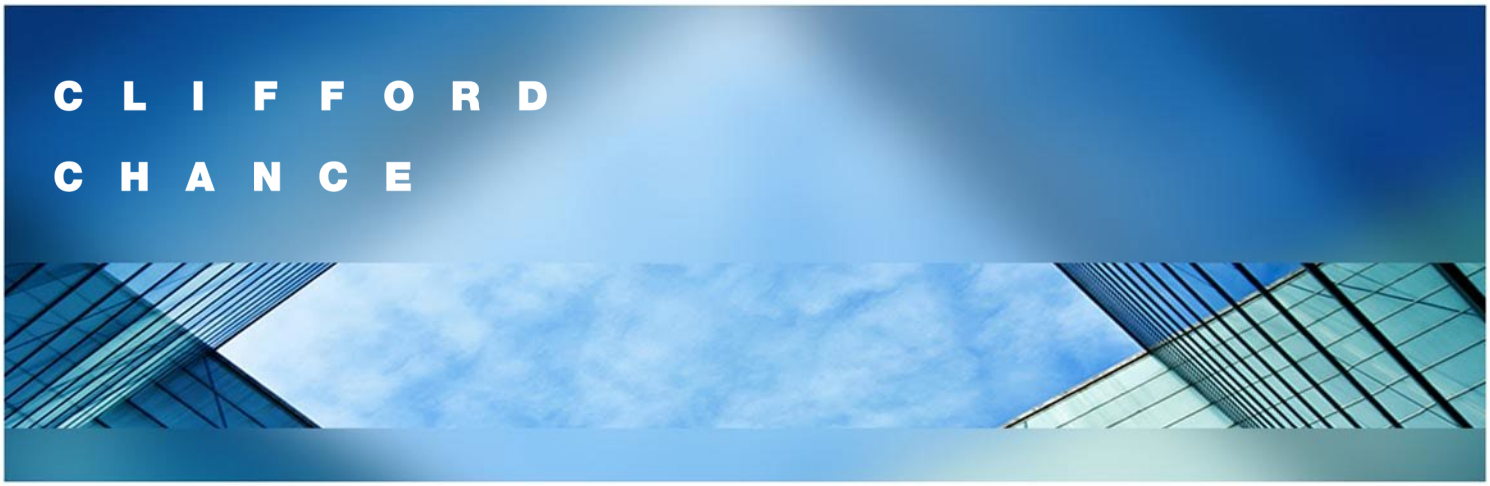

FINANCIAL COLLATERAL ARRANGEMENTS – VALUING COLLATERAL IN A "COMMERCIALLY REASONABLE MANNER"

In *ABT Auto Investments Ltd v Aapico Investment Ptd Ltd and others* [2022] EWHC 2839 (Comm), the English Court has blessed the appropriation of shares held in a private company as a legitimate security enforcement mechanism.

Appropriation offers a less formal route compared to the more traditional route of appointing a receiver to enforce who will then exercise a power of sale to realise the assets, with certain duties still owed to the collateral provider in terms of realisation process. This case represents the first time that the Court has considered the duty in Regulation 18 of the Financial Collateral Arrangements (No 2) Regulations 2003 ("**FCARs**") requiring collateral takers to value the financial collateral they are seeking to appropriate in accordance with the terms of their arrangement "and in any event in a commercially reasonable manner". In this case it was held that, unlike in a traditional enforcement scenario, no separate fiduciary duties to the collateral provider arose, but instead there is a requirement that the valuation of the collateral is to be conducted in a commercially reasonable manner. The case also considered arguments around the validity of appropriation itself based around Regulation 17 of the FCARs.

This case will likely be of most relevance to clients with the benefit of a financial collateral arrangement where (a) the collateral is difficult to value because it is illiquid (either intrinsically or due to market stresses), and/or (b) where the relevant documentation contains a prescriptive valuation process. It will also be interesting to see if some of the factors identified by the judge – in particular around the manner of instruction and communications between the collateral taker and the valuer – may be read across into valuation disputes elsewhere, for example on general security enforcements or even in the context of cross-class cram down and the relevant alternative for a Part 26A Companies Act restructuring plan.

