The Court of Appeal’s recent decision in *PK Airfinance SARL & Anr v Alpstream AG & Ors* provides welcome clarity on the nature and limits of the duty owed by mortgagees when selling distressed assets and also reminds mortgagees of the importance of their acting fairly towards their mortgagor borrowers.

**Introduction**

For any mortgagee, the option of enforcing its security is one of last resort, even where the borrower is in serious default. If the borrower can be persuaded to market and sell the asset, this is usually a much preferable alternative. Nevertheless, it may occasionally become necessary for a mortgagee to resort to enforcement. For this purpose, the inclusion of ‘self-help’ remedies in the mortgage documentation to permit a mortgagee to repossess and to sell the asset itself, without the assistance of the court, is of great importance and value to any mortgage lender.

If a mortgagee does exercise its power of sale, it must comply with the duties that equity imposes on it, specifically to act in good faith and for proper purposes and to take reasonable care to obtain the best price reasonably obtainable at the date of sale. A mortgagee owes these duties both to the mortgagor and to any other persons with an interest in the ‘equity of redemption’, including second and subsequent mortgagees, co-mortgagors and guarantors of the mortgagor’s debt.

1. [2015] EWCA Civ 1318
2. *Downsview Nominees Ltd v First City Corporation Limited* [1993] AC 295, 311F-H - referred to in para 115(b) of the Court of Appeal’s judgment in Alpstream.
3. *Gee v Liddell* [1913] 2 Ch 62 - referred to in para 115(c) of the Court of Appeal’s judgment.
If a mortgagee fails to comply with these duties, it may be ordered to account for what should have been obtained. This is particularly relevant where the asset could have been sold for more than the secured debt, leaving a surplus or ‘equity’ after the loan debt was fully repaid.

It is not uncommon for mortgagees of aircraft or ships, when exercising their power of sale, to ‘warehouse’ the asset by transferring it to a special purpose company set up by the mortgagee in order to trade or lease out the asset, often on a temporary basis until the asset can later be conveniently sold outright following a market recovery. For this purpose, a mortgagee may not legally sell to itself. A mortgagee may, however, sell to an affiliate or party in which it is interested, but in such case there will be a ‘heavy onus’ on the mortgagee to show that it had acted fairly.

The Court of Appeal’s ruling in Alpstream overturned a first instance judgment of the Commercial Court made in July 2013 which considered these issues (discussed in our previous briefing note). In particular, the Court of Appeal held that the first instance judge was wrong to find the mortgagee’s duty to be owed to a junior, unsecured lender which had only a contractual right, under documentation intended to cross-collateralise various loan facilities, to receive any residual balance following a sale of the mortgaged assets. The first instance judge had held that the mortgagee had sold the assets (mortgaged aircraft) to an associate but had failed to comply with its equitable duty to obtain the best price obtainable. The judge held that the mortgagee, which wished to purchase the aircraft in order to lease them to a favoured customer, was a ‘special’ or ‘uncommonly motivated’ purchaser and, as such, should have paid a full market price for the aircraft as determined by an independent valuation which the judge held that the mortgagee should have obtained. The first instance judge therefore held the mortgagee liable to account the difference between that full market price and the lower price actually obtained. The judge held that the mortgagee, which wished to purchase the aircraft in order to lease them to a favoured customer, was a ‘special’ or ‘uncommonly motivated’ purchaser and, as such, should have paid a full market price for the aircraft as determined by an independent valuation which the judge held that the mortgagee should have obtained. The first instance judge therefore held the mortgagee liable to account the difference between that full market price and the lower price actually obtained. Again, the Court of Appeal rejected the judge’s findings. On the evidence, it was clear that the mortgagee would not have paid more than it had actually paid. Accordingly, whatever criticisms might be made of the mortgagee’s conduct of the auction process, a mortgagee, which was under no duty to purchase a mortgaged asset, could not be compelled to purchase that asset for more than it had decided to pay.

Background
The appellants (and defendants at first instance) were PK Airfinance SARL (“PK”), a company which provides aviation finance, and GE Capital Aviation Services Limited (“GECAS”), an affiliate of PK, which leases and manages the leasing of aircraft. Both are members of the group headed by General Electric Company (“GEC”) in the USA. The claimants (and respondents on appeal) were various companies in the NRC group, controlled by the Russian oligarch, Alexander Lebedev.

