

# Mortgagee duties: *PK Airfinance Sarl v Alpstream AG* – Court of Appeal decision

Security enforcers should note today's timely reminder from the Court of Appeal on the scope of their duties as mortgagee. In finding for the mortgagee (for whom Clifford Chance acted), the Court of Appeal confirmed existing law that the mortgagee does not owe its duties to those without a recognised interest in the property sold. The decision also confirms that whilst a mortgagee who seeks to buy mortgaged property is under a heavy duty to show that it has acted fairly to the mortgagors, the mortgagee still decides on the timing and method of sale. The decision recognises the value to aircraft mortgagors of a mortgagee being able to bid for the aircraft and that a mortgagee is not obliged to pay more than the market price. The decision should reassure secured financiers as to the enforcement powers available to them under English law.

Mortgagees owe duties to their mortgagors when realising the mortgaged property, but that duty does not extend to unsecured creditors even if it is foreseeable that the unsecured creditors might be adversely affected if the sale is not conducted properly. In *PK Airfinance Sarl v Alpstream AG* [2015] EWCA Civ 1318, the Court of Appeal decided that the mortgagee's duty is confined to those who have an interest in the mortgaged property itself, not third parties who might have a contractual right to monies at the far end of an agreement as to the application of payments, including certain sale proceeds (a so-called "payments waterfall").

## Background

In *Alpstream*, the Defendant (D) financed the purchase of seven aircraft. The loans were secured by shares in the borrower vehicles and mortgages over the aircraft.

D subsequently financed the purchase of three additional aircraft. The security taken in respect of the three additional aircraft also stood as security for the loans in respect of the initial seven aircraft; this cross-collateralisation is typical in multiple asset financings.

The Claimant ("C") was a junior and unsecured creditor of the buyer of the three aircraft. It would only receive repayment if and when all the prior obligations secured by the mortgages were paid. C agreed in the inter-creditor agreements that it would have no security interest in any aircraft. C also provided no evidence to show how much, if anything, it was owed.

The borrowers defaulted. The operator of the seven aircraft went into liquidation. These aircraft were in poor condition when repossessed. D forced the sale of those seven aircraft at public auction when the borrowers'

## Key lessons

- Mortgagees do not owe duties to those with no interest in the mortgaged property
- Mortgagees can choose the timing of the realisation of their security in their own interests
- Mortgagees buying the property must show that they obtained the best price, but do not have to pay more than the market price at the time

parent company and junior lenders refused to repay the senior debt.

D successfully bid for and bought the aircraft at the auction. C alleged that the price paid was less than it should have been and, as a result, that C had suffered a loss because, as the party at the bottom of the waterfall for the three cross-collateralised aircraft, it would ultimately receive less. At first instance ([2013] EWHC 2370 (Comm)), the judge upheld C's claim.

The Court of Appeal has overturned that decision.

### No duty owed to unsecured third party creditor

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 *Alpstream* were to whom that duty is owed and whether the claimant had proved a loss. The first instance judge 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 C must not receive anything until D had been fully repaid. A conclusion that C was entitled to damages before D 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 [C], agreed".

### Sale to self

C argued that the sales of the seven aircraft were void because a mortgagee is prohibited from purchasing the mortgaged property for himself. Both the first instance judge 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.

### Best price reasonably obtainable

In practice, 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. The trial judge found that the price paid by D was more than would have been recovered through a well run auction or a lengthy private sale process. In *Alpstream*, D was the only bidder at the auction, C and its associates attended but declined to bid as much as D. C complained that D had not obtained an independent valuation of the aircraft and that such a valuation would have been for more than the price D paid at the auction: so it argued that D had failed to discharge the heavy burden on a mortgagee buying mortgaged

property to show that it had obtained the best price.

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. C'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 the mortgagee is entitled to choose the timing of the 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 D was higher than anyone else would have been prepared to pay in the circumstances. D's purchase at that price therefore had benefited the mortgagors (and potentially C); it had not disadvantaged them.

### Conclusion

The Court of Appeal judgment in *Alpstream* 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 borrower / mortgagor 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.

Clifford Chance LLP acted for the lead appellant in *Alpstream*.

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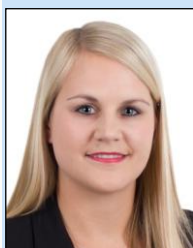
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