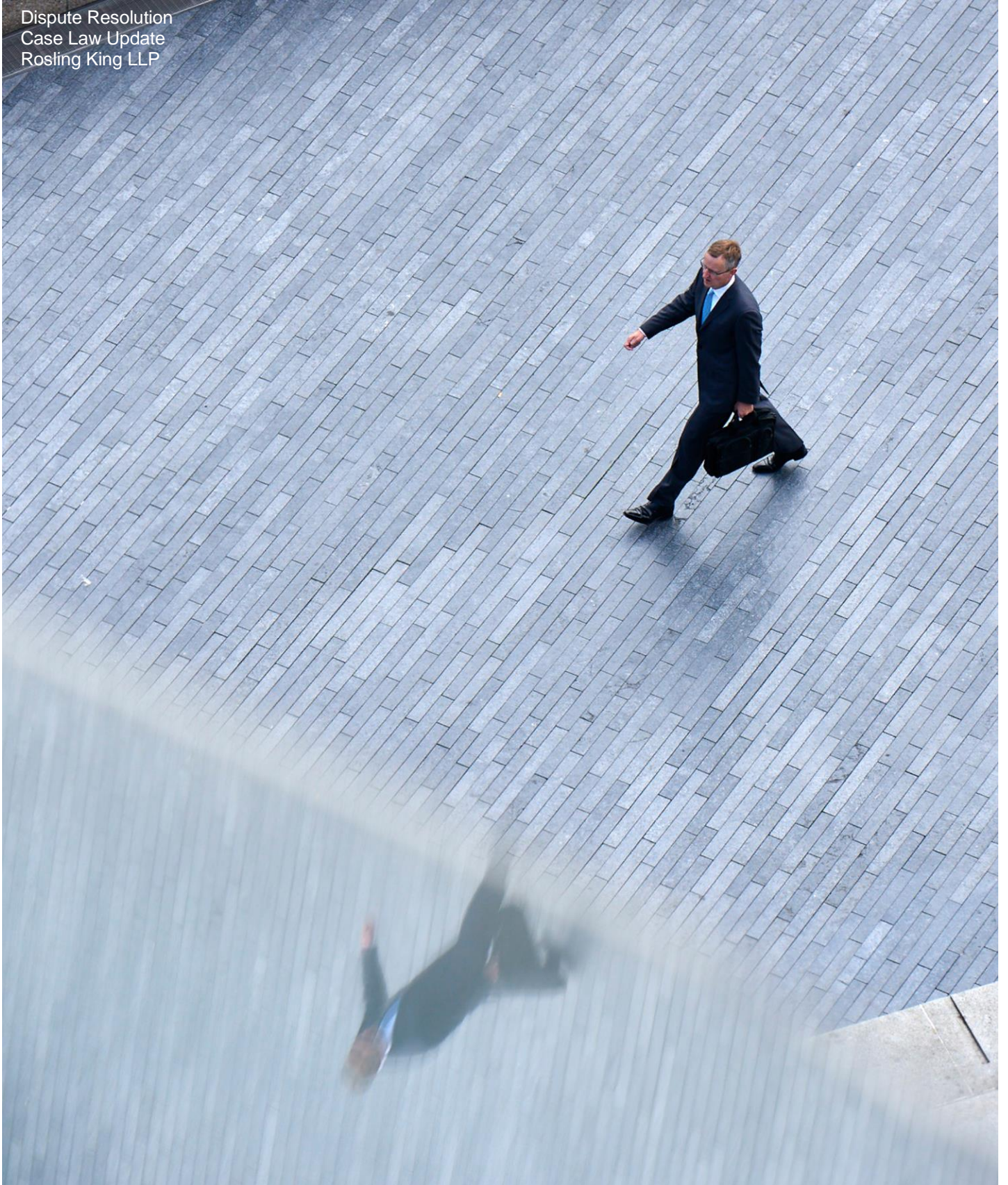


Dispute Resolution
Case Law Update
Rosling King LLP



The Court of Appeal recently reaffirmed the existing law that a mortgagee, upon disposing of its security, does not owe a duty to those without a recognised interest in the property. The Court of Appeal also confirmed that, while a mortgagee who seeks to buy mortgaged property is under a duty to show it has acted fairly to the mortgagors, the mortgagee is still in a position to decide the method and timing of the sale

Background

The First Defendant provided finance to purchase seven aircrafts, which were then leased to a low cost carrier, Blue Wings. These loans were secured by shares in the borrower vehicles and mortgages over the aircrafts. The First Defendant also financed the purchase of three additional aircrafts, which were leased to Olympic Airways. The security taken in respect of these three additional aircrafts was cross-collateralised.

