

## **THE BASICS OF A RIGHTS OFFERING**

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## THE BASICS OF A RIGHTS OFFERING

A rights offering is an offer made by a company to persons that permits such persons to buy X shares of the company's stock<sup>1</sup> at Y price. It is a method for a company to raise additional equity capital. Outside of the context of a bankruptcy or a reorganization, it is usually a direct offer made by the company to the company's existing shareholders.

[T]he direct rights offering . . . is distinguished by the fact that the corporation is offering the new stock directly to and through its current stockholders. Initially, each owner is given a subscription "right" . . . to purchase a pro rata amount of new common stock from the company at a fixed subscription price. This subscription right is thus a valuable call option on the newly issued shares, although the option is typically short-lived, lasting only the typical two- or three-week subscription period. During this subscription period, new shares are sold through the exercise of subscription rights. The subscriber pays the corporation the subscription price for each subscribed share and simultaneously cashes in the appropriate number of subscription rights.

Robert Hansen, *Evaluating the Costs of a New Equity Issue*, 4 MIDLAND CORP. FIN.J. 42, 43 (1986)

If a company's stock is publicly traded and the rights to buy the additional shares of the company's stock are to be offered to all current shareholders, then the rights offering must be registered under Section 5 of the Securities Act of 1933 (the "Securities Act"). If the rights are to be freely transferable, then the rights offering must be registered under Section 5 of the Securities Act. In contrast, if the rights offering is only offered to a limited amount of institutions, whether or not they are existing shareholders of the company, who would qualify as

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<sup>1</sup> It can be common stock or preferred stock although it is often common stock.

accredited investors,<sup>2</sup> then the rights offering may qualify as a private placement<sup>3</sup> and registration of the rights offering ( or the shares purchased in the rights offering) would not be required under Section 5 of the Securities Act. The rights would not be freely transferable,

<sup>2</sup> Accredited Investor means any of the following institutions referred to in any of clauses (a) through (m) below with total assets of at least \$5 million:

(a)	Corporation	A Corporation (other than a bank as defined in Section 3(a)(2) of the Securities Act of a savings and loan association or other institution referenced in Section 3(a)(5)(A) of the Securities Act of a foreign bank or savings and loan association equivalent institution).
(b)	Partnership	A partnership or similar business trust.
(c)	Limited Liability Company	A limited liability company.
(d)	Business Trust	A business trust which was not formed for the purpose of investing in the securities offered.
(e)	Tax-Exempt Organization	A tax-exempt organization described in Section 501(c)(3) of the Code.
(f)	Personal (non-business) Trust	A personal (non-business) trust which was not formed for the purpose of investing in the securities offered and whose investment decisions are directed by a person who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the investment.
(g)	Plan	A plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions for the benefit of its employees.
(h)	Employee Benefit Plan	An employee benefit plan within the meaning of Title I of the ERISA.
(i)	Business Development Company, Section 2(a)(48)	A business development company as defined in Section 2(a)(48) of the Investment Company Act.
(j)	Business Development Company, Section 202(a)(22)	A business development as defined in Section 202(a)(22) of the Investment Advisers Act.
(k)	Small Business Investment Company	A Small business Investment Company licensed by the US Small Business Administration under Section 301(c) or (d) of the U.S. Small Business Investment Act of 1958, as amended.
(l)	Bank	A bank as defined in Section 3(a)(2) of the Securities Act, a savings and loan association or other institution as referenced in Section 3(a)(5)(A) of the Securities Act or a foreign bank or savings and loan association or equivalent institution that has an audited net worth of at least \$25 million in its latest annual financial statements.
(m)	Entity, all of the equity owners of which are Accredited Investors	Any entity, all of the equity owners of which are Accredited Investors, acting for its own account or the accounts of other Accredited Investors.

<sup>3</sup> A private placement under Section 4(2) of the Securities Act exempts transactions by an issuer not involving any public offering. Generally, a private placement should involve no more than 35 purchasers of securities from the issuer and the purchasers must be accredited investors (although there are some limited exceptions to this requirement).

although it is possible that an accredited investor could receive the rights and have another accredited investor exercise the rights instead. In such circumstances, there cannot be a solicitation of a large number of entities by the company or its professionals with respect to the rights offering because such a solicitation would constitute a public offering.

If the rights offering is made to a large group, then the rights offering may be underwritten. An investment bank or a consortium of investment banks may act as the underwriter. The underwriter agrees to buy the shares of stock that the company offered in the rights offering but which was not acquired by purchasers through the exercise of the rights. The underwriter will either be paid a fee for acting as the underwriter or contract to purchase any unsubscribed stock of the company offered in the rights offering at a price which is less than the price offered in the rights offering.

Potential purchasers will receive a subscription agreement. If it is a registered rights offering, potential purchasers will also receive a registration statement. If it is a private placement, potential purchasers will receive a certification form requiring any potential purchaser to certify that it is an accredited investor. The subscription agreement will allow for the potential subscriber to subscribe for all or a portion of its initial allotment. The initial allotment is based upon the number of shares of stock of the company to be issued to potential purchasers in the rights offering. If the rights offering is being offered to all existing shareholders, then the initial allotment to any particular shareholder will be determined based upon the number of shares of stock of the company that such potential purchaser currently owns. If the rights offering is being offered to a smaller group of potential purchasers, the company will determine the initial allotment available to each potential purchaser.

The rights offering may or may not permit a potential purchaser to oversubscribe, i.e. to acquire more shares than the initial allotment. If oversubscription is permitted, then the potential purchaser must indicate on the subscription agreement how many additional shares beyond its initial allotment it would like to subscribe for. In most rights offerings, not every potential purchaser chooses to exercise the rights and subscribe for its entire initial allotment. Thus, there are often shares of stock of the company that were offered in the rights offering but which were not subscribed to as part of the initial allocation. These remaining shares or sometimes a portion thereof (if there is an underwriter) will be allocated among those potential subscribers who have indicated a desire to acquire more shares than their initial allotment.

The rights offering will generally last for a short fixed period (a few weeks) and will have a fixed deadline for submission of the subscription agreement and other forms. Sometimes, payment for the shares of the company's stock will be required to be sent with the subscription agreement and sometimes, such payment will not be required to be sent until it is actually determined how many shares will be sold to the potential purchaser (i.e. after the deadline for the rights offering has passed).

If the company is in Chapter 11, a rights offering may be included as part of a plan of reorganization for the company. The rights to buy shares of stock of the reorganized company may be offered under a plan of reorganization to all creditors, all shareholders, all creditors and all shareholders or a subsection of creditors and/or shareholders, depending on the circumstances of the case.

Section 1145 of the United States Bankruptcy Code ( the “Bankruptcy Code”) exempts such rights (and the underlying shares of stock being issued upon the exercise of such rights) from registration under Section 5 of the Securities Act if such rights are being received:

(A) in exchange for a claim against, interest in or claim for administrative expense in the case concerning, the debtor or such affiliate; or

(B) principally in such exchange and partly for cash or property.

In order for a rights offering to be exempt from registration, if the creditors and/or shareholders receiving the rights are also receiving other consideration under the plan of reorganization, then the value of the rights (and the underlying stock acquired by the exