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Shifting the class goal posts: the *Boart Longyear* schemes of arrangement

KEY POINTS

- On 26 May 2017, the New South Wales Court of Appeal, in *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116, upheld a controversial scheme classes decision of the New South Wales Supreme Court to convene creditor meetings for two schemes of arrangement involving the restructuring of Boart Longyear Ltd ('BLY').
- Under the secured creditor scheme of arrangement noteholders and the term loan holder were included in the same class despite only the term loan holder receiving shares in the restructured BLY.
- The New South Wales Supreme Court held that the shares were of little value and therefore this difference in treatment did not make it impossible for the noteholders and term loan holder to consult together to their common interest.
- Given that Australian and UK scheme of arrangement regimes are essentially identical, the decisions of these courts have international significance for large scale restructurings.

OVERVIEW AND BACKGROUND

This article discusses the important class formation issues arising in the recent decisions of the New South Wales Supreme Court and Court of Appeal (together '*Boart Longyear*') in respect of the restructuring of BLY by way of schemes of arrangement.

Boart Longyear's restructurings

BLY suffered from financial difficulties over a number of years, resulting in a financial restructuring of the Boart Longyear Group ('BLY Group') in 2014-15. On completion of that restructuring, Centerbridge Partners LP ('Centerbridge') became BLY's largest shareholder with 48.9% of the shares and BLY had the following financial indebtedness:

- US$195m senior secured notes due 1 October 2018 10% interest rate ('SSNs');
- US$120m secured term loan A due October 2020 12% interest rate ('TLA');
- US$105m secured term loan B due 1 October 2018 12% interest rate ('TLB'); and
- US$284m senior unsecured notes due 1 April 2021 7% interest rate ('SUNs').

The maturity dates for the TLA and TLB were subsequently extended to 3 January 2021.

Despite this restructuring, BLY continued to suffer losses and defaulted on an interest payment under the SSNs on 1 April 2017.

BLY therefore pursued a further restructuring, announcing its entry into a Restructuring Support Agreement ('RSA') with some of its largest creditors, including Ares Management LP ('Ares'), Ascribe II Investments LLC ('Ascribe') and Centerbridge, on 3 April 2017. Centerbridge was the sole lender under the TLA and the TLB and Centerbridge, Ares and Ascribe held significant percentages of the SSN debt.

The schemes of arrangement

BLY's restructuring plan involved the RSA and two creditors' schemes of arrangements: the 'Unsecured Creditors' Scheme' and the 'Secured Creditors' Scheme'.

Under the Unsecured Creditors' Scheme:

- US$196m of the SUNs were to be exchanged for 42% of BLY's post-restructuring equity; and
- the remaining US$88m of SUNs were to be reinstated with an interest rate of 1.5%.

Under the Secured Creditors' Scheme the holders of the SSNs, and the holder of the TLA and TLB, would vote as a single class and (among other things):

- the maturity dates of the TLA, TLB and SSNs were all extended to 31 December 2022 (the existing expiry dates for the SSNs was 1 October 2018 and for the TLA and TLB was 3 January 2021);
- payment of interest on all facilities was converted to payable in kind ('PIK') until December 2018 (the TLA/TLB interest was already PIK which would not change);
- the interest rate on the TLA and TLB was reduced from 12% to 10%, in exchange for Centerbridge receiving 56% of BLY's post-restructuring equity. Centerbridge would also be granted the right to appoint five directors to the board of BLY (up from its pre-existing right to appoint four directors); and
- the holders of those instruments waived their rights in relation to any change of control event occurring as a result of the restructuring (noting that Centerbridge would hold 56% of the shares post-restructuring).

Notably, the Secured Creditors' Scheme did not provide for any reduction in the amount of principal owed to any of the TLA, TLB or SSNs.

THE SUPREME COURT DECISION

On 10 May 2017, Justice Black of the New South Wales Supreme Court in *Re Boart Longyear Ltd* [2017] NSWSC 567, granted orders to convene creditor meetings in respect of the restructuring plan of BLY's schemes of arrangement. The main issue before the court was whether the holders of the SSNs, TLA and TLB should all constitute a single class for the purpose of voting on the Secured Creditors' Scheme.

