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CONTROVERSIAL SCHEME CLASSES DECISION IN BOART LONGYEAR RESTRUCTURING

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Legal Briefings – By **Paul Apáthy** and **Andrew Rich**

In a recent landmark decision, *Re Boart Longyear Limited* [2017] NSWSC 567, the New South Wales Supreme Court granted orders to convene creditor meetings for two schemes of arrangement in respect of the restructuring plan of Boart Longyear Limited.

The decision has given rise to some controversy and placed renewed scrutiny on the determination of creditor classes in restructuring schemes. The schemes placed Centerbridge Partners LP, the term loan lender, and secured noteholders in the same class for voting purposes, despite those creditors having differing rights (and commercial interests) both before and after the scheme. In particular, the term loan lender received majority ownership and control of the restructured Boart Longyear Group but the secured noteholders received no equity. On its face this is a significant difference in treatment of creditors within the same class, and to our knowledge without precedent.

The decision of the Supreme Court has been subject to an application for leave to appeal, with judgment pending until Friday 26 May or the following Monday. The Court stated at the hearing that while it had not decided on the leave application it would still hear full arguments. As such, it is unclear whether the court will deliver judgment in relation to both the leave application and appeal. Whatever the ultimate outcome, the appeal is likely to see the Boart Longyear matter set a key precedent for determining appropriate class composition in respect of restructurings by way of scheme of arrangement, both in Australia and other jurisdictions that have a scheme of arrangement procedure.

EXECUTIVE SUMMARY

- On 10 May 2017, the Supreme Court of NSW delivered a judgment in favour of Boart

Longyear Limited (**BLY**) granting orders to convene meetings of creditors in relation to two proposed schemes of arrangement despite significant opposition from one of the creditors.

- Under the scheme in dispute, BLY proposed to include the holders of the senior secured notes, term loan A and term loan B in a single class of creditors for the purposes of the scheme meeting. The notes were widely held but there was a single holder of term loans A and B.

- The holder of 29% of the senior secured notes objected to being placed in the same class as the holder of term loans A and B. The objector pointed towards a number of significant differentiating features between the position of the senior secured note holders and the single holder of the term loans A and B.

- The Court (correctly) relied on the long-settled principle that separate classes should only be ordered where the rights of the creditors are so different that consultation as to their common interests would be impossible (with the focus being on legal rights not commercial interests). However, the Court's application of this principle in this case resulted in what many would regard as a surprising result.

- The Court found that the holders of the senior secured notes, term loan A and term loan B were correctly placed in a single class. While the Court acknowledged that some of these differences (including the issuance of a majority equity stake to the term loan A and B holder) constituted a difference in legal rights, the Court did not consider that such differences outweighed the areas of common interest between them, being the common risks upon insolvency and the security interests over common assets.

- This matter will set an important precedent. We are unaware of any other case that deals with a similar fact pattern before an Australian or other Court. Many will consider it somewhat surprising that the shared risk of insolvency and security over common assets were deemed to be sufficient to override the significant differences between the groups of creditors, including in particular that a creditor gaining majority ownership of the company was placed in the same class as creditors receiving no equity.

- We explore the judgment in further detail below, including a consideration of the important issues that the case raises for future restructurings.

FACTS

Boart Longyear Limited (**BLY**) is an Australian incorporated and ASX listed, but Utah headquartered, mineral exploration company.

BOART'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 2014-2015. 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$195 million senior secured notes due 1 October 2018 10% interest rate (**SSNs**);
- US$120 million secured term loan A due October 2020 12% interest rate (**TLA**);
- US$105 million secured term loan B due 1 October 2018 12% interest rate (**TLB**); and
- US$284 million 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 in 2014, 2015 and 2016, 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. The RSA contemplated that this restructuring would involve two schemes of arrangement in respect of the various financial creditors of the company.