The Claimant was a junior, and unsecured, creditor of the buyer of the three aircrafts. It was only to receive repayment if, and when, all the prior obligations secured by the mortgages were paid. The Claimant agreed in the inter-creditor agreement that it would not have a secured interest in any of the aircrafts. In 2009, Blue Wings ran into difficulties and went into liquidation, causing the borrowers to default on the loans. The First Defendant enforced their mortgages and the aircrafts were repossessed. The First Defendant forced the sale of the seven aircrafts at public auction and they successfully bid for and bought the aircrafts at the auction. The control of the aircrafts was then transferred to the Second Defendant, who subsequently leased them on to JetBlue.

In this claim, the Claimant alleged that the price paid for the aircrafts was less than it should have been and, as a result, the Claimant had suffered a loss. The Claimant argued that, as an unsecured creditor for the three cross-collateralised aircrafts, it would ultimately receive less than it deserved from the transaction. At first instance, the Judge in the High Court upheld the Claimant's claim awarding damages of \$10,175m. The Defendants appealed this decision and the Court of Appeal overturned the High Court's decision.

The Court of Appeal Decision

1) No Duty to unsecured creditors

The Court of Appeal held that, 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 also held that it is for the mortgagee to decide whether and when to sell, even if the timing of the sale is unfavourable.

The first question the Court of Appeal considered was to whom that duty of care is owed. The Court of Appeal found that the High Court Judge had extended the law, and in doing so held that a mortgagee owed a duty beyond those with a direct interest in the aircrafts, to include an unsecured creditor. The Court of Appeal stated that this extended the duty too far. In line with existing authority, it held that a mortgagee owes a duty to those with a registered interest in the property, but not to anyone else. If the mortgagee realises the mortgaged property for less than it should have done, the mortgagee must compensate the mortgagor for the shortfall,

and this correction would then flow down to those further down in the chain i.e. unsecured creditors.

2) Sale to Self

The Court of Appeal also considered the first Defendant's conduct in selling the aircrafts back to itself. The Claimant argued that the sale of the seven aircrafts by the First Defendant back to itself was void, because a mortgagee is prohibited from purchasing the mortgaged property for himself. Both the High Court and the Court of Appeal rejected this. In this arrangement, it was found that the sale was not a sale by the mortgagee to itself, but the seller was the owner trust. 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. In a connected party transaction, where a sale gives rise to a risk of a conflict of interest and duty, the Court held that the mortgagee bears the burden of proof to show that it has discharged its duties.

3) Best Price Reasonably Attainable

Finally, the Court of Appeal held that, where the burden of proof is reversed as a result of a connected party sale, the mortgagee is required to show that it obtained the best price reasonably obtainable. The High Court Judge found that the Defendant paid a price that was more than would have been recovered had the aircraft been sold through a private sale process or well-run auction. The Claimant complained that the First Defendant had not obtained an independent valuation, and that this valuation would have been for an amount significantly higher than the amount paid by the First Defendant at the auction.

The Court of Appeal confirmed that obtaining a valuation report may be one way for a mortgagee to discharge the duty owed, but it was not the only way. The Claimant's loss was calculated on the basis that the aircraft were valued and a lengthy marketing process was followed and allowed for no discount in relation to the possibility of a forced sale. This loss calculation ignored the fact that the mortgagee is entitled to decide on the timing, and the method of sale, and in this case the first Defendant's chosen method would have led to a forced sale discount being applied. The expert valuation evidence that was put before the Court of Appeal indicated that the First Defendant had paid higher than anyone else would have been willing to pay in the circumstances and, as such, the First Defendant's purchase had benefitted the mortgageor and potentially the Claimant.

Conclusion

This Court of Appeal decision provides a useful reminder of a mortgagee's duties and to whom they are owed. It should provide comfort to lenders as it reaffirms that mortgagees do not owe duties to those with no registered interest in the mortgaged property and that a mortgagee can choose when it wishes to sell the security property.

For further information, please contact [Georgina Squire](#) or the Partner with whom you usually deal.