First Pacific Advisors ('FPA'), the holder of 29% of the SSNs, objected to the SSNs being included in the same class as the TLA and TLB, pointing to a number of differences in the rights of the SSNs and TLA/TLB both before and after the scheme. These included:

- differences in security coverage, including that part of the interest due under the TLA and TLB was unsecured (whereas the SSNs were entirely secured);

- the SSNs were due prior to the TLA and TLB, yet all were being extended to the same expiry date;
- the SSNs were being converted from interest of 10% payable in cash to an arrangement under which BLY would have the option of interest of 12% PIK until December 2018 (with retrospective effect from January 2017). The interest under the TLA and TLB was already PIK (and this did not change);
- Centerbridge (as the TLA and TLB holder) would receive a 56% shareholding in, and outright majority control of, the restructured BLY by virtue of foregoing some interest (whereas the SSNs did not);
- the waiver of the change of control event right affected the SSNs and TLA/TLB differently in that it was to the advantage of Centerbridge as holder of the TLA and TLB (who was obtaining outright majority control of BLY); and
- Centerbridge obtained the right to nominate five persons to the BLY board (up from its existing right to appoint four directors).

Common interest test

Justice Black's starting point was the long established class test postulated in *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573 that creditors in a single class should only be those persons *'whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'.* This test is concerned with differences in the legal rights, rather than the commercial interests (which are generally only relevant to the exercise of the courts' fairness discretion), of creditors.

The court considered that the differences in existing rights between the SSNs and TLA/TLB did not amount to a sufficient difference in legal rights to justify the creation of separate classes.

With respect to the new rights granted in connection with the scheme, Justice Black accepted that the equity interest and director nomination rights bestowed on Centerbridge created a difference in legal rights between the TLA/TLB holder and the SSNs.

However, Justice Black considered that these differences in rights did not outweigh the common areas of interest. His Honour placed particular weight on two factors of common interest:

- that the SSNs and TLA and TLB holder '*face a common and imminent issue as to the insolvency of [BLY Group]*'; and
- that the SSNs, TLA and TLB holder were party to *'complex security arrangements over BLY Group such that [the SSNs and Centerbridge] would likely have to negotiate arrangements between themselves to allow the realisation of the securities in an insolvency'*. There was no further elaboration in the judgment as to the nature of these complexities or the required negotiations in an insolvency.

FPA appealed this decision to the New South Wales Court of Appeal.

THE COURT OF APPEAL'S DECISION

The Court of Appeal distilled the case into two issues:

1. *The interest issue*: whether the differential interest regime in relation to the SSNs and TLA/TLB was class creating.
2. *The equity issue*: whether the waiver of change of control rights and the issuance of equity, and grant of directorship rights, to one of the creditors was class creating.

The court dealt with the 'interest issue' quickly by rejecting FPA's submission that the different interest regime between the SSNs and TLA/TLB was class creating on the basis that in the 'context of imminent liquidation' such difference would not make consultation between the creditors impossible.

In relation to the 'equity issue', the Court of Appeal considered that the additional equity and director nomination rights conferred on Centerbridge, when combined with the operation of the waiver of change of control rights which benefitted Centerbridge, were not sufficient to make it 'impossible' (being the *Sovereign Life* test) for the creditors to consult together such as to justify the creation of a separate class.

While the Court of Appeal acknowledged that the waiver of change of control rights benefitted Centerbridge as it moved to outright majority control of BLY, the court ultimately reasoned that:

> 'The right to call up loans, which is held by both parties, is of limited benefit having regard to the fact that BLY would be unable to pay and would in all probability be placed into liquidation, in which case both groups of creditors would receive a significantly less amount than on the implementation of the scheme.'

The Court of Appeal noted that the 'critical question' was whether the grant of additional equity to Centerbridge affected this position. The court concluded that it did not because:

- the SSN holders did not hold any shares in BLY prior to the restructure;
- Centerbridge had *de facto* control of BLY prior to the restructure due to its existing 48.9% shareholding (this existing holding would be significantly diluted as a result of the equity issuance under the Unsecured Creditors' Scheme);
- Centerbridge was unlikely to receive any 'significant financial advantage' as the evidence was that the BLY shares would, immediately after the restructuring, likely be of little value; and
- the director nomination right did not affect the analysis as, prior to the restructuring, BLY already had the ability to appoint four directors and, after the restructuring, when it would hold more than 50% of the shares, it could appoint and remove directors as it pleased.

The first two factors were arguably not relevant to the analysis. Both of these factors relate to the pre-restructuring position of BLY, and it seems to have been agreed that pre-restructuring BLY was insolvent (and the only alternative to the scheme was formal insolvency) and therefore the shares pre-restructuring were valueless. Similarly, the fact that Centerbridge had the right to appoint four directors pre-restructuring was also arguably irrelevant. The key issue is how the new equity (and associated rights) was to be awarded under the restructuring.

The Court of Appeal placed heavy reliance on the evidence that the shares that would be

issued to Centerbridge if the schemes were implemented would have little value (even after the restructuring). However, this ignores the important fact that, even if the shares had little value immediately after the scheme was implemented, they would remain a vehicle through which, assuming BLY is restored to financial health, additional value (and potentially considerable additional value) could be delivered to Centerbridge. Some might cynically ask why, if the equity was truly of no value, some equity was not also given to all of the holders of the SSNs.

In a number of schemes of arrangement, certain groups of creditors are given warrants (sometimes colloquially referred to as 'hope notes') the value of which is entirely contingent on the resuscitated entity undergoing a significant financial turnaround in the future. Despite the fact that warrants often have very little value on the implementation date of the scheme, practitioners would, all things being equal, generally accept that these are rights which are important to the class question.

In the *Boart Longyear* matter, the precise basis of the post-restructuring valuation of the shares was unclear from the face of the judgment. The two post-restructuring valuations of the shares were referred to, and seemingly relied on, by the Court of Appeal, being those contained in:

- a KordaMentha independent expert's report, the primary aim of which was demonstrating to noteholders and lenders their expected recoveries under their instruments in a liquidation and under the schemes. For this purpose, BLY was given an enterprise value of $266.6m. When this figure was compared against the anticipated outstanding secured debt at the time of implementation of the restructuring of $445.1m, the Court of Appeal stated that *'whether the shares would have any value post implementation of the scheme is at best speculative'*; and
- a KPMG independent expert's report, the primary aim of which was to demonstrate to the existing shareholders that the restructuring was fair and reasonable. That report took the view that the shares would be worthless in a liquidation, but ascribed a post-recapitalisation valuation range of US$.0011 to US$.0045.

From the limited information in the judgment, it does not appear that the value of the shares post-restructuring was addressed in detail in either report (although the KPMG report did ascribe a value to the shares immediately post-restructuring). Neither of these reports appears to specifically address the potential future value of the equity (and related control rights), which is arguably a very relevant consideration for stakeholders in these circumstances.

This raises the broader topic of the appropriate basis and methodology for undertaking valuations in the context of schemes of arrangement. There is relatively little authority on the point, even in the context of determining the pre-restructuring valuation of the company (the most well-known being the English case of *Re Bluebrook Ltd* [2010] BCC 209), and none that we are aware of in the context of the position post-restructuring. Given how central the valuation point appears to have been to the Court of Appeal's analysis, it would have been helpful to have had further consideration of this issue.

It is also interesting to note that the Court of Appeal relied on different reasoning from Justice Black at first instance, who relied primarily on the fact that the TLA, TLB and SSNs shared the same risk of insolvency and security over the same assets, rather than relying on the value of the equity granted (which Justice Black regarded as highly uncertain).

COMMENTARY

The *Boart Longyear* decision is important for persons contemplating a scheme of arrangement in any jurisdiction. Although prior to this case, many practitioners may have considered it virtually axiomatic that creditors receiving equity in the company post-restructuring should not be placed in the same class as creditors not receiving such a benefit, there is in fact no written judgment which specifically considers this question. The case therefore sets an important precedent as to the extent to which creditors can be granted different benefits under a scheme, but remain within the same class.

The class test

Both the Supreme Court and the Court of Appeal placed significant emphasis on the dictum in *Sovereign Life*. Whilst noting that there were significant differences between the legal rights of the creditors, such differences were not considered so dissimilar: *'as to make it impossible for them to consult together with a view to their common interest'*.

This class test has been the subject of significant discussion and analysis in the context of creditors' existing rights when going into a scheme of arrangement. The courts have (rightfully) held in this context that, where the alternative to a successful scheme is the insolvent liquidation of the company, the rights to be compared are those that actually make a difference in such insolvency. This has tended to allow a reasonably broad and practical approach to class formation in such circumstances, where the key differentiating factor will usually be whether the creditors' existing rights give them the same or differing priorities in a formal insolvency.

Observations on unequal treatment

There has been significantly less consideration of differences in the new rights given by a scheme of arrangement. The only real extent to which this issue has recently arisen in connection with schemes is in the context of pre-scheme voting agreements and fees and costs payable to those creditors who enter into such arrangements. In the cases to date, these arrangements have not led to a requirement to divide creditors into separate classes.

Nevertheless, the dictum of the Court in such cases is noteworthy. For example, in *Re Telewest Communications plc* [2004] EWHC 924, David Richards J considered that entry into a voting agreement was not sufficient to place such bondholders into a separate class. His Honour went on to note:

> **'A serious issue would arise if in consideration of its agreement to vote in favour of the scheme, or collaterally to it, the bondholder received benefits not available to the other bondholders. In effect, the result would be unequal treatment under the scheme and the**

Insight

Biog box

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bondholder could not, I think, be included in the class.'

