turkey Ltd*[6] shows that the willingness of the court to grant equitable relief from forfeiture, where a lender had exercised rights of appropriation and had itself registered as owner of shares in companies forming part of its security. *Cukurova* involved mortgages over certain shareholdings. The Privy Council found that the mortgagee's primary interest in the shares was not to realise its security, but to obtain control over the underlying company and so, when an event of default occurred, it sought to exercise its power under the loan agreement to appropriate the shares despite the fact that the borrower had given notice that it intended to repay the loan in full. The Privy Council accepted that, given that an event of default had been established, the mortgagee was entitled to accelerate, and rejected the borrower's arguments that appropriation was nonetheless invalid because it was actuated by bad faith or malice. However, the Privy Council nevertheless proceeded to grant relief from forfeiture, in exercise of a jurisdiction not limited to real property, but also to other property including shares. Thus the borrower succeeded in retaining the shares upon repayment of the loan. While the decision in *Cukurova* turned on what the Privy Council described as "unusual and unlikely to be repeated" facts, *Cukurova* is another instance of the court intervening to restrain a mortgagee from taking liberties with its rights on foreclosure.

Conclusion

Although the mortgagee's power of sale remains as important as ever, as *Alpstream* and other recent decisions demonstrate, it is not a power without limit. The courts are increasingly conscious of the importance of the interests of both the mortgagor and other creditors, and will step in to prevent a mortgagee from apparently abusing its position.

Mortgagees must therefore have their duty of care uppermost in their minds when exercising the power of sale. A properly conducted auction or private sale may well be sufficient to discharge that duty, but particular caution is required where the sale is to a connected party. In many such cases, ship and aircraft mortgagees will have 'white knights' or 'preferred bidders', either third party buyers whom they intend to finance to purchase the asset, or 'warehouse' buyers, whom they own, or control, or retain some kind of interest in, such as through favourable terms or 'equity kickers'. In these cases, mortgagees would be well advised to seek independent legal and valuation advice, preferably from several valuers or brokers, to ensure that the price paid is the true market value of the asset. Mortgagees should be cautious about approaching white knights and even more cautious about signing 'letters of intent' with them, as happened in *Alpstream.* Mortgagees should also ensure not to sell to themselves, a 'sale to self' being void under English law *(Farrer v Farrars Limited*[7]*)*, a trap into which the mortgagee in *Alpstream* nearly fell, and was only saved because the court was prepared to treat the back-to-back on-sale as part of the same transaction.

Mortgagees are often well-advised to conduct any sale through brokers, to distance themselves from the sale and to ensure proper advertisement. In ship finance, the cost of maintaining floating assets, often fully crewed, as well as the fact that such a sale will not deliver the vessel to the buyer free of maritime liens, may cause an arrest and court sale

6 [2013] UKPC 2
7 [1888] 40 Ch D395

process, depending on the jurisdiction, to be preferable to a private sale process. With aircraft, court processes are usually much more cumbersome, maintenance costs correspondingly less of an issue, and having possession rarely an issue, such that private sale will invariably be the preferred sale method.

Mortgagees may also wish to include provisions in the mortgage deed seeking to exclude liability for breach of duty. However, it is important to be aware that such clauses will be strictly construed. In *Alpstream*, for example, it was held that an exclusion clause which operated to limit PK's liability unless wilful misconduct could be shown was not applicable as PK knew it was preferring the interests of GECAS over its obligations as a mortgagee, and covered this up where necessary. Thus particular caution should be exercised when drafting such clauses.

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