Court of Appeal clarifies mortgagee's duties in aircraft finance case

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Banking & Finance analysis: What are the duties owed by a mortgagee in possession? David Bowden, independent legal consultant, comments on the consequences of Alpstream AG and others v PK Airfinance Sarl and another and talks to Elaine Skittrell, a barrister specialising in financial services at 1 Gray's Inn Square Chambers, about what lessons can be learned from this case.

Original news

Alpstream AG and others v PK Airfinance Sarl and another [2015] EWCA Civ 1318, [2016] All ER (D) 05 (Jan)

The Court of Appeal has overturned the ruling of the Commercial Court and clarified the duties owed by a mortgagee in possession. The Court of Appeal held that a mortgagee could bid for or buy repossessed property and there was no absolute bar on it doing so. However, a mortgagee continues to owe a duty to obtain the best price reasonably possible and in a sale to self the burden of proof is reversed. Although this was an aircraft finance case the principles laid out by the Court of Appeal are applicable to retail mortgages relating to land.

What were the facts in these cases?

David Bowden (DB): The claimants (Alpstream) were all part of a group, NRC, ultimately based in Russia and controlled by a Mr Lebedev. Alpstream had aviation interests and was directly or indirectly interested in the shares of an Irish company and a Maltese company (the borrowers). PK Finance (a Luxembourg company which provided aviation finance) became part of the General Electric Company in the US as was the second defendant, GECAS (collectively 'the lenders'). The borrowers borrowed from these lenders moneys for the purchase of seven aircraft (the Blue Wings aircraft).

The first and second claimants were the holding companies of the borrowers and were co-mortgagees to PK Finance of the shares in the borrowers by way of security for the loans. In 2009, three more aircraft (the Caelus aircraft) owned by another company (a special purpose company within the NRC group) were funded by PK and leased out to Olympic Airways. These were much newer and more valuable than the Blue Wings aircraft. There was substantial equity over and above the amounts advanced for the Caelus aircraft by PK Finance which provided cross-collateralisation in respect of the amounts owing to PK Finance on the Blue Wings aircraft.

The Blue Wings airline ran into financial difficulties in 2009 and in early 2010 filed for insolvency. PK Finance's power of sale arose in respect of the Blue Wings aircraft. Six of the aircraft were purchased by PK Finance at an auction organised by PK Finance, transferred to the order of GECAS and then leased to JB Airways.

The six Blue Wings aircraft were repossessed in poor condition in breach of their redelivery conditions. They were put by PK Finance into effectively 'good as new' condition for the lease to JB Airways at net cost. A $49m charge to reflect this was added to the mortgage account. These aircraft were then bought by PK Finance at $146.8m and this was credited to the mortgage account. The mortgage account was in substantial arrears, and the outstanding balance was set off and/or cross-collateralised against the equity on the Caelus aircraft, which had not been sold and remained operating.

Alpstream complained of the way in which the lenders had acted in respect of the exercise of the power of sale over the six aircraft. Alpstream contended that the lenders had always intended to lease out the Blue Wings aircraft to JB Airways, and that PK Finance had failed to exercise its duty as mortgagee:

- to take reasonable steps to obtain best value for the Blue Wings aircraft (since the sale was to PK Finance itself, the burden was on it to establish compliance with its duty), and
- to act in good faith and for proper purposes

Alpstream contended that the lenders failed to take sufficient steps to market the Blue Wings aircraft. Alpstream said this failure was due to the fact that the lease to JB Airways was pre-destined such that steps taken to set up the auction and advertise such auction, in which PK Finance had been the only bidder, was merely going through the motions but did not risk a sale to a genuine third party. PK Finance relied on an exemption clause whereby it was exempted from liability for breach of duty save in respect of wilful misconduct.

Alpstream contended that the lender's conduct was wilful misconduct. The duty, if breached, was plainly owed to the borrowers and Alpstream but those parties could not establish that they had suffered any loss as the Blue Wings loans were so far under water.

Alphastream Ltd asserted a claim for breach of duty and claimed to have suffered losses because it was entitled to sums payable in respect of the equity in the Caelus aircraft after cross-collateralisation, by virtue of its position in what was termed a 'waterfall' after PK Finance and prior to GECAS.

If the mortgage account was overcharged, then there would have been less to offset against the equity in the Caelus aircraft, and Alphastream accordingly claimed that it had suffered loss by the amount, which would have flowed to it down the 'waterfall'. PK Finance denied that it owed Alphastream any duty, and in any event denied that Alphastream had suffered (at least unless and until the Caelus aircraft were sold) any or any recoverable loss. It was further contended that there had been an unlawful conspiracy between both the lenders in relation to the sale of the aircraft.

What did Burton J decide in the Commercial Court?

Following a 28-day trial, Burton J handed down his reserved judgment in July 2013 (*Alpstream AG v PK Airfinance Sarl* [2013] EWHC 2370 (Comm), [2014] 1 All ER (Comm) 441). Not surprisingly, given that the trial judge found the lenders' non-expert witnesses to be 'unimpressive', Burton J upheld Alpstream's claim. The lenders were granted permission to appeal this ruling to the Court of Appeal.