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

The schemes of arrangement ultimately proposed by BLY were:

- **the Unsecured Creditors' Scheme**: this was a scheme of the SUNs, pursuant to which:

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

- **the Secured Creditors' Scheme**: this was a scheme of the SSNs, the TLA and the TLB as a single class, pursuant to which (among other things):
  - the maturity dates of the TLA, TLB and SSNs were all extended to 31 December 2022;
  - the holders of those instruments waived their rights in relation to any change of control event occurring as a result of the restructuring;
  - payment of interest on all facilities was converted to payable in kind (**PIK**) until December 2018; and
  - the interest rate on the TLA and TLB was reduced from 12% to 10%, in exchange for the lender under those facilities (Centerbridge) receiving 56% of BLY's post restructuring equity (pursuant to a separate subscription agreement). Centerbridge would also be granted the right to appoint 5 directors to the board of BLY (up from its pre-existing right to appoint 4 directors).

In addition, Centerbridge, Ares and Ascribe underwrote a new US$75 million asset-based lending facility.

THE SCHEME CONVENING HEARING

BLY applied to the NSW Supreme Court for an order to convene creditors' meetings in respect of the schemes of arrangement.

First Pacific Advisors LLC (**FPA**), as the holder of 29% of the SSNs, opposed the order to convene the scheme meetings, on a number of grounds including in particular:

- that the SSNs should be in a separate class from the lenders under the TLA and TLB due to the difference in rights between the SSNs and the TLA and TLB holders, both before and after the scheme; and

- that collateral benefits were being conferred on Centerbridge, Ares and Ascribe that either required the SSNs to be placed in a different class, or which rendered the scheme unfair.

FPA held approximately 29% of the SSNs, and therefore would be able to block a scheme if it was just compromised of SSN holders.[1] However, if placed in the same class as the TLA and TLB holder, FPA's claims (and hence voting rights) would be diluted by the TLA and TLB debt, and it would no longer have the ability to block the scheme by itself.

ISSUES AND FINDINGS

SHOULD THE SSNS, TLA AND TLB FORM A SINGLE CLASS?

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.

FPA objection

FPA 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 differences 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);
- that the SSNs were due prior to the TLA and TLB, yet all were getting extended to the same expiry date;
- that 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% payable in kind until December 2018 (with retrospective effect from January 2017). The interest under the TLA and TLB was already PIK (and this did not change);
- that 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 (as it was obtaining outright majority control of BLY as mentioned in the next point);
- that Centerbridge (as the TLA and TLB holder) would receive a 56% shareholding in, and control of, the restructured company by virtue of foregoing some interest (whereas the SSNs did not);[2] and
- that Centerbridge obtained the right to nominate 5 persons to the BLY board (up from its existing right to appoint 4 directors). Additionally, Ares and Ascribe each obtained the

right to nominate to the BLY board. FPA received no such rights under or in connection with the scheme.

Common interest test

Justice Black's starting point was the long established class test postulated in *Sovereign Life* 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'*.[3] 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.

His Honour enunciated a number of further principles as to class composition, including that:

- the appropriate comparator when considering creditor's existing rights in respect of an insolvent company is the position of those creditors in an insolvent liquidation of the company;
- when considering the new rights granted to creditors pursuant to the scheme, the appropriate comparator is the position after the proposed restructuring takes place; and
- it is the 'bundle of rights' as a whole, both before and after the proposed scheme, which is the relevant reference point when considering differences in rights.

Justice Black did not accept FPA's submission, based on the English *Primacom* case,[4] that '*a relatively narrow degree of differentiation in rights both before and after the scheme will be sufficient to require separate classes*'.[5] However, his Honour also rejected BLY's submission that the fact that all creditors would be 'better off' as a result of the scheme (as winding-up would be avoided) was insufficient to justify the constitution of a single class.

Commonality in rights

Justice Black noted a number of 'common features' between the SSNs, TLA and TLB. These included that they each had the same issuer (**BLM**) and the same Australian guarantors. His Honour placed particular weight on two factors:

- that the SSNs and TLA and TLB holders *'face a common and imminent issue as to the insolvency of [BLY Group]'*; and

- that the SSNs, TLA and TLB holders 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'.*[6] There was no further elaboration in the judgment as to the nature of these complexities or the required negotiations in an insolvency.

His Honour also noted that the scheme had a common legal effect on the rights of the SSN, TLA and TLB holders in that they were extended to a common maturity date.

Differences in existing rights

The Court then examined the specific differences alleged by FPA, considering whether they gave rise to difference in rights (or merely a difference in interests which could not give rise to class issues), and if so whether the difference in rights was sufficient to result in separate classes.