Key issues

- This is the first case to consider the issue of valuing collateral when seeking to enforce by way of appropriation.
- The primary duty of valuation rests ultimately with the collateral taker.
- A flawed valuation does not however affect the validity of the appropriation itself.
- Clauses whereby collateral givers agree that the prescribed method of valuing the collateral is reasonable do not prevent a contrary argument from being advanced at a later stage.
- Valuations must be carried out in a commercially reasonable manner - something which becomes more complex to achieve with illiquid collateral.
- On appropriation, the collateral taker owes no independent duty of good faith or other equitable or similar duties (unlike on traditional enforcements) but remains always subject to the requirement for valuations to be conducted in a commercially reasonable way.

BACKGROUND

ABT Auto and Aapico formed a joint venture in 2017 to hold shares in companies representing the automotive foundry part of the Sakthi group (the parent group of ABT Auto). The shares in this joint venture, Sakthi Global Auto Holdings Limited, were ultimately held as to c. 50.1% by ABT Auto and c. 49.9% by Aapico. Aapico made two loans into the joint venture in 2017 and 2018. ABT Auto provided a charge over its shares in the joint venture as

security for the amounts due under the 2017 and 2018 loans and provided certain guarantees.

Unfortunately, the financial position of the joint venture deteriorated and in August 2019 Aapico made demand on its loans and on the guarantees provided by ABT Auto. When no payment was immediately forthcoming, Aapico exercised its rights under the share charge to appropriate the 50.1% shareholding owned by ABT Auto in the joint venture. A value of £27,000,000 was ascribed to the shares based on a valuation dated 31 July 2019 carried out by FTI.

There was no dispute between the parties as to whether the share charge was enforceable or whether it qualified as a financial collateral arrangement. However, ABT Auto challenged Aapico's right to appropriate the collateral for two reasons:

- the share charge was not effective to confer a legally valid power of appropriation because the method of valuation set out therein was not commercially reasonable; and
- alternatively, the valuation of the collateral by FTI had not been carried out in a commercially reasonable manner.

What is a Financial Collateral Arrangement?

The FCARs implemented EU Directive 2002/47/EC on financial collateral arrangements ("**FCD**") in the UK, the purpose of which was to simplify enforcement procedures relating to "financial collateral" (broadly speaking, cash, shares and bonds) across the EU and to ensure a degree of consistency.

The FCARs covers both "title transfer financial collateral arrangements" (where one party transfers legal and beneficial ownership in financial collateral to another party on terms such that when the relevant financial obligations have been discharged, the title to the collateral will be transferred back to the original owner) and "security financial collateral arrangements" (where one party provides a security interest in collateral to secure their obligations to another party). This latter form of financial collateral arrangement was reflected in the Aapico share charge.

Financial collateral arrangements benefit from certain advantages over traditional security, including (but not limited to) a rapid and non-formalistic method of enforcement known as appropriation, and exemptions from certain insolvency restrictions which would otherwise apply to security, such as the statutory moratorium applicable under Schedules A1 and B1 of the Insolvency Act 1986.

The right of a collateral taker to appropriate financial collateral in discharge of an equivalent amount of debt is a useful alternative to a collateral taker exercising a power of sale or appointing a receiver but, in exercising a right of appropriation, the collateral taker must account to the collateral provider for any surplus value of the financial collateral above the amount secured.

Validity of appropriation

Regulation 17 of the FCARs provides that where a financial collateral arrangement includes a power of appropriation, that power may be exercised by the collateral taker without requiring any form of foreclosure or sales order from a court. Regulation 18 of the FCARs provides that where a collateral taker exercises their power of appropriation, they must value the collateral in accordance with the terms of the arrangement and "in any event in a

commercially reasonable manner". The judge separated the issue of the validity of the appropriation from the issue of valuation by making it clear that Regulation 17 is not concerned with valuation.

If, after the event of appropriation, a valuation was found to be unacceptable, that did not invalidate the appropriation itself carried out under Regulation 17. Non-compliance instead may lead to the original valuation being set aside and the court substituting its own valuation. If this substituted valuation, for example, ascribed a higher value to the collateral than the original valuation, then the collateral taker may, if appropriate, be required to account to the collateral provider for the difference. Any alternative conclusion would lead to uncertainty as to the ownership of collateral (which would be unacceptable in fast moving financial markets) and would not have been the intention of the FCARs and the FCD.