What were the central issues in this appeal?

The lenders as appellants put their appeal on three bases:

- the lenders owed no duty of care to unsecured third party creditors
- the sale of the aircraft at auction to the lenders was a proper sale, and
- the lenders as mortgagees owed a duty to get the best price reasonably obtainable for the aircraft and had fulfilled this duty

What did the court decide on duties owed to unsecured third party creditors?

When realising its security, a mortgagee owes an equitable duty to take reasonable care to obtain the best price reasonably obtainable at the date of the sale. It is for the mortgagee to decide, in its own interests, whether and when to sell even if the timing is unpropitious. The key questions in this case were to whom that duty is owed and whether Alpstream had proved a loss. Burton J at first instance had extended the law, holding that a mortgagee owed a duty beyond those with a direct interest in the aircraft to a creditor of a different company because that creditor could be affected by the sale of the mortgaged property.

The Court of Appeal was satisfied that this extended the duty too far. A mortgagee owes a duty to those with an interest in the mortgaged property, but not to anyone else. That conclusion is consistent with existing authority. If a mortgagee realises the mortgaged property for less than it should have done, the mortgagee must compensate the mortgagor for the shortfall by correcting the mortgage accounts. That correction will then flow through to those further down the waterfall, as far as the proceeds allow.

The Court of Appeal was also concerned to give effect to the documents agreed by the parties with the benefit of advice from experienced law firms. Equitable duties can be amended by agreement between the parties. The transaction documents in this case provided that Alpstream must not receive anything until the lenders had been fully repaid. A conclusion that Alpstream was entitled to damages before the lenders had in fact been paid off would undermine the parties' arrangements.

Equity should not recognise any duty that would 'confound the arrangements as to priority which the parties, including [Alpstream], agreed'.

The Court of Appeal did not accept this. Obtaining an independent valuation might be one way for a mortgagee to show that it discharged the duty, but it was not the only way. Alpstream's claim for loss relied upon a valuation following a lengthy marketing process, with no discount for the perception of a forced sale. This approach ignored the fact that a mortgagee is entitled to choose the timing of a sale which, in this case, would have led to a forced sale discount. The expert valuation evidence before the court showed that the sum paid by the lenders was higher than anyone else would have been prepared to pay in the circumstances. The lenders' purchase at that price therefore had benefited the mortgagors (and potentially Alpstream)—it had not disadvantaged them.

What did the court decide on sale to self?

Alpstream argued that the sale of the seven initial aircraft was void because a mortgagee is prohibited from purchasing the mortgaged property for himself. Both Burton J and the Court of Appeal rejected this contention on what was a connected party sale.

The specific arrangement was not a sale by the mortgagee to itself. The seller was the owner trust, not the mortgagee. The Court of Appeal acknowledged the common practice in the aircraft industry for a non-recourse secured lender to bid to protect the value of its security. There was no good reason to apply or expand the self-dealing rule. In a connected party transaction, where a sale gives rise to a risk of a conflict of interest and duty, the mortgagee has the burden of proof to show that it has discharged its duties.

What did the court decide on a mortgagee's duty to reasonably obtain the best price?

Where the burden of proof is reversed as a result of there being a connected party sale, the mortgagee will need to show that it obtained the best price reasonably obtainable. Burton J found that the price paid by the lenders was more than would have been recovered through a well-run auction or a lengthy private sale process. In *Alpstream*, the lender was the only bidder at the auction. Alpstream and its associates attended but declined to bid as much as the lenders. Alpstream complained that the lenders had not obtained an independent valuation of the aircraft and that such a valuation would have been for more than the price the lenders paid at the auction. Alpstream argued that the lenders had failed to discharge the heavy burden on a mortgagee buying mortgaged property to show that it had obtained the best price.

How does this decision clarify the issue of mortgagee's duties?

Elaine Skittrell (ES): Christopher Clarke LJ affirmed *Michael v Miller* [2004] EWCA Civ 282, [2004] All ER (D) 399 (Mar) in which Parker LJ said that it is a matter for the mortgagee how the general duty is to be discharged and that such decisions inevitably involve 'an exercise of informed judgement on the part of the mortgagee, in respect of which there can, almost by definition, be no absolute requirements'.

This makes it clear that mortgagees are free to choose how to obtain the best price reasonably obtainable—this may be by public auction or private sale. However, I would say that the prevailing market conditions must be considered. In *Alpstream,* Burton J said that the mortgagee was in breach of duty for, among other things:

'The absence of any significant consideration of how to get the best price and how to communicate with the market.'

DB: The Court of Appeal judgment here is a useful reminder of:

- a mortgagee's duties
- to whom they are owed, and
- contractual limitations in the context of market practice in aviation finance

By confirming the limits of the duties owed by a mortgagee when realising mortgaged property, it reduces the scope for disputes with third parties and unsecured creditors. Further, the Court of Appeal recognises that a mortgagor (or borrower) is not best served if the law or equity is construed so as to discourage a mortgagee from offering to buy the property at a fair price because of fears it might be required to pay more than market price to be able to show it is not in breach of duty.

