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COURT OF APPEAL UPHOLDS SCHEME CLASSES DECISION IN BOART LONGYEAR RESTRUCTURING

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

The New South Wales Court of Appeal has, in a decision that has surprised many practitioners, dismissed an appeal which challenged the composition of classes in the creditors' scheme of arrangement involving Boart Longyear Limited.[1]

The background to, and the initial Court challenge to the composition of classes in this restructuring is set out in our earlier article titled '[Controversial scheme classes decision in Boart Longyear restructuring]' dated 25 May 2017.

The Court of Appeal decision is, perhaps, the most significant development in schemes of arrangement in Australia in almost 40 years (that is, since the Full Court in *Re The Bank of Adelaide*[2] confirmed that schemes of arrangement could be used to effect takeovers).

In this article we examine the implications of the Court of Appeal's decision for future schemes of arrangement.

EXECUTIVE SUMMARY

- The Court of Appeal has unanimously dismissed an appeal in relation to the orders of the Supreme Court to convene creditor meetings for two schemes of arrangement involving the restructuring of Boart Longyear Limited (**BLY**).
- The Court affirmed the 125 year old test for identifying a class for a scheme of

arrangement as being those persons whose rights (not interests) are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. However, the Court's application of this time-honoured test has surprised many practitioners.

- The Court considered that the additional equity conferred on certain but not all creditors in the class, the differential effect of the waiver of change of control rights, and the different changes to interest regimes in relation to the secured noteholders and term loan holder, was not sufficient, when considering the only alternative for BLY as an insolvent liquidation, to require the creation of separate classes.

- The Court confirmed that the holders of senior secured notes, and the term loan A and B holder, were correctly placed in a single class for voting purposes.

- The very small value of the equity in BLY immediately post restructuring was important for the Court in finding that the additional equity conferred on certain creditors was not sufficient to create separate classes.

- We explore the judgment, the issues it raises and possible future challenges in this article.

REFRESHER OF THE FACTS

As outlined in our previous article, on 10 May 2017, Justice Black of the New South Wales Supreme Court granted orders to convene creditor meetings in respect of the restructuring plan of Boart Longyear Limited (**BLY**).[3]

BLY's restructuring plan involved two creditors' schemes of arrangements – the 'Unsecured Creditors' Scheme' and 'Secured Creditors' Scheme' – as well as a Restructuring Support Agreement (**RSA**) entered into with some of BLY's largest creditors, including Centerbridge Partners LP **(Centerbridge)**.

Under the Unsecured Creditors' Scheme:

- US$196 million of the senior unsecured notes (**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%.

Under the Secured Creditors' Scheme the holders of the senior secured notes (**SSNs**), and the holder of the secured Term Loan A (**TLA**) and secured Term Loan B (**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 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 the lender under those facilities (Centerbridge) receiving 56% of BLY's post restructuring equity. 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); 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).

Entities associated with Centerbridge held a significant percentage of the SSN debt and all of the TLA and TLB debt.

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 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% 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);
- that 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);

- 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 (who was obtaining outright majority control of BLY); and
- that Centerbridge obtained the right to nominate 5 persons to the BLY board (up from its existing right to appoint 4 directors).

At first instance, Justice Black held that the rights affected by the scheme were the rights that the holders of the SSNs and TLA/TLB would have in a winding-up of BLY, since that was the alternative to the scheme. His Honour found that it was appropriate for Centerbridge and the SSN holders to all vote in a single class. His Honour considered that despite the differences in rights, the areas of common interest between the SSNs and TLA/TLB were sufficient to justify the creation of a single class. His Honour placed particular weight on two factors, being that the holders of the SSNs and TLA/TLB:

- faced a ‘common and imminent issue as to the insolvency of [BLY Group]’, which would, absent the scheme, render moot many of the differences between their existing rights, in particular their rights to interest and the maturity dates of their loans; and
- were parties to ‘complex security arrangements over common assets, which will give rise to significant difficulties in any insolvency of the BLY Group, such that the SSN holders and Centerbridge as the TLA and TLB holder would likely have to negotiate arrangements between themselves to allow the realisation of the securities in an insolvency’.[4]

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 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; and
2. **The Interest Issue** – whether the differential interest regime in relation to the SSNs and TLA/TLB was class creating.

