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Valuing appropriated financial collateral in a "commercially reasonable manner" - what ABT Auto Investments v Aapico tells us!

Introduction

In a typical real estate financing, a lender's security will comprise of a number of different forms of security. The core security will be created by a debenture given by the borrower, incorporating a legal mortgage over the property, assignments of rental income and insurance, and fixed and floating charges over the borrower's other assets.

It is also very common for a lender to take security over the borrower's shares from the borrower's parent. Having this security will give the lender the option of enforcing through a sale of the shares in the asset owning company, as an alternative to enforcing through a sale of the charged land itself.

Share security and the remedy of appropriation

Lenders will usually want to ensure that this share security qualifies as a security financial collateral arrangement under the Financial Collateral Arrangements (No. 2) Regulations 2003 (the "**FCARs**"). Under the FCARs, certain formal requirements and insolvency provisions are disapplied or modified for security financial collateral arrangements between non-natural persons. Furthermore, the remedy of "appropriation" will be available.

Appropriation is a very useful self-help remedy. It enables the collateral-taker to appropriate (or take as its own) the financial collateral, without the need for a court order if the security document provides for a power of appropriation and if the collateral-taker values the financial collateral "*in accordance with the terms of the arrangement and in any event in a commercially reasonable manner*"[1].

Certain offshore jurisdictions allow security over shares in a company incorporated in that jurisdiction to be governed by the laws of other jurisdictions. It is becoming more common for offshore jurisdictions (such as the British Virgin Islands) to elect to use the law of England and Wales to govern share security as this enables the security document to include a power of appropriation which would not otherwise be available if the security document were governed by the local law.

When is a valuation obtained in a "commercially reasonable manner"?

Neither the FCARs nor the underlying EU Directive which the FCARs sought to implement[2] explain what is required to make a valuation in a "*commercially reasonable manner*". When dealing with listed shares, there is an available and liquid market. However, commonly the shares over which a lender may have security in a real estate financing will be unlisted and illiquid shares in a private company, leading to uncertainty over how they should be valued and whether it will be done in a "*commercially reasonable manner*" for the purposes of Regulation 18 of the FCARs.

The case of ***ABT Auto Investments Ltd v Aapico Investment Pte Ltd and others***[3] is the first case to look at the meaning of "*commercially reasonable manner*" in the context of Regulation 18 of the FCARs. It provides some much-welcomed guidance

[1] Regulation 18(1), FCARs.
[2] EU Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.
[3] [2022] EWHC 2839 (Comm)

on what a valuation made in a "*commercially reasonable manner*" might look like in practice.

- **Who is responsible for the valuation?**

  The court made it clear that the collateral taker is responsible in law for the valuation, even if it has used a third-party valuer. If the third-party valuer has not carried out the valuation in a commercially reasonable manner, the valuation will not have been carried out in a commercially reasonable manner and the collateral taker cannot say that it has been on the basis it has acted reasonably in instructing an apparently competent third party to do the work.

- **It is the method, not the result!**

  It is the way in which the valuation is done which must be commercially reasonable, but it does not necessarily follow that the result itself must be a commercially reasonable one. That said, a commercially reasonable/unreasonable result may indicate (in the absence of evidence to the contrary) that that result has been arrived at in a commercially reasonable/unreasonable manner.

- **The manner of valuation should confirm with "the reasonable expectations of sensible businessmen"**

  The court confirmed that the requirement for the valuation to be made in a commercially reasonable manner imports an objective standard. The subjective view of the collateral taker (or of its third-party valuer) about what is commercially reasonable is irrelevant. The word "commercially" indicates that the standard to be applied is that of reasonable participants in the relevant financial market. In other contexts, the manner of valuation should conform to "the reasonable expectations of sensible businessmen"[4].

- **Look at the facts!**

  The question of what, in any given case, is commercially reasonable is fact sensitive. Depending upon the nature of the collateral and the circumstances of the case, there could be only one commercially reasonable manner of valuation, or there could be several. It will depend, in each case, on the particular facts.

- **No good faith requirement, and no implied equitable duties**

  In the context of the valuation required to be made on appropriation, there is no separate and independent requirement for the collateral taker to act in good faith, and no room for the implication of any of the equitable or other duties associated with the law of mortgage in English law. The statutory requirement in the case of a financial collateral arrangement is therefore simply that the valuation must be made "*in accordance with the terms of the arrangement and in any event in a commercially reasonable manner*" - no more, no less.

- **Personal gain...?**

  Despite the fact a collateral-taker will have no requirement to act in good faith and no equitable duties will be implied, other than in the rare situations where the collateral-taker is the only buyer, it is unlikely to be a commercially reasonable valuation process for the valuing party to have primary regard to its own interests. In cases where there is a range of approaches that could potentially be regarded as commercially reasonable, the collateral taker cannot deliberately adopt the approach which produces the lowest valuation, or which otherwise suits it best. It must still act overall in a way which is commercially reasonable.

Non-compliance with Regulation 18 of FCARs will not invalidate appropriation

The court was clear that the requirement under Regulation 18 of the FCARs is not a pre-requisite to an effective appropriation. Non-compliance will not invalidate an appropriation, but it could potentially lead to the non-compliant valuation subsequently being set aside. The judge explained that any other conclusion would inevitably lead to uncertainty as to the ownership of the collateral and this would be something which would be wholly unacceptable in the (often fast-moving) financial markets, and therefore very unlikely to have been intended to be the effect of the FCARs or the EU Directive which the FCARs implemented.

[4] Steyn LJ (as he was then) in G Percy Trentham Ltd v Archital Luxfer Ltd [1993] 1 Lloyd's Rep 25 at 27; First Energy (UK) Ltd v Hungarian International Bank Ltd [1993] 2 Lloyd's Rep 194 at 196.

Special value of the collateral of the collateral-taker

In this case, the judge did not need to consider the issue of whether a "*commercially reasonable manner*" of valuation should reflect any special value to the collateral-taker.

There had been an unsuccessful attempt by ABT Auto to amend its Particulars of Claim a month before the trial to argue that the charged shares had a "special value" to the collateral-taker in excess of the ordinary market value and that the special value (which had not been reflected in the valuation) should have been taken into account by any commercially reasonable valuation. However, the trial judge did not need to consider the issue as the application to amend the Particulars of Claim had been unsuccessful.

ABT Auto's application for permission to appeal was also refused and therefore we will need to wait for a future case to determine this particular issue, which the judge acknowledged was "*interesting and difficult*".

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