Aapico also advanced the argument that because the share charge set out a method of valuation and included an express agreement from ABT Auto that this method was commercially reasonable, ABT Auto was now estopped from arguing that this method of valuation was not commercially reasonable. Many financial collateral arrangements contain similar clauses regarding the reasonableness of the prescribed method of valuation. Whilst the judge had already rejected ABT Auto's argument that the method of valuation was not commercially reasonable, he noted that ABT Auto was not precluded from contending that the method of valuation was unreasonable despite their previous agreement to the contrary. Regulation 18 makes it clear that a valuation must be commercially reasonable "in any event" and was designed to serve a protective function with regards to the objectives set out in Regulation 17. As such, parties cannot contract out of the requirement that collateral must be valued in a commercially reasonable manner, and any methods of valuation expressly set out in financial collateral arrangements will need to be considered in such a light.

What are the requirements for a "commercially reasonable" valuation?

The issue of the valuation of financial collateral on appropriation will always be a contentious one, since the valuation will determine how much debt is "set-off" as a result of the appropriation of the collateral. Collateral providers will want to ensure that the valuation is as high as possible to reduce the amount of collateral the security taker might appropriate to repay themselves, but collateral takers may wish for the exact opposite.

Neither the FCARs nor the FCD contain any description of what exactly constitutes a "commercially reasonable manner" of realising value.

The share charge in this case prescribed the following method of valuation:

- the value of the collateral should be determined by the collateral taker.
- the value of the collateral should be the "market value" of the shares.
- the market value of the shares was to be determined by reference to an independent valuation.
- the valuation had to be conducted in a commercially reasonable manner.
- the valuation had to be conducted in good faith.

The judge came to the following conclusions regarding what Regulation 18 of the FCARs required with regards to a "commercially reasonable" valuation:

- First, Regulation 18 places the duty of valuation on the collateral taker (i.e. Aapico). They are ultimately responsible for the valuation even if they use a third party to carry out the valuation itself. The third party valuer must themselves act in a commercially reasonable manner when carrying out the valuation – the mere act of the collateral taker appointing an independent valuer is not a sufficient enough step in this regard.
- Second, whilst the valuation must be carried out in a commercially reasonable manner, the result does not necessarily have to be a commercially reasonable one. That said, if the value produced was less than might have been reasonably expected, that may be an indication that the valuation itself was flawed. In the other alternative, if a valuation was not carried out in a commercially reasonable manner but still produced the same result as would have been achieved with a commercially reasonable approach, the court was unlikely to set aside the original valuation merely to substitute the same figure.
- Third, an objective standard applies to a commercially reasonable valuation - i.e. that of reasonable participants in the relevant financial market. The subjective view of the collateral taker or their third party valuer about what is commercially reasonable is irrelevant.
- Fourth, what is commercially reasonable or not will be fact sensitive in each case. For example, where the financial collateral in question is made up of listed securities, the commercially reasonable approach to valuation would likely be to reference the publicly quoted price of those securities on the relevant exchange.
- Fifth, whilst there is no separate and independent requirement for the collateral taker to act in good faith under Regulation 18, the objective standard that must apply to valuations in this context means that it will be unlikely to be commercially reasonable for a collateral taker to have primary regard to their own commercial interests. Even in cases where there is a range of approaches that could be considered to be commercially reasonable, the collateral taker cannot deliberately adopt the approach that produces the lowest valuation or which otherwise suits them best.

Other key points to note

There is no express indication in either the FCARs or the FCD about whether a "commercially reasonable" valuation should respect any "special value" ascribed to collateral by the collateral taker. ABT Auto alleged that the collateral shares had a special value to Aapico in excess of the ordinary market value and that this should have been taken into account – such a special value was not reflected in the FTI valuation. However, this point was raised at a particularly late stage in proceedings and was not considered by the judge. This point therefore remains open and may be addressed in future cases.

A further point to note is that whilst Aapico had communicated to FTI its desire that the valuation would be a low one, this did not mean Aapico acted in a commercially unreasonable manner. The judge considered that Aapico's desire for a low valuation would have been obvious from the circumstances in

which FTI were instructed, but more importantly Aapico placed no constraints on FTI and did not seek to persuade them to act other than in a professional and independent way. In fact, Aapico encouraged FTI to produce a well evidenced and reasoned valuation to ensure it was robust in the event of any challenges.

Conclusion

The High Court has provided some useful and clear guidance on the factors that will need to be considered when carrying out a valuation of financial collateral to ensure such valuation is conducted in a "commercially reasonable" manner, although it remains to be seen whether the case will be appealed or not. The confirmation that an appropriation will not necessarily be set aside completely if a valuation is successfully challenged in court will also be a welcome assurance to those with the benefit of financial collateral arrangements.

Given that the FCARs are derived from the FCD, this case could also be relevant to financial collateral arrangements governed by the laws of EU member states.

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