KEY POINTS

- Appropriation of security under the provisions of the Financial Collateral Arrangements (No 2) Regulations 2003 (the Regulations) is supposed to provide a "rapid and non-formalistic enforcement procedure" for secured creditors.
- The Privy Council has now determined that relief from forfeiture is in principle available following an appropriation of security under the Regulations and has granted such relief in the *Cukurova* case.
- The reasoning of the Privy Council in the *Cukurova* litigation may give rise to attempts to seek relief from forfeiture in many future cases. This may undermine commercial certainty and the policy objectives underlying the Regulations.

Feature

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An offer you can't refuse? Relief from forfeiture in the Privy Council

In two major decisions in the *Cukurova* litigation (*Cukurova Finance International v Alfa Telecom Turkey* ([2009] UKPC 849 and [2013] UKPC 2) the Privy Council has considered how the rules of English law relating to equitable mortgages of shares have been affected by the introduction of the Financial Collateral Arrangements (No 2) Regulations 2003. Guidance has now been provided as to the steps that are required for a secured creditor to appropriate any security under the Regulations and the potential availability of relief from forfeiture following an appropriation.

THE *CUKUROVA* LITIGATION

The *Cukurova* litigation concerned a battle between Russian and Turkish investors for control of Turkcell, Turkey's largest mobile phone network operator.

The Russian investors (whose investment was held through Alfa Telecom Turkey Limited (ATT)) agreed to lend US$1.352bn to the Turkish investors (whose investment was held through Cukurova Finance International Limited (CFI)) under a Facility Agreement dated 28 September 2005. The facility was to be repaid in four equal annual instalments with interest payable at an annual rate of 8% above LIBOR and a default interest rate of 11.5% over LIBOR in relation to overdue payment.

CFI's debt to ATT was secured in part by an equitable mortgage (governed by English law) over CFI's 51% shareholding in a BVI company, Cukurova Telecom Holdings Limited (CTH). CTH in turn held a controlling interest in Turkcell through another holding company. The charges expressly permitted appropriation of the charged shares in accordance with the Regulations towards satisfaction of CFI's liabilities under the Facility Agreement.

On 16 April 2007 ATT informed CFI that in its view there had been a number of events of default in relation to the Facility Agreement and demanded immediate repayment of the whole of the outstanding loan. CFI did not repay the whole of the outstanding loan by the date ATT demanded payment and by means of a letter on 27 April 2007 ATT informed CFI that it had appropriated CFI's shares in CTH in satisfaction of the outstanding loan in accordance with the Regulations.

> The charges expressly permitted appropriation of the charged shares in accordance with the Regulations towards satisfaction of CFI's liabilities ...

On 17 May 2007 CFI gave five days' notice that it wished to repay the whole of the outstanding loan under the Facility Agreement and the whole of the outstanding sum was then tendered on 25 May 2007. ATT rejected the tender and the monies tendered were then kept for several years in an escrow account.

ATT and CFI then commenced proceedings in the BVI to determine the following issues:

- Whether on the facts there had been an event of default in relation to the Facility Agreement.
- Whether (assuming there had been an event of default) ATT's actions had been sufficient to constitute an effective appropriation of the charged shares.
- Whether the Court had power to grant relief from forfeiture once an appropriation had taken place in accordance with the Regulations, and if so, whether that relief should be granted in the instant case.

In order to resolve these matters, the Privy Council ultimately had to consider the impact on the equitable mortgage over CTH's shares of both the Regulations and EC Directive 2002/47 on financial collateral arrangements (the Directive) upon which the Regulations were based.

THE DIRECTIVE AND THE REGULATIONS

The Directive provides the basis for an EU-wide regime governing the regulation of financial collateral agreements such as the mechanisms of enforcement for collateral takers and the effects of national insolvency laws on such arrangements.

A sense of the policy objectives underlying the Directive is to be found in Recital (17) of the Directive which provides as follows:

> "This 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. However, this Directive 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."

in their application to the categories of financial institution set out in Art 1 of the Directive. Instead, the Regulations created a regime which allowed private companies to enter into security arrangements which would be subject to the enforcement methods (including appropriation) that were provided for in the Regulations.

Regulations 17 and 18 of the Regulations provide the basis for appropriation of collateral in the following terms:

"No requirement to apply to court to appropriate financial collateral under a security financial collateral arrangement

... [appropriation] ... appears from context to be a self-help remedy by which the secured creditor may effectively sell the collateral to himself ...

Article 1 of the Directive limits the scope of the Directive to situations where both the collateral taker and the collateral provider fall into a number of discrete categories of major financial institution such as public authorities and central banks (including the European Central Bank).

Article 4 of the Directive obliges member states to ensure that on the occurrence of an enforcement event a collateral taker may realise his financial collateral, subject to the terms agreed in a security arrangement,

"by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations".

