**KEY POINTS**

- The case of *ABT Auto Investments Limited v Aapico Investment PTE Limited and others* (*ABT v Aapico*) is the latest example of cases which raise questions of interpretation and application of the Financial Collateral Arrangements (No 2) Regulations 2003 (FCARs) arising from the UK Treasury's decision to "gold-plate" the Directive on financial collateral arrangements, thus extending their ambit far wider than that required or contemplated by European law.
- If commercial parties agree on a method of valuation in their contract it is not obvious why a valuation conducted as per such agreement should be rejected as being commercially unreasonable.
- The appropriation remedy permits self-dealing at a stipulated price, rather than an arms-length third-party sale so it is not obvious that a collateral taker will be subject to a duty to take reasonable care – akin to that imposed on a mortgagee or chargee to obtain the best price reasonably obtainable.

Feature

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# Appropriation of financial collateral under English law security financial collateral arrangements

For nearly 20 years English law has permitted mortgagees and chargees of financial collateral to exercise a self-help remedy of appropriating charged collateral as a means of enforcing their security. The requirements include agreeing on the valuation of the collateral and conducting the valuation in a commercially reasonable manner. Since the implementing legislation is far wider than required by European law, the effectiveness of the remedy can be undermined by disputes as to what is commercially reasonable in particular factual contexts.

Almost 20 years after they introduced the novel remedy of appropriation into English law as a means of enforcing security over financial collateral, the UK Financial Collateral Arrangements (No 2) Regulations 2003 (FCARs) continue to raise difficult issues of interpretation and application, particularly when a secured party (known in the jargon of the FCARs as the "collateral taker") exercises the appropriation power over shares in private companies or other illiquid or non-listed securities. The latest case to have considered a challenge to the exercise by a collateral taker of a right of appropriation over financial collateral is the decision of the High Court (Mr Richard Salter QC sitting as a deputy High Court Judge) in *ABT Auto Investments Limited v Aapico Investment PTE Limited and others*. In this case the claimant (ABT) asserted that the defendants' (Aapico) purported appropriation of charged shares was ineffective because the defendants allegedly failed to value the shares in "a commercially reasonable manner" as required by the FCARs. To understand the arguments and the decision, a short recap on the provisions of the FCARs may be helpful.

The FCARs were formulated and introduced by the UK Treasury under s 2(2) of the European Communities Act 1972 in order to give effect to the requirements of the Directive 2002/47 of the European Parliament and Council of 6 June 2002 on financial collateral arrangements (FCD). The stated purpose of the FCD was to improve the integration, efficiency and stability of financial markets by, amongst other things, simplifying enforcement procedures and eliminating or reducing difficulties arising from the insolvency laws of different member states.

In this context recital (17) FCD is important. It states that the Directive "provides for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement … [it] balances the latter objectives with the protection of the collateral provider and third parties by explicitly confirming the possibility for member states to keep or introduce in their national legislation an *a posteriori* control which the courts can exercise in relation to the realisation or valuation of financial collateral and the calculation of the relevant financial obligations. Such control should allow for the judicial authorities to verify that the realisation or valuation has been conducted in a commercially reasonable manner".

Article 4 of the FCD provides that on the occurrence of an enforcement event, the collateral taker should be able to realise financial security provided under a security financial collateral arrangement in various ways, including by way of appropriation. Appropriation was to be possible only if the parties had agreed to it as a remedy in their security financial collateral arrangement *and* if they had agreed on the valuation of the financial instruments provided as collateral.

Member states which did not already recognise the remedy of appropriation were not required to do so by the FCD. From the perspective of English law, the remedy of appropriation was the most controversial of the remedies. In drafting the FCARs to confer a right of appropriation over financial collateral, the UK Treasury appears to have laboured under the misapprehension that the remedy was already generally available under English law, when it was not.

As the judgment of the Privy Council in the leading case of *Cukurova Finance International v Alfa Telecom Turkey* [2009] Bus LR 1613 records, the UK Regulations were cast significantly wider than was required

by the Directive in respect of the categories of transaction covered. The application of the Directive was mandatory only in respect of transactions between public authorities, central banks and institutions authorised to participate in financial markets. In other words, it was designed to apply to large, sophisticated parties who were generally active in the wholesale financial markets and whose use of collateral usually encompassed fungible securities for which there existed a ready market and where there were well-known market-standard terms of dealing. Given their role in the provision of liquidity to financial markets this was readily understandable.

The application of the Directive was optional if one party to the security arrangement was an authority, bank or authorised institution and the other was an ordinary company. However, the Treasury extended the ambit of the FCARs far more widely than the UK was required to do, so as to include transactions between ordinary companies whose dealings might only have an exiguous or even no role in the liquidity or stability of financial markets. This example of legislative overreach or "gold-plating" as the over-implementation of Directives is often picturesquely described, has created problems of interpretation for the courts which continue to resonate today. For in such cases, of which *ABT* is the latest example, the court is concerned with the interpretation and application of Regulations as between parties to which the Directive, as a matter of European law, neither required nor contemplated that its terms would apply.

Prior to the Directive and their transposition into English law via the FCARs, a collateral taker under an instrument such as an English law charge or mortgage could not enforce its security simply by appropriating financial collateral by its unilateral act. That would have been open to challenge as prohibited self-dealing and a clog on the equity of redemption. Be that as it may, as a result of the long-running *Cukurova* litigation, it became clear that under a FCARs-compliant security financial collateral arrangement, a collateral taker could validly appropriate financial collateral. The requirements are that the security financial collateral arrangement must expressly confer a power of appropriation on the collateral taker (reg 17) and that in exercising such a power the collateral taker must value the financial collateral in accordance with the terms of the arrangement and in any event in a commercially reasonable manner (reg 18). Those requirements were central to the dispute in *ABT*.

ABT was part of an Indian conglomerate active in the supply of automotive components. A group company incorporated in the US (SAGUSA) entered into a joint venture with a Chinese company with the aim of supplying components to General Motors. The first and second defendants, incorporated in Singapore and Thailand respectively, were members of the Aapico group of companies. In 2017 the two groups formed a joint venture company, SGAH (the third defendant). The shares in SGAH were held as to 74.9% by ABT and as to 25.1% by Aapico. ABT contributed its shareholding in SAGUSA to the joint venture. Aapico's contribution was financial in the form of equity and loans.

SAGUSA experienced financial difficulties in 2018. Aapico agreed to contribute further equity to SGAH, raising its stake to 49.9% and to provide further loans. On this occasion, ABT executed a charge over its shares in SGAH to secure all of Aapico's loans. The charges contained a power of appropriation over ABT's shareholding. The charges also included terms to the effect that if Aapico exercised the power of appropriation, then the value of the shares should be determined by Aapico, that the value of the shares should be the market value of such shares determined by Aapico by reference to a public index or independent valuation or if neither such option was available or reasonably practicable, such other process as Aapico might select. ABT agreed in the charge document that the method of valuation provided for was commercially reasonable for the purposes of reg 18 of FCARs.

SGAH failed to repay a tranche of the loans and interest timeously. As a result, in August 2019 Aapico accelerated the loans and demanded immediate repayment of nearly US$103m. When neither SGAH nor ABT repaid the loans (the latter pursuant to guarantees) Aapico gave notice that it had appropriated ABT's 50.1% holding in SGAH. It ascribed a market value of some US$27m to the shares based on a recent valuation carried out by FTI Consulting.

Some 10 months later ABT brought proceedings challenging the validity of Aapico's appropriation of the charged shares and the value which Aapico had ascribed to them based on the FTI valuation. ABT did not dispute that SGAH was in default of its loan obligations, nor that Aapico was entitled to enforce the charge. ABT's challenge was to Aapico's entitlement to exercise the right of appropriation at all, and in any event to the value of US$27m, which it contended represented a significant undervalue.

A trial took place over eight days in July 2022 supported by expert valuation evidence on both sides. One is entitled to ask whether a three-year delay and such an expensive exercise is really what the framers of the FCD had in mind when they referred to "rapid and non-formalistic enforcement procedures". Of course, the answer is obviously "No". The "blame", if there is any, is to be laid at the door of the Treasury and those who sought to extend the remedy of appropriation far beyond the scope of what was required by the FCD; if it had not done so, it is highly unlikely that a court would ever have been concerned with disputes over the appropriation of securities in entities for which there was no ready market or whose market value was not readily ascertainable. Be that as it may, in this case the court was obliged to deal with the dispute before it and make the best sense it could of the FCARs.

ABT's primary case was that the appropriation was ineffective since, so it claimed, the method of valuation adopted by Aapico was not commercially reasonable and because the valuation had not been carried out in a commercially reasonable manner. If it was wrong about its primary case, it contended that in any event the FTI valuation was at a gross undervalue, presumably also contending that the debt owed by SGAH/ABT to Aapico had, *pro tanto*, been discharged by the amount of the undervaluation.

As the court observed, there is no description in either the FCD or the FCARs as to what constitutes a valuation in a commercially reasonable manner. Indeed, the FCD refers only twice to realisation or

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valuation being conducted in a commercially reasonable manner in connection with appropriation. The first reference is in Recital (17) where the possibility of a member state keeping or introducing *a posteriori* control to allow verification by judicial authorities that realisation or valuation has been conducted in a commercially reasonable manner is mentioned. But Recital (17) did not mandate the keeping or introduction of such *a posteriori* control into national law if it did not otherwise exist. The second reference is in FCD Art 4(6) which provides that the right of appropriation was to be without prejudice to national law requirements that the realisation or valuation of financial collateral must be conducted in a commercially reasonable manner. Prior to the introduction of the FCARs there was no such specific requirement in English law, since the remedy of appropriation was not generally available to collateral takers in any event. Therefore, the only requirement in English law for a collateral taker to value collateral in a commercially reasonable manner in the context of an appropriation is that contained in reg 18 itself which does not cast any further light on what is required.

The court rejected ABT's primary complaint that the exercise by Aapico of its right of appropriation was legally ineffective. It was plainly correct to do so. There was no dispute but that the charge had become enforceable and so, prima facie, as long as the charge complied with the requirements of the Regulations, Aapico was entitled to exercise the remedy of appropriation over the shares. The charge expressly conferred a power of appropriation over the charged shares and so complied with the requirement of reg 17. It also contained a method or methods of valuation as implicitly required by reg 18. The methods of valuation in the charge plainly allowed for Aapico to select a commercially reasonable method – whatever the precise ambit of that requirement-in compliance with reg 18.

As established in the *Cukurova* litigation, the exercise of the remedy of appropriation over charged shares can be effected by the collateral-taker giving notice of appropriation to the collateral provider. The exercise of such a right is in effect a self-sale of the collateral which extinguishes the collateral provider's rights in it.

Having exercised the right of appropriation, Aapico was obliged to treat ABT's debt as extinguished pro tanto by the value placed by it on the collateral in accordance with the valuation provisions in the charge. As already explained, the charge expressly provided for Aapico to determine the market value of the shares by reference to a public index or independent valuation and if neither option was available or practicable by such other process as Aapico might select. The shares in SGAH being unquoted, Aapico exercised its option to value the shares by engaging FTI Consulting to carry out the valuation. ABT challenged both the chosen valuation process and its output. The court rejected Aapico's argument that ABT's agreement in the charge that the method of valuation provided for was commercially reasonable meant that ABT was contractually estopped from challenging the method of valuation chosen by Aapico-valuation by an independent valuer – but it did recognise that it was an important evidential factor in determining what was commercially reasonable.

In that context the court referred to dicta of the Privy Council in *Cukurova (No 3)*. There the charged shares were in an unlisted BVI company which indirectly held shares in Turkcell, the largest mobile phone company in Turkey, whose shares were quoted on the Istanbul and New York stock exchanges. The agreed valuation method was a "fair price" calculated on a "look-through" basis based on the weighted average of the market value of Turkcell's shares over a 60-day period. This valuation method did not allow for the fact that the charged shares would confer control over Turkcell on Alfa if it appropriated the shares and could therefore attract a control premium. The Privy Council did not have to decide whether the chosen method could be challenged on the basis that it was not commercially reasonable. It did however express scepticism that the words "and in any event in a commercially reasonable manner" in reg 18 could override the agreed basis of valuation.

On the one hand, there is much to be said for an approach which, at least as regards commercial parties of equal bargaining power, treats them as masters of their own contractual fate and does not permit them subsequently to dispute that a method of valuation expressly chosen in their security documents is reasonable for the purpose of reg 18. After all, such an approach is consistent with the FCD's emphasis on rapid and non-formalistic enforcement procedures and conducive to commercial certainty. If commercial parties agree on a method of valuation in their contract it is not obvious why a valuation conducted as per such agreement should be rejected as being commercially unreasonable. On the other hand, when a mortgagee or chargee exercises a power of sale over collateral it is normally under a duty to take reasonable care to obtain the best price reasonably obtainable. It might then be argued that since an appropriation is in effect a self-sale, commercial reasonableness requires the collateral taker to be subject to an analogous duty of care in valuing the collateral so as to produce something akin to the best price reasonably obtainable. However, the route to that result is by no means certain or obvious in the light of the terms of the Regulations and in the light of the nature of the remedy which permits self-dealing at a stipulated price, rather than an arms-length third-party sale.

In *ABT* the court concluded, after a very detailed evidential exercise, that the valuation conducted by FTI on Aapico's behalf was in fact conducted in a commercially reasonable manner so the appropriation and valuation could not be challenged. The lesson to be taken from this case is that if parties wish to make use of this remedy in a context which was never envisaged by the FCD, they should take the trouble to agree on a method of valuation in their security arrangements that is as transparent, and which achieves as close an approximation to market value, as possible. ■

*Further Reading:*

- An offer you can't refuse? Relief from forfeiture in the Privy Council (2014) 1 JIBFL 21.
- Enforcement of share charges: in practice (2013) 2 JIBFL 74.
- LexisPSL: Banking & Finance: Practice note: Key provisions of the financial collateral regulations.