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Distressed Investment Strategies: Rights Offerings

I. Introduction

A busy restructuring market over the past couple of years brings to light a variety of issues facing distressed investors and advisors today. Key concerns frustrating investors include (i) assessing when to fund operational losses versus exiting investments quickly; (ii) determining whose recovery gets impaired for the cost of the restructuring; and (iii) determining strategies to salvage distressed investments that head south. One strategy that may be available to investors in distressed companies is additional investment through a rights offering. A rights offering provides existing shareholders and eligible creditors the opportunity to purchase additional shares of the issuer's stock, often at a discount. Depending on the circumstances, rights offerings can present several potential ways to capitalize on a distressed situation and increase returns for investors.

In the chapter 11 context, the Bankruptcy Code provides flexibility that allows parties to use rights offerings to achieve the goals of a chapter 11 reorganization. By exempting rights offerings from certain federal and state securities laws, purchasers are incentivized to invest in the debtor, providing debtors with capital needed to emerge from chapter 11. As such, rights offerings in chapter 11 cases can provide benefits to all parties involved.

However, backstop agreements supporting a rights offering may give rise to overreaching through excessive backstop fees, or where the process provides for an "inside" track for the backstop party to acquire, for example, a control position in the reorganized debtor without providing fair value.

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The following provides an overview of rights offerings and the use of rights offerings in the chapter 11 context. Also provided is a brief overview and summary of recent representative cases involving rights offerings.

II. <u>Overview</u>

A rights offering provides an issuer's existing shareholders the opportunity to purchase a pro rata portion of additional shares (referred to as "subscription warrants") of the issuer's stock at a specific price per share (the "subscription price"), often at a discount to the recent trading price of the issuer's stock. A rights offering is typically open for a period of 16 to 30 days, usually starting from the day that the issuer's registration statement relating to the rights offering becomes effective. The issuer will typically have to halt trading for some period of time prior to the opening of the rights offering in order to determine the shareholders of record entitled to participate in the rights offering; this is referred to as the shareholders as of the "record date" which is usually the effective date of the registration statement.

There is no specified period of time that a rights offering must remain open under federal securities laws. The issuer is not required to obtain shareholder approval for the rights offering, as long as the rights offering encompasses 20% or more of the outstanding shares of the issuer, and the subscription price is at a discount to the current market value.

There is no dilutive effect to shareholders who choose to take part in the rights offering, as all shareholders are given the right to purchase shares based on the number of shares they already own. However if a shareholder decides *not* to exercise its rights under the offering, the shareholder's ownership in the issuer will be diluted by those shareholders who do exercise their rights and take part in the offering.

Most rights offerings involve non-transferable rights. However an issuer may elect to structure an offering to permit rights to be transferable. In such offerings, shareholders who choose not to exercise their transferable rights can trade them in the secondary market during the offering period. In this way, the non-participating shareholders are able to offset dilution by earning a profit through trading their rights.

III. Rights Offerings in the Chapter 11 Context

The use of rights offerings in the chapter 11 context evolves from the flexibility provided through Section 1145 of the Bankruptcy Code. Chapter 11 cases often involve the recapitalization of a reorganizing company which frequently includes the issuance of new securities of the debtor in exchange for outstanding claims against or interests in the debtor.[2] Where certain conditions are met, section 1145(a)(1) exempts rights offerings from SEC registration requirements providing certainty and incentive for investors to purchase new securities in the chapter 11 case. "Section 1145 strikes a balance between allowing parties to a chapter 11 reorganization the necessary flexibility to achieve the goals of chapter 11, while maintaining the protections of the federal and state securities laws where appropriate."[3]

A rights offering can be used by a debtor to offer creditors or equity security holders the right to purchase equity in the reorganized debtor, at a discount to the assumed value of the reorganized enterprise. The creditors or equity holders are offered the right to purchase their pro rata share of the equity available under the offering, based on the percentage that their current holdings represent.

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[2] *See, generally*, 8 COLLIER ON BANKRUPTCY ¶ 1145.02[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

[3] *Id.*

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