Appropriation is only to be permitted if it has been agreed by the parties to the arrangement and the parties have also agreed on the valuation of the collateral and the outstanding debt.

The Directive was implemented in English law by means of the Regulations. Crucially, the Regulations were not limited

17. Where a legal or equitable mortgage is the security interest created or arising under a security financial collateral arrangement on terms that include a power for the collateral-taker to appropriate the collateral, the collateral-taker may exercise that power in accordance with the terms of the security financial collateral arrangement, without any order for foreclosure from the courts.

Duty to value collateral and account for any difference in value on appropriation

18. (1) Where a collateral-taker exercises a power contained in a security financial collateral arrangement to appropriate the financial collateral 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.

(2) Where a collateral-taker exercises such a power and the value of the financial collateral appropriated differs from the amount of the relevant financial obligations, then as the case may be, either—

(a) the collateral-taker must account to the collateral-provider for the amount by which the value of the financial collateral exceeds the relevant financial obligations; or
(b) the collateral-provider will remain liable to the collateral-taker for any amount whereby the value of the financial collateral is less than the relevant financial obligations."

THE MEANING OF "APPROPRIATION"

In accordance with Regs 17 and 18 of the Regulations, where a collateral taker (including a mortgagee under an equitable mortgage) is entitled to enforce its security it may do so by means of "appropriation". No formal definition of "appropriation" is provided either in the Regulations or in the Directive but it appears from context to be a self-help remedy by which the secured creditor may effectively sell the collateral to himself at a price to be determined in accordance with a contractually agreed valuation mechanism.

The circumstances in which such a power may be exercised are to be determined in accordance with the terms of the security arrangement between the parties but the existence of such a power, as well as a means of valuing the collateral, must be included in the terms of the security arrangement itself.

Traditionally English law has refused to permit a secured creditor to take the collateral for itself in the event of the debtor's failure to repay the debt or some other default by the debtor. A secured creditor could enforce a sale of the collateral to a third party but if the secured creditor attempted to take the asset for itself then the creditor's acquisition of the collateral would have been open to challenge as infringing either against the self-dealing rule or the

rule against the imposition of a clog on the mortgagor's equity of redemption. Appropriation is therefore apparently a novel remedy in English law (at least in so far as collateral other than cash is concerned, as to which see Lord Hoffmann's comments in *Re Bank of Credit and Commerce International SA* (No 8) [1998] AC 214 at 226-227) which also marked a potentially dramatic departure from the methods of enforcement that had previously been available to secured creditors under English law.

Somewhat surprisingly, in implementing the Directive it appears that the UK Treasury took the view that appropriation was already a familiar remedy in English law (see the comments of Lord Walker at para 32 of [2009] UKPC 849). Consequently the Regulations contained little guidance as to what exactly was meant by "appropriation" in the context of an equitable mortgage and what steps would be necessary for a secured creditor to avail themselves of such a remedy.

In the *Cukurova* litigation, ATT argued that an appropriation had been effected over the shares in CTH without the need for ATT either to register its ownership of the shares or to take any action beyond deciding that it wished to appropriate the shares following the event of default. By contrast, CFI argued that in order for appropriation to take place the secured creditor must give prior notice to the debtor of its decision to carry out the appropriation and that, in the case of shares, the appropriation would not be completed until the share register had been updated so that the secured creditor became both the legal and beneficial owner of the shares.

This point was determined as a preliminary issue by the Privy Council ([2009] UKPC 849). Lord Walker (giving the decision of the Board) held that:

- Commercial practicalities require that there should be some overt act by a secured creditor evincing the intention to exercise a power of appropriation before the exercise of that power could be effected but that ATT's notice on 27 April 2007 had satisfied this requirement in any event; and
- In the case of an equitable mortgage over shares, an appropriation was complete from the moment that the secured creditor succeeded in obtaining equitable title to the shares free of the debtor's equity of redemption and that registration as the legal owner of the shares was not a necessary step in the appropriation.

The Privy Council's decision on this preliminary issue represents a commercially sensible approach to the interpretation of the Regulations against the background of the Directive.

Commercial certainty demands that a secured creditor should communicate its decision to exercise a power of appropriation not least because the debtor might otherwise continue to deal with the asset as if it were his if he had not first been made aware of its appropriation.

Likewise, the Directive's objective of ensuring the availability of a rapid and non-formalistic enforcement procedure would have been unnecessarily thwarted if the Privy Council had determined that an equitable mortgagee of an interest in shares was required to be registered as the legal owner of the shares before the appropriation could be completed as, depending upon the nature of the procedures for effecting such registration, it might otherwise have been possible for a debtor to frustrate or prolong the process of registration.

Commercial certainty demands that a secured creditor should communicate its decision to exercise a power of appropriation ...

