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# Enforcement via self-help remedy of appropriation upheld by English court, notwithstanding valuation dispute; notable guidance on valuation process

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## At a Glance

In the first case to consider what is required to make a valuation "in a commercially reasonable manner" for the purposes of exercising the self-help enforcement remedy of appropriation under English law, the court upheld the collateral-taker's appropriation in full.[1] In doing so, it rejected the collateral-provider's case that the requisite valuation of the collateral was not conducted in a commercially reasonable manner (as is required by the relevant legislation).

The court held that there is no separate and independent requirement for a collateral-taker exercising the remedy of appropriation to act in good faith. The statutory requirement in exercising the remedy of appropriation is 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".

This imports an objective standard. The collateral-taker is not permitted to act in an arbitrary or unreasonable manner in choosing the method of valuation. The question of what is commercially reasonable in any given case is of course fact-sensitive.

Even if the valuation had *not* been conducted in a commercially reasonable manner, it would not have been void from the beginning, the court held. Instead, the primary remedy would have been for the court to set aside the valuation, to substitute a compliant one, and to make any necessary consequential orders.

Cases on appropriation are rare, but the valuation issues raised in this case may apply more broadly. In a precursor of the approach we anticipate the English court is likely to adopt in future restructuring cases involving valuation disputes (including restructuring plans), the parties' valuation experts were directed to meet and produce a joint memorandum setting out the matters on which they were agreed and those about which they did not agree.

## Background to remedy of appropriation

Appropriation is a powerful self-help remedy available to a collateral-taker permitting it unilaterally to take certain types of collateral as its own property without the formality of a court order. In effect, appropriation operates as a sale by the collateral-taker to itself at a price determined by an agreed valuation process.

Broadly, appropriation is available where:

- there is a "security financial collateral arrangement" - in the UK, this can include security over shares in a private company; and
- the security document expressly provides for the remedy of appropriation and contains provisions for valuation of the relevant financial collateral.

The collateral-taker must value the collateral in accordance with the security document and in any event in a "commercially reasonable manner". What constitutes a "commercially reasonable manner" for this purpose is not defined in the relevant legislation and there is no existing case law directly on-point.

If the value of the collateral exceeds the secured debt, the collateral-taker must account to the collateral-provider for the excess value. Conversely, if the value of the collateral is less than the secured debt, the collateral-taker retains a claim against the collateral-provider for the balance of debt. Accordingly, the collateral-taker will naturally desire a low valuation of the collateral.

Appropriation was introduced into English law under The Financial Collateral Arrangements (No. 2) Regulations 2003 (the "FCARs"). The FCARs implemented the European directive on financial collateral arrangements, which aimed to improve the efficiency of financial markets by introducing rapid, non-formalistic enforcement procedures for various forms of "financial collateral" (including (a) cash credited to an account and (b) financial instruments, including shares and bonds).

## Factual background

Following payment defaults under loan agreements, a collateral-taker enforced a share charge granted by a collateral-provider by appropriating the shares in the security-provider's subsidiary. In the appropriation notice, the collateral-taker ascribed a value of $27 million to the charged shares, based on a valuation conducted by a third-party valuer. In contrast, the collateral-provider's case was that the charged shares were worth c.$90 million.

The collateral-provider:

- alleged that the valuation placed on the shares by the collateral-taker did not comply with the requirements of the share charge and/or of the FCARs — in essence, because it did not require a commercially reasonable method of valuation;
- alleged that the purported appropriation was therefore invalid, i.e., the collateral-provider remained the beneficial owner of the shares; and
- alternatively, asked the court to determine the value which should have been attributed to the shares had the valuation been carried out "in a commercially reasonable manner" in accordance with the FCARs.

## Judgment

The court dismissed the collateral-provider's claim in full: the collateral-taker and the valuer acted in connection with the valuation (a) in accordance with the terms of the arrangement and (b) in any event, in a commercially reasonable manner. Accordingly, the appropriation was not invalid. The court held as follows.

- **Responsibility**: It is the collateral-taker that is responsible in law for the valuation, even if (as here) it has used a third-party valuer. If the third-party valuer does not carry out the valuation in a commercially reasonable manner, the statutory requirements will not have been satisfied.
- **Reasonable manner, not result**: It is the way in which the valuation is made which must be commercially reasonable. It does not *necessarily* follow that the result itself must be a commercially reasonable one.
- **Objective standard**: The requirement for the valuation to be made in a commercially reasonable manner imports an objective standard: the manner of

valuation must conform to “the reasonable expectations of sensible businessmen”. The subjective view of the collateral-taker (or its third-party valuer) is irrelevant.

- **Negotiated terms**: An important evidential factor in determining what is “commercially reasonable” in any given case will often be the terms which the parties have agreed (if they are of equal bargaining power).
- **Fact-sensitive analysis**: The question of what is commercially reasonable in any given case is of course fact-sensitive. In this case:
  - the collateral-taker’s omission to arrange for the valuer to have discussions with certain management did not of itself mean that the valuation was not done in a commercially reasonable manner;
  - similarly, the valuer’s rejection of the discounted cashflow method in this case was not inappropriate, given that a DCF analysis cannot be reliably completed unless the underlying forecast of cash flows is reliable, and the valuer had expressed concerns about the reliability of certain management forecasts; and
  - the fact that the valuation eventually arrived at was lower than earlier assessments was explicable by the distressed circumstances of the group.

- **No "good faith" requirement**: There is no separate requirement for the collateral-taker to act in good faith. The statutory requirement is 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.
- **Desire for low valuation**: The collateral-taker did not act in a commercially unreasonable manner in communicating to the valuer its desire that the valuation produced should be a low one. The collateral-taker’s interest would in any event have been obvious from the circumstances in which the valuer was instructed. Critically, the collateral-taker had not sought to persuade the valuer to act other than in a proper, independent and professional way.
- **Objective exercise**: Nevertheless, the valuation of financial collateral is essentially an objective exercise. The collateral-taker cannot deliberately adopt the approach which produces the lowest valuation or which otherwise best suits its own commercial interests. It must still act overall in a way which is commercially reasonable.
- **Not arbitrary**: The legislation does not require the security document to exclude the possibility of any non-compliant manner of valuation: all that is required is that the valuation in fact conducted is done in a commercially reasonable manner and is in accordance with the terms of the security document. However, the collateral-taker is not permitted to act in an arbitrary or unreasonable manner in choosing the method of valuation.

- **Remedy**: Non-compliance with the requirement for a valuation to be conducted in a commercially reasonable manner would not render the appropriation ineffective but could lead to the non-compliant appropriation subsequently being set aside by the court. Importantly, the appropriation would not be invalid upfront; to hold otherwise would inevitably lead to uncertainty as to the ownership of the collateral, which would be wholly unacceptable in the financial markets.

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1. *ABT Auto Investments Ltd v Aapico Investment Pte Ltd & others* [2022] EWHC 2839 (Comm), 14 November 2022. ↩

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- 26 July 2022 Kirkland Alert Houst: English Court Approves SME Restructuring Plan