In 2007 and 2008, PK had agreed to finance the purchase of seven aircraft by two NRC group companies. The aircraft, which were to be leased to Blue Wings, a German low cost airline, were mortgaged to PK to secure repayment of the loans. In 2009, PK agreed to finance the purchase of three additional aircraft by Caelus Aviation Ltd (“Caelus”). The Caelus aircraft were mortgaged to secure both the Caelus loan and the Blue Wings loans. One of the NRC companies, Alphastream

6 Tse Kwong Lam v Wong Chit Sen [1983] 1 WLR 1349 – quoted at paras 92 and 213 of the Court of Appeal’s judgment.
Clearer Skies Ahead: The Court of Appeal Reviews the Extent of a Mortgagee’s Duties On Sale of a Distressed Asset

Limiting (“Alphastream”), was a junior, unsecured lender to Caelus that was entitled, under a contractual ‘waterfall’ provision in the Caelus documentation, to any remaining proceeds of sale of the Caelus aircraft once the Blue Wings and Caelus loans had been fully repaid. Alphastream also had options to purchase the Caelus aircraft or the Caelus shares.

In late 2009, payment defaults occurred under the 2007/8 loans when Blue Wings ran into financial difficulties and filed for insolvency. In early 2010, PK recovered possession of the Blue Wings aircraft and determined to sell them by public auction in exercise of its power of sale. No third party turned up to the auction in May 2010, and the aircraft were sold to PK for $146.8 million, having outbid a bid by an NRC group company. A number of NRC companies, including Alphastream, then commenced proceedings against PK and GECAS, alleging the sale to be a sham.

At first instance, the judge held that, as the aircraft were purchased by PK and transferred to affiliates of GEC, there was a sale to a connected party and accordingly PK had to show that it had acted in good faith to obtain the best price reasonably obtainable. The judge determined the best price reasonably obtainable to be $158 million, and therefore assessed the measure of damages as the $11.2 million difference between that and the price actually paid. The judge held that duty to be plainly owed to the borrowers. However, they could not establish any loss because the Blue Wings loans were so far ‘under the water’ that, even if a higher price had been paid, they would have been left with no equity. The judge nevertheless held that the borrowers’ mortgage account should be reduced by the difference. He then went on to hold that PK also owed a duty to Alphastream as the residual beneficiary of the sales proceeds “within the same contractual structure” and was liable to account the difference to Alphastream.

The defendants appealed. A large number of arguments were raised on the appeal, but the key issues, on which this briefing note will focus, concerned the question of whether PK owed any duty to Alphastream, and if so, whether PK had breached that duty by failing to obtain an independent valuation of the Blue Wings aircraft and/or bidding up to the amount of such valuation.

The Court of Appeal held that to extend the duty of PK as mortgagee of the Blue Wings aircraft to Alphastream as an “unsecured junior lender or possible recipient of the Caelus waterfall” would constitute an unjustified departure from established case law.

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The Court of Appeal reached the unanimous conclusion that PK owed no duty to Alphastream. Having so decided, it was not strictly necessary for the Court of Appeal to go further. Nevertheless, Lord Justice Christopher Clarke went on to comment that in any event he would have dismissed the claims made by Alphastream for various other reasons, including the fact that the loss that it contended it had suffered could only be contingent, since the Caelus aircraft remained unsold and operating, and was therefore not actionable.

In further *obiter* comments the Court of Appeal gave a number of helpful clarifications.

‘Sale to self’

PK had transferred the shares in the borrowing entities which owned the aircraft to a bank (Wells Fargo) before the auction to act as ‘owner trustee’ before buying the aircraft in at the auction and then on-selling directly to special purpose entities in the GEC group. The Court of Appeal expressed the view that the mortgagee (PK) had not therefore sold to itself. Further, as PK had on-sold to special purpose entities, the Court of Appeal observed that these sales were effective to transfer title, even if the original sale to PK could be assailed7. Further, the Court of Appeal indicated that an estoppel might possibly have been raised against the mortgagor, which had not objected to PK’s right to bid – that was expressly in the auction notice – to the extent that the mortgagor sought to impugn the sale8. For the above reasons, although the sales could not be challenged as sales to self, the sales were to parties connected with PK and, accordingly PK bore the burden of proving that it had acted in good faith and taken the necessary precautions to obtain the best price reasonably obtainable.

The judge’s ‘special purchaser’ analysis

The Court of Appeal rejected the judge’s finding that PK should have paid more for the Blue Wings aircraft than it did. The first instance judge had held PK to be a ‘special’ or ‘uncommonly motivated’ purchaser, given its enthusiasm to buy in the aircraft to lease them out to a favoured customer. As such, the judge held that the best price reasonably obtainable for the aircraft was their full market value, as determined by an independent valuation that PK should have obtained, but had failed to obtain. For this purpose, the judge relied on a valuation of one of the experts which assumed a marketing process extending over many months and excluding the 20% discount which both experts agreed would normally be applicable on a sale at auction. In addition, the judge held that PK could and should have paid a premium on top of the independent, undiscounted valuation figure. The Court of Appeal, having observed that it is quite usual in the aviation market for mortgagees to enter protective bids at auction, noted that the judge’s analysis could have potentially striking consequences for mortgagees, effectively requiring them to enter bids at a full, undiscounted market price plus a premium to avoid exposure to the sale being challenged for breach of duty. The Court of Appeal further noted that the judge’s reasoning ignored the fact that mortgagees are under no duty to bid at all. That aside, the Court of Appeal observed that the evidence in this case clearly showed that PK was not prepared to bid more than the amount actually paid. Only in cases where the evidence showed that the mortgagee had deliberately bid

7 The Court of Appeal cited the earlier case of *Henderson v Astwood* [1894] AC 150 as authority for this proposition – see para 83.