THE AVAILABILITY OF RELIEF FROM FORFEITURE

Once the preliminary issue concerning the meaning of the term "appropriation" had been addressed by the Privy Council, the case proceeded to trial in the BVI. It was not until 30 January 2013 that the Privy Council delivered its second major judgment in the *Cukurova* litigation (see [2013] UKPC 2).

On that occasion the Board determined that as a matter of fact there had been at least one event of default in relation to the Facility Agreement at the date of ATT's notice on 16 April 2007 so that ATT had a *prima facie* right to exercise its power of appropriation over the shares in CTH.

CFI then argued that ATT's appropriation had been carried out in bad faith and for a collateral purpose which was an impermissible attempt to frustrate the CFI's equity of redemption. The Board rejected this argument, observing that CFI's real complaint was that ATT's purpose had been to obtain the shares in CTH for itself (rather than selling them on the open market to a third party) but that this was the very thing that the Regulations (as incorporated into the Facility Agreement) permitted ATT to do. Accordingly, ATT could not in any way be said to have exercised its power of appropriation for a collateral purpose since its acquisition of control of CTH was a necessary incident of an expressly permitted mode of satisfying CFI's debt. The fact that this was an incident that was highly attractive to ATT did not mean that the right of appropriation was exercised in bad faith.

CFI was therefore left to rely upon its claim for relief from forfeiture which meant that the Privy Council had to resolve the important question as to whether relief from forfeiture was theoretically available following an appropriation of collateral under the Regulations and, if so, whether it should be granted in that case.

The Board concluded that, as a matter of general law, relief from forfeiture is in

Feature

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principle available where the forfeiture in question concerns proprietary or possessory rights (as opposed to merely contractual rights) regardless of the type of property concerned. The Board then had to consider whether relief from forfeiture was excluded either expressly or by implication by the Regulations. ATT argued that the scheme of the Directive and the Regulations excluded the possibility of any relief from forfeiture and that the only *a posteriori* control (as mentioned in Recital (17) of the Directive) which the court could exercise was in ensuring that the valuation of the collateral was carried out in a commercially reasonable manner. The Board rejected this argument and held that nothing in the Directive or the Regulations excluded the possibility of the court granting relief from forfeiture.

The Board then went on to decide that relief from forfeiture should indeed be granted. The Board accepted ATT's submission that commercial certainty was a very relevant consideration but held (see para 125 of [2013] UKPC 2) that the case before it involved *"a combination of unusual features"* which were *"most unlikely to be repeated"* so that granting relief from forfeiture would not produce uncertainty in subsequent cases. Foremost among the *"unusual features"* identified by the Board was the fact that the valuation mechanism set out in the Facility Agreement took no account of the marriage value to ATT of the charged shares which (together with ATT's existing shares in CTH) gave ATT a controlling interest in CTH. The Board also took account of the following matters: (a) that whole transaction was structured so as to maintain CFI's control of CTH; (b) that it appeared from the outset that ATT was primarily concerned with acquiring the charged shares not as security but as a means of acquiring control of Turkcell; (c) that the events of default were limited in number and were not shown to have occurred wilfully; (d) within a month of the appropriation CFI tendered the whole of what would have been the outstanding liability.

> The Board's suggestion that the facts arising in the Cukurova litigation were *"unusual features"* is open to some doubt.

The Board's suggestion that the facts arising in the Cukurova litigation were *"unusual features"* is open to some doubt. In practice it is no doubt extremely common that the events of default arising under a security arrangement may be few in number and may not have been committed wilfully by the debtor.

Moreover, the Board's concern that the valuation mechanism contained in the Facility Agreement did not give rise to a commercially fair valuation may well have been a reason for interfering with the contractual valuation mechanism (a power apparently contemplated in Recital (17) of the Directive and by Reg 18(1) of the Regulations) but it is not obvious that such concerns justify granting relief from forfeiture.

It seems likely that in future cases debtors will seek to rely upon the list of so-called *"unusual features"* in support of their own attempts to seek relief from forfeiture. Unless the courts are prepared to take a robust approach in limiting the outcome of the *Cukurova* litigation to its own facts, there is a real danger that commercial certainty will be undermined notwithstanding the Privy Council's protestations to the contrary.

CONCLUSION

The Privy Council's judgments in the *Cukurova* litigation have elucidated the Regulations in several important respects. The Board's pragmatic approach to defining appropriation in the context of an equitable mortgage over shares provides welcome confirmation that the policy objectives underlying the Directive will not be impeded by attempts to impose unnecessary additional formal requirements before appropriation can be completed.

The wisdom of the Board's decision to grant relief from forfeiture in the *Cukurova* litigation is open to some doubt. Future cases will determine whether the effect of that decision will be to undermine both certainty in the market and the policy objectives underlying the Directive and the Regulations. ■