In *Re PrimaCom Holding GmbH* [2011] EWHC 3746 (Ch), most of the lenders entered into a lock-up agreement under which they agreed to vote in favour of the scheme and were entitled to consent fees. Hildyard J held that:

> 'it does seem to be an unlikely determinant of jurisdiction that a relatively small fee should be payable to those who happen to promise their votes on the schemes, which is not an unusual arrangement in the context of schemes such as this. It is most unlikely that the consent fee would determine the behaviour of the member of a given class.'

Similar approaches to *PrimaCom* were taken in *Re DX Holdings Ltd* [2010] EWHC 1513 (Ch) and *Re Seat Pagine Gialle SpA* [2012] EWHC 3686 (Ch).

These cases indicate that the English courts closely scrutinise any conferral of unequal benefits on creditors within a class. Whilst they have allowed differential treatment in some cases, this has been where it is 'most unlikely' to affect voting decisions. This can be contrasted with the position in *Boart Longyear*, where the correspondence appended to the statement filed by FPA's counsel in the US Bankruptcy Court (SDNY) indicates that the failure to provide equity to FPA was its primary reason for contesting the scheme.

The approach of the English courts outlined above was not referred to in the judgments of the New South Wales Supreme Court and Court of Appeal. Both courts simply relied instead on the *Sovereign Life* test, with the further gloss of Barrett J in *Re Hills Motorway Ltd* [2002] NSWSC 897 that only differentiation that 'destroys' the ability to consult together results in a separate class. The fact that, in practice, Centerbridge and FPA seemed locked into diverging views as to the merits of the scheme did not, in Black J's view make such consultation 'impossible' (although he conceded there was 'little likelihood' of it occurring).

The approach of English courts provides helpful guidance for the application of the *Sovereign Life* test. That is: where the differential treatment of creditors under a scheme is significant enough that it is likely to affect their decision to vote for or against the scheme, it becomes difficult to see the rationale for including them within the same class. Whilst there is some common ground in that all creditors would presumably be incentivised to avoid an insolvency that results in a lower recovery, the creditors are fundamentally not getting the same deal.

In this regard Chadwick LJ's further development of the *Sovereign Life* test in *Re Hawk Insurance Company Ltd* [2001] EWCA Civ 241 is of relevance:

> 'Nevertheless, it is important to keep in mind the underlying question, to which Lord Justice Bowen's test [in Sovereign Life] must be directed, is that posed by the statutory language: with whom is the compromise or arrangement to be made? Or, as I have put it earlier in this judgment: "are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought it to be regarded, on a true analysis, as a number of linked arrangements?"'

Given the difference in treatment between the SSN holders and the TLA/TLB holder, it seems arguable that this is one such case where a true analysis would regard this as a number of linked, but separate, arrangements.

Expanded role for fairness discretion?

Another possibility is that the Court of Appeal's decision should simply be viewed as another example of the reluctance of courts to stop schemes from proceeding on technical class grounds, particularly in circumstances where splitting a class would, as would be the case in the *Boart Longyear* matter, result in a particular creditor being given a veto right.

The courts have, historically, been comfortable in adopting such an approach in the knowledge that their ability to set aside schemes on fairness grounds at the final court hearing gives them broad discretion to come to what the court considers to be the 'right' decision (taking into account all the facts and evidence). As the court has previously noted in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] 3 HKLRD 634:

> 'The Court will decline to sanction a Scheme unless it is satisfied… that the result of each meeting fairly reflected the views of the creditors concerned.'

By way of contrast, if a creditor is given a veto right over a scheme, the court will have no power to later rescue it. We frequently see this in members' schemes of arrangement where the court may request that the votes of certain shareholders are 'tagged' so that the court has a deeper understanding of the voting picture at the scheme meeting which it can take into account as part of its fairness discretion.

Applying this analysis to the *Boart Longyear* matter, at the final court hearing, the level of support for the scheme amongst the holders of the SSNs (other than FPA) will, no doubt, be a very relevant factor to the court when deciding whether to approve the scheme of arrangement.

Post-script

At the time of writing, the final court hearing had been part-heard by Justice Black of the Supreme Court and adjourned, with the hearing set to recommence on 27 July 2017. Justice Black has ordered the parties to engage in mediation prior to the hearing recommencing and indicated that, if the parties do not reach a mediated outcome, the court will hand down its decision in early or mid-August 2017. In parallel with the Supreme Court proceedings, FPA has appealed the decision of the Court of Appeal to the High Court of Australia. Whatever the outcomes, we are likely to be left with some very important new case law. ■

Further reading

- *Re Dee Valley Group plc*: avoiding manipulation of the numerosity test for schemes of arrangement (2017) 3 CRI 99
- Scrutinising schemes: GGP and subsequent cases demonstrate no rubber stamping of schemes by the courts (2016) 6 CRI 206
- Singapore's new 'supercharged' scheme of arrangement (2017) 5 JIBFL 282