THE EQUITY ISSUE

Like Justice Black, the Court of Appeal was not minded to distinguish between rights conferred on Centerbridge by the scheme itself and rights conferred on it by the related agreements. It nonetheless 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 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 will move 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.[5]

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. This was because:

- the holders of the SSNs do not currently hold any shares in BLY;
- Centerbridge currently has de facto control of BLY 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 is 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 BLY already had the ability to appoint 4 directors and, after it held more than 50% of the shares, it could appoint and remove directors as it pleased.

There is room for debate as to whether the first two factors are 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 therefore the shares pre-restructuring were valueless. The key issue is how the new equity 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 are implemented will have little value (even after the restructuring). However, on one view, this ignores the important fact that, even if the shares had little value immediately after the scheme is implemented, they 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 many schemes of arrangement, certain 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 this case, the precise basis of the post-restructuring valuation of the shares was unclear from the face of the judgment. Two valuations 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 creditors that the unsecured noteholders would get nothing on a liquidation. For this purpose BLY was given an enterprise value of US$266.6 million. When this figure was compared against the anticipated outstanding secured debt at the time of implementation of the restructuring of US$445.1 million, the Court of Appeal stated that ‘whether the shares would have any value post implementation of the scheme is at best speculative’;[6] and
- a KPMG independent expert’s report, the primary aim of which was to demonstrate to the existing shareholders that the restructuring was fair and reasonable. That report took the view that the shares would be worthless in a liquidation, but ascribed a post-recapitalisation valuation range of US$.0011 to US$.0045.[7]

From the limited information in the judgment, it appears that the primary focus of each of these reports was on pre-restructuring value of the shares and, to some extent, the value of the shares immediately upon implementation of the restructuring. Neither of these reports appears to specifically address the potential future value of the equity, 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). This merits further consideration.

It is also interesting to note that the Court of Appeal appears to have relied on somewhat 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 the option value of the equity granted (which his Honour regard as highly uncertain).

THE INTEREST ISSUE

The Court rejected FPA's submission that the different interest regime in respect of the SSNs and TLA/TLB was sufficient to require separate classes.

Using the appropriate comparator of an insolvent liquidation, the Court held that:

in the context of imminent liquidation as the only alternative, it does not seem … that the adjustments made, whether more favourable to the Term Loan creditors or otherwise, is such as to prevent the two groups of creditors consulting together on the scheme.[8]

WHAT'S NEXT: POSSIBLE FUTURE CHALLENGES

HIGH COURT CHALLENGE?

It remains open for FPA to seek leave to appeal to the High Court. However, whether the High Court would be prepared to hear an appeal remains to be seen (noting that the parties do not presently appear to be in dispute as to what the appropriate legal test is for class determination in a scheme of arrangement – the main focus of the dispute addressed in the judgments to date is the application of the legal test).

FAIRNESS CHALLENGE?

The Court of Appeal made a point of stressing that some of the matters raised by FPA were relevant to the Court's general fairness discretion (which only gets exercised at the final court hearing), rather than to the class question, and that nothing in the Court's judgment should be taken as expressing a view one way or the other on the fairness of the scheme. In this regard, the Court of Appeal stated:

Some of the matters raised by the appellant may well be said to go to the fairness of the scheme rather than to the particular class issues. Nothing in this judgment should be taken as expressing a view one way or the other on the fairness of the scheme.[9]

Accordingly, the Court has left the door ajar to allow FPA to seek to convince the Court at the final court hearing not to approve the scheme on fairness grounds (the final court hearing is scheduled to be heard on 4 July 2017). No doubt the level of support for the Secured Creditors' Scheme amongst the holders of SSNs (other than FPA) will be a relevant consideration for the Court at the final court hearing.