What are the practical implications of this decision? Is this case of interest outside the aircraft finance field?

ES: This case is of interest to mortgagees outside the aircraft finance field. In allowing the lender's appeal, Christopher Clarke LJ relied heavily on authorities relating to the retail mortgage field.

In terms of the practical implications of the decision, it appears that mortgagees wishing to realise their security will have to think about the buyers' perception of how the sale is being conducted. Christopher Clarke LJ was careful to point out (at para [200]) that sale by auction is not 'intrinsically value destructive' but that if buyers perceive that the mortgagee wants to sell 'relatively quickly' this is likely to reduce the price. It follows that prudent mortgagees should avoid creating that perception.

DB: The decision is useful in confirming the general nature of a mortgagee's rights and responsibilities—particularly the duty to take reasonable precautions to obtain the best price reasonably obtainable. However, the circumstances of this case are unusual. It will be rare that where there is a retail mortgage used to buy residential property that a mortgagee in possession will be able to sell that property to itself. Such a sale can only be made by a court and even then such a prospective purchaser will need to obtain the permission of the court to bid at an auction.

Where a mortgagee wants to sell a repossessed property to one of its employees, it will bear the burden of proof (as we saw in this case) to demonstrate the propriety of the transaction. Such a mortgagee will need to prove it acted in good faith, and took reasonable care to obtain the best price.

A good example of the problems that can arise in practice is one from the property slump of the early 1990s. The Court of Appeal looked at what turned out to be a 'sale to self' in *Bradford & Bingley plc v Ross* [2005] EWCA Civ 394, [2005] All ER (D) 210 (Mar). Following repossession and sale of his former home, by trawling through subsequent entries at HM Land Registry, the customer established that his home had been sold by Homes for Tenants 4 Plc but this company was legally connected with the mortgagee, Bradford & Bingley. Chadwick LJ decided that it would not be right to simply set aside the judgment below because of the 'abuse' of the lender. Instead, he said this would not be a just outcome and sent the matter back for a re-trial in the County Court so it could decide on proper evidence (and applying the reverse burden of proof) what shortfall the lender had properly sustained.

Are there any grey areas remaining following this decision?

ES: Yes, arguably in relation to the prevailing market conditions.

While the Court of Appeal reminded us that the mortgagee does not owe the mortgagor any duty of care in relation to his choice of timing of the sale (*Silven Properties Ltd v Royal Bank of Scotland plc* [2003] EWCA Civ 1409, [2004] 4 All ER

484) Christopher Clarke LJ said 'the circumstances of a sale influence the price obtainable'. Therefore, the prevailing market conditions ought to be considered. It might be said that if the market was improving rapidly and substantially, consideration should be given to postponing the sale.

This situation was discussed in *Dimmick v Pearce Investments Pty Ltd* [1981] 43 FLR 235. This was a decision of the Australian Supreme Court in which Kelly J said:

> 'Unless there are very clear signs that the market is improving rapidly and substantially, I do not think that a mortgagee displays a lack of good faith in not postponing a sale otherwise regularly conducted on the chance that the market may improve.'

Conversely, when there is a falling market, mortgagees should bear in mind that sale by public auction 'might not be appropriate' according to the Court of Appeal in *Miller*.

DB: It should be noted that section 126 of the Consumer Credit Act 1974 (CCA 1974) provides that where a regulated agreement is secured by a land mortgage, the mortgage is enforceable only on an order of the court. Nearly all secured second charge lending to individuals whatever the amount since April 2008 will be CCA 1974-regulated. CCA 1974 contains no sanction as such for a breach of CCA 1974, s 126. The prevailing view has been that a mortgagee who sells in breach of CCA 1974, s 126 can still pass good title to a subsequent purchase of land.

The Court of Appeal considered CCA 1974, s 126 on an application for permission to appeal in *Waterside Finance Ltd v Karim* [2013] EWCA Civ 1472. Norris J had rejected a claim for an injunction under CCA 1974, s 126 as being bound to fail because of the Karim's delay in seeking the injunction (*Waterside Finance v Karim* [2012] EWHC 2999 (Ch)). In rejecting an application for permission to appeal, Briggs LJ noted that there was no appeal against this ruling of Norris J. It is clear that if an application had been made promptly a sale in breach of CCA 1974, s 126 could have been restrained by a court.

Those advising purchasers from mortgagees should obtain appropriate indemnities on this.

What action should lawyers take in light of this decision?

ES: In *Alpstream,* causation was a pivotal issue. Lawyers need to address this at a very early stage when there is an allegation of a sale at an undervalue. Here the borrowers complained about the 'minimalist auction' set up by the lenders and they alleged it was a 'charade'. However, in the final analysis, the failings in the auction process would have made no difference. It was held that a private sale to a third party following good exposure to the market would not (on Burton J's findings) have produced a higher net sale price.

DB: Where there is a sale to self, then lenders should keep proper records as to what they have done (or not done) and why so that they are in a position to meet the reverse burden of proof.

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