8 The Court of Appeal disagreed with the judge, however, that the mortgagor had affirmed the sales by attending the auction without objecting to PK’s purchase of the aircraft – see para 84-86.
less for the asset than the mortgagee was prepared to bid might such a breach of duty be made out – for example in a case where the mortgagee had confused its duty to obtain the best price with its desire to procure the best bargain for an associate. Further, the Court of Appeal disagreed with the judge that the only way for PK to sell was to obtain an independent valuation. But, as the Court of Appeal observed, had PK obtained such a valuation, it would simply have confirmed to PK a price which it was not prepared to pay, so the outcome would have been no different.

The Court of Appeal accordingly rejected the first instance judge’s analysis as unsound. The basic principle was that a mortgagee must show that it has put the interests of the mortgagor first and taken reasonable precautions to obtain the best price reasonably obtainable, whether by private sale or auction. However, this principle was not to be applied so as to prejudice the mortgagor by preventing the mortgagee from bidding. The fact that PK had not put the mortgagor’s interests first, and that the lead up to the auction was poorly handled, was immaterial. On the evidence, a higher price would not have been obtained by conducting a public auction in the most perfect way possible, or by a private sale to a third party following good exposure to the market. Although an independent valuation might generally be the best arbiter of the best price reasonably obtainable, it might not always be so, and in this case PK had effectively proved that it had obtained the best price reasonably obtainable.

**Conclusion**

The Court of Appeal’s decision in *Alpstream* provides some clarity and reassurance to mortgagee lenders considering whether to exercise their power of sale. First, the law has been clarified as regards which parties are legitimately interested in the ‘equity of redemption’ and to whom the mortgagee owes duties to act fairly and to obtain the best price. Secondly, whilst sales to the mortgagee itself are void, a back-to-back on-sale by a mortgagee will not be able to be challenged, although best practice remains for a mortgagee to use a special purpose company to purchase distressed assets, even if an on-sale is intended. Thirdly, a mortgagee is under no duty to bid at an auction or offer to purchase a distressed asset, but if it does so, it is not obliged to bid more than the best price reasonably obtainable, which, if the mortgagee participates in the bidding, cannot exceed the maximum which the mortgagee has decided to bid. Finally, the Court of Appeal has restated that, whilst, ordinarily, an independent valuation is the best arbiter of the best price obtainable, it is doubtful whether it always provides a clear and certain signpost and there is no inflexible requirement for the mortgagee to obtain such a valuation.

It is clear that, in *Alpstream*, the first instance judge took a very dim view of the manner in which the mortgagee conducted the public auction of the Blue Wings aircraft. It was clear that the mortgagee wanted to buy in the aircraft to lease them back to a favoured customer and that the auction was conducted in a half-hearted way to achieve that preferred outcome. Probably, the mortgagee would have been better advised not to conduct what risked appearing as a rather contrived auction and rather to have informed its borrowers of the intended sale and to have given them a right of first refusal. In practice, mortgagees of assets often look to preferred

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9 As held in *Australia & New Zealand Banking Group Limited v Bangadilly Pastoral Co. Pty Ltd.* [1978] 139 CLR 195 – cited by the Court of Appeal at paras 219-221.
10 There is no “inflexible” rule that a mortgagee must obtain an independent valuation - see para 217 of the Court of Appeal judgment.
11 See para 248.
customers to purchase distressed assets, often with the promise of finance as a sweetener. There is nothing wrong in doing so. Indeed, usually mortgagees do so precisely to improve on the likely sale price. In many cases, in an enforcement situation, the mortgage debt will decisively exceed the market price of the asset, so there will be no equity of redemption for the mortgagee to protect. But in cases where there is or may be equity in the asset, or where the difference is marginal, and where the mortgagee intends to bid at an auction or to make a protective offer in sale negotiations, which might leave its affiliate holding the asset, a mortgagee remains well-advised to obtain independent, expert valuation advice, including advice as to the best method of sale, and to follow that advice. Sales to parties associated with the mortgagee enable a court to scrutinise the sale arrangements forensically, and will place the evidential burden on the mortgagee to explain and to justify its actions. Any failure by a mortgagee to do so risks incurring the displeasure if not the wrath of the court.

FOR MORE INFORMATION

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