CHAPTER 15 CHALLENGE?

On 22 May 2017, the US Bankruptcy Court issued an order that recognised the BLY Australian scheme of arrangement as a foreign main proceeding under chapter 15 of the US bankruptcy code.

The SSNs are governed by New York law. Accordingly, if the BLY schemes of arrangement are approved in Australia, BLY will presumably seek an order from the US Bankruptcy Court to enforce and give effect to the Australian schemes in the United States (in particular to ensure the schemes are effective to preclude any action by SSN holders in the US courts). This could give rise to a further forum for the parties to continue their dispute over the schemes.

As previewed in US court filings, certain parties may contend that the US Bankruptcy Court should not enforce and give effect to the Australian BLY schemes of arrangement because the classes used in the schemes (as discussed above), and resulting distributions, would be inconsistent with the class formation rules applicable to chapter 11 cases under the US bankruptcy code. The US bankruptcy code requires that the US Bankruptcy Court compare the outcome of the foreign process with the rules applicable to domestic US bankruptcy cases in considering whether discretionary 'additional relief' should be granted in chapter 15 cases. There is however some precedent that suggests, in the interest of comity, a US bankruptcy court has discretion to grant relief in a chapter 15 case that would not otherwise be granted in a chapter 11 case, as long as such relief is not manifestly against US public policy. As such, the outcome may well turn on the weight given by the US Bankruptcy Court to the US class formation and distribution rules as compared against the broader policy to grant comity to foreign judgments.

COMMENTARY

NEW CLASS BOUNDARIES?

The different rights that are sought to be negotiated (or extracted) in complex restructurings often give rise to difficult class questions and thus can create completion risk issues. Whilst most would accept that some differential treatment of creditors within a class is permitted (albeit within boundaries), the extent of the differentiation amongst creditors under the Secured Creditors' Scheme in the Board Longyear restructuring would have surprised many practitioners as it goes beyond any previous restructuring by way of scheme of arrangement (at least in any reported English or Australian judgment).

As a result, we expect many would regard the effect of the Court of Appeal's decision as:

- having pushed the boundaries in terms of the differential rights that may be conferred on different groups of creditors without causing the creation of separate classes; and
- introducing a degree of uncertainty as to where the boundaries now sit.

AN EXPANDED ROLE FOR THE 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 have been the case in the Boart Longyear matter, result in a particular creditor being given a veto right.

In this regard, 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 Courts have previously noted:

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.[10]

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 Court will, no doubt, be very interested in the level of support for the scheme amongst the holders of the SSNs (other than FPA).

FINAL THOUGHTS

It will be very interesting to see what the *Boart Longyear* decision means for future creditors' schemes of arrangement in Australia. We may well see an increasing trend towards different groups of creditors receiving different rights under schemes yet still being included in the same class for voting purposes with the Court's broad fairness discretion taking on a far more prominent role in future schemes of arrangement.

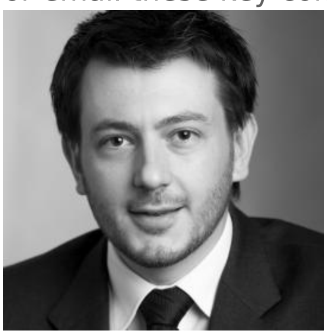
In any event, it will also be interesting to see whether the English courts (still the main international jurisdiction for complex restructurings by way of creditor schemes of arrangement) will follow, distinguish or ignore the Court of Appeal's decision.

ENDNOTES

1. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 (‘***Boart Longyear***’).
2. *Re The Bank of Adelaide* (1979) 4 ACLR 405.
3. *In the matter of Boart Longyear Limited* [2017] NSWSC 567.
4. *In the matter of Boart Longyear Limited* [2017] NSWSC 567 at [46]
5. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [93].
6. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [88].
7. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [89].
8. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [99].
9. *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [102].
10. *UDL Argos Engineering & Heavy Industries Co Limited v Li Oi Lin* [2001] 3 HKLRD 634 at [27].

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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