Applying the *Sovereign Life* test, Black J dismissed all of FPA's arguments based on a difference of their existing rights as follows:

FPA’s argument as to differences in rights	Court’s view on whether this is a differentiating legal right	Court’s view on whether difference is sufficiently significant to result in separate classes
Secured interest: The entire interest due to SSN holders is secured, while part of the interest due on the TLA/TLB is unsecured.	**No**: Each of SSNs, TLA and TLB are secured creditors as to a substantial debt.	**N/A**
Priority over debts: Due to the operation of the Unsecured Creditors’ Scheme, the TLA/TLB holder will receive priority for debts in relation to the senior unsecured notes.	**No**: This is a matter between unsecured creditors and TLA/TLB, not between SSN and TLA/TLB.	**N/A**
Maturity of debts: Extension of the SSNs and TLA/TLB loans to a common date involved extension of the TLA/TLB loans for a shorter period than the SSNs.	**No**: BLY is presently effectively insolvent and likely to be subject to insolvency proceedings long before either of the existing maturity dates. The different maturity dates were therefore of little significance in creating distinction of rights.	**No**: Even if this was a difference in rights, the different extension periods are not so material as to bring about (alone or in connection with other matters) any inability of the SSN, TLA and TLB holders to consult as to their common interests.
Interest: Payment of SSN interest is altered from 10% payable in cash to allow BLY the option of instead paying 12% PIK interest. No corresponding change to interest under TLA and TLB, which is already payable in PIK.	**Yes**: Change in payment of interest amounts to a difference in legal rights.	**No**: This does not (alone or combined with other matters) make it impossible for the SSN, TLA and TLB holders to consult together with a view to their common interest in respect of the BLY Group’s insolvency and their security interests over common assets. The common interests outweigh the difference in legal rights.
Waiver of change of control rights: This had a different practical and commercial effect on SSNs than the TLA/TLB holder. It advantaged the TLA/TLB holder given it would gain control of BLY.	**No**: This is a difference in commercial impact rather than a difference in legal rights.	**N/A**

Differences in new rights

Justice Black then considered FPA’s arguments based on the rights conferred on Centerbridge, Ascribe and Ares by the equity subscription agreement and director nomination agreement. He considered that notwithstanding these rights were granted under separate agreements (rather than the schemes themselves), such arrangements were conditions precedent to the schemes and were plainly closely connected with Centerbridge’s participation thereunder. They were therefore relevant to the question of class composition.

Equity

FPA argued that the additional equity Centerbridge (in connection with its TLA and TLB holdings) and Ares and Ascribe (in connection with their SUNs) received would incentivise them to vote in favour of the schemes.

FPA further argued that the post-restructuring shares in FPA had an option value given the prospect of improved performance of BLY following a restructuring. BLY in contrast argued that such value was merely speculative. There was a difference in views in this regard between Korda Mentha, which provided the independent expert’s report for the schemes, and KPMG, which had prepared a confidential draft report. However, the Court did not consider it necessary to make any finding as to which view was to be preferred given that:

- the equity value would depend on future performance of BLY and had a high degree of uncertainty; and
- the right to such equity did not prevent consultation as to the common interests of the parties to the Secured Creditors' Scheme.

Instead, Black J considered that the interests that the creditors had in common (in particular the risk of insolvency and the shared security) outweighed the differences between them. The key passage was as follows:

It seems to me that Centerbridge's right to additional equity arising under the Subscription Agreement and Ares' and Ascribe's right to equity in exchange for debt under the Unsecured Creditors Scheme are not such as to prevent consultation between the SSN holders as a group (a position which First Pacific did not, I think, advance) or between the SSN holders on the one hand and Centerbridge as the TLA and TLB holder on the other as to their common interests. I recognise that the allocation of additional equity to Centerbridge, Ares and Ascribe may reinforce the difference in the commercial interests of the parties in such a consultation. However, the interests that the SSN holders and Centerbridge as the TLA and TLB holder have in common, including their common exposure to the risk of insolvency and the fact that they share security over the same assets, again seem to me to outweigh these differences, particularly given the real uncertainty as to the value of equity in BLY even if the schemes are implemented, such that consultation as to their common interests can properly occur.[7]

Board nominations

Under the director nomination agreement Centerbridge was entitled to appoint 5 directors, and each of Ares and Ascribe were entitled to appoint a director each. This gave Centerbridge control of BLY's board (a right that it would have been able to exercise anyway by virtue of owning more than 50% of the shares).

Whilst Black J accepted that Centerbridge's appointment rights were of 'greater practical significance' than those in the *Nine Entertainment Group* creditors' scheme (**Nine**),[8] given that in this case a single entity – Centerbridge – would obtain board control (unlike in *Nine* in which two entities shared board control), he considered that the 'magnitude' of the difference was not sufficient to justify holding that it was impossible for them to consult with other scheme creditors.

JUSTICE BLACK'S CONCLUSION

His Honour therefore concluded, on balance, that although there were differences in rights between the SSNs and TLA and TLB holder, those differences were not such that:

they cannot consult together with a view to their common interests, including the very substantial common interest which they have in addressing the risks of BLY's insolvency and how those risks are increased by the fact that they share security…in respect of the same assets.[9]

DISCUSSION

BREAKING NEW GROUND

The *Boart Longyear* decision is important - we are unaware of a similar fact pattern having arisen before a court in Australia, England or elsewhere. The matter will therefore set an important precedent.

Significant differences were raised by FPA, both in respect of the rights of the creditors prior to the scheme and the rights granted to them pursuant to the scheme, as outlined in more detail above. It may seem somewhat surprising to many that the Court considered that the shared risk of insolvency and the security over common assets were enough to override these differences and for the Court to be comfortable having the relevant creditors in a single class for voting purposes. We focus on two particular aspects of these differences below.

THE EXISTING SECURITY – A UNIFYING FACTOR?

The details of the existing security package, including the precise rankings and enforcement mechanics, were not explained in the judgment. However, the Court did indicate that the SSN, TLA and TLB holders had different rights in this regard, which potentially could give rise to the need for negotiation between those groups should there be an insolvency.

Debtwire's summary of the Boart Longyear situation indicates relatively complex priorities in a liquidation scenario, with different priorities to different assets:[10]

CREDITOR PRIORITIES (LIQUIDATION SCENARIO)

Debt obligation	Working capital assets – ABL Obligors	Working capital assets – Other Obligors	Certain drill rig assets – DLL Obligors	IP assets – IP Obligor	Other assets – ABL Obligors	Other assets – Other Obligors
SSNs	Fourth ranking	Second ranking	N/A	N/A	First ranking	First ranking
Term Loan B	Fourth ranking	Second ranking	Second ranking	Second ranking	First ranking	First ranking
Term Loan A	Third ranking	First ranking	Second ranking	Second ranking	Second ranking	Second ranking

Based on these differences, it may seem curious that the Court considered the shared security to be a reason for the creditors to be placed into the same, rather than different, classes. It is a pity that this aspect of the decision was not explained in greater detail.According to Debtwire, this resulted in varying expected returns on the dollar in a liquidation scenario between the TLA (32.6c), TLB (35.4c) and SSNs (22.1c).[11]

MAJORITY OWNERSHIP AND CONTROL

On its face, the issuance of a majority stake in BLY (together with control of the board of directors) to Centerbridge, but no issuance of equity (or director seats) to the SSN holders is arguably a very substantial difference in treatment. The shareholding was allocated to Centerbridge expressly due to its foregone interest under the TLA and TLB (it is unclear how directly linked the directorship was).

Whilst there appears to have been some difference in opinion as to the value of the equity stake at the time of the restructuring, no formal finding was made in this regard by the Court (although the Court indicated some uncertainty as to value).

We are not aware of any other cases where creditors receiving such markedly different rights pursuant to a scheme have been placed in the same class. Typically there is more debate as to differences among the existing rights of creditors – companies and creditors are normally very conscious of ensuring that creditors within a class are treated in the same or similar way. Any differences in treatment are typically small or proportional and commercially justified.

From the face of the judgment in *Boart Longyear*, it appears that no consideration was given by the Court as to whether the grant of shares and control to Centerbridge was likely to have influenced its behaviour in this case.

Whilst no specific finding was made as to the value of the shares, most financial restructurings aim to return the company to a sustainable financial state. In theory at least, this should return some value to the equity. Furthermore, in practice, it is the primary objective of many distressed investors to obtain the majority equity shareholding of the restructured company, under what is frequently known as a 'loan-to-own' investment strategy. The precise valuation of such shares at any given time can give rise to significant debate, and will depend on the valuation assumptions and methodology. Nonetheless, it would seem surprising in such circumstances to proceed on an assumption that the shares were of no real value or did not influence the behaviour of the parties.

HEAVYWEIGHT FACTORS?

The Court acknowledged that the issuance of shares to Centerbridge gave rise to a difference of rights, but considered that such difference was 'outweighed' by the common interest of the SSN, TLA and TLB holders being their common exposure to the risk of insolvency and the fact that they share security over the same assets.

The emphasis given by the Court to these factors is somewhat puzzling. In most schemes implementing a financial restructuring, the alternative to a successful scheme is the formal insolvency of the company. It therefore does not seem a particularly remarkable or unusual factor in this case, such as to give rise to a heightened commonality of interest. If a shared interest in avoiding formal insolvency was sufficient to create a common interest, the unsecured creditors could have been placed in the same class. Indeed there would be very few restructurings implemented by way of creditor scheme where more than one class would be required.

Likewise, the mere fact that the SSN, TLA and TLB holders had security over common assets seems insufficient of itself to guarantee the requisite commonality of interest. It is generally well accepted that differences in priority as to security will, in most cases, lead to creditors being placed in separate classes (as this would normally lead to differing recoveries in a liquidation). Whilst the details are unclear from the judgment, it appears at least possible in the *Boart Longyear* case that the differences in security position between SSN, TLA and TLB could have given rise to differing rights and outcomes that tended towards a difference rather than a commonality of interest.

Even if these two factors were regarded as factors validly pointing to a commonality of interest, each of these factors only go to the similarity of rights and position of the SSN, TLA and TLB holders prior to the scheme of arrangement. It is difficult to see why a similarity of position prior to the scheme should justify a divergence of treatment under the scheme. Again, we are not aware of any authority for this principle. Indeed, the cases suggest that the analysis of the differences in existing rights and in new rights are two separate questions – each of which must be taken into account in considering the class question.

IMPOSSIBILITY OF CONSULTATION

One is left with the impression that Black J applied the dictum in *Sovereign Life* rather literally – ultimately returning to the fact that despite the significant differences between the creditors, they were not so dissimilar *'as to make it impossible for them to consult together with a view to their common interest'.* The fact that in practice, Centerbridge and the FPA seemed locked into diverging views as to the merits of the scheme, driven it would seem by FPA's concern that Centerbridge was achieving a better deal for itself than the SSN holders, did not in Black J's view make such consultation 'impossible' (although he conceded there was 'little likelihood' of it occurring).

In this regard it may have been helpful if the Court had given consideration to Chadwick LJ's further development of the *Sovereign Life* test in *Re Hawk Insurance*:[12]

Nevertheless, it is important to keep in mind the underlying question, to which Lord Justice Bowen's test 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 rights and 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.

ENDNOTES

1. A scheme of arrangement must be approved by 75% by value and a majority in number of those creditors in each class present and voting at the scheme meeting.

2. Prior to the schemes, Centerbridge had a 48.9% shareholding in BLY. However, the effect of the Unsecured Creditor Scheme was to dilute the shareholding of Centerbridge to 3.7%. Centerbridge was then issued further shares pursuant to the subscription agreement and the Secured Creditors Scheme such as to increase Centerbridge's holding to 56% of BLY.

3. *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573.

4. *Primacom Holding GmbH v Credit Agricole* [2011] EWHC 3746 (Ch).

5. *Re Boart Longyear Limited* [2017] NSWSC 567 at [41] (**Boart Longyear**).

6. *Re Boart Longyear Limited* [2017] NSWSC 567 at [46].

7. *Re Boart Longyear Limited* [2017] NSWSC 567 at [61].

8. *Re Nine Entertainment Group Ltd* [2012] FCA 813.

9. *Re Boart Longyear Limited* [2017] NSWSC 567 at [74].

10. Debtwire, ‘Case profile: Boart Longyear’ 28 April 2017.

11. Debtwire, ‘Case profile: Boart Longyear’ 28 April 2017.

12. *Re Hawk Insurance Company Limited* [2001] EWCA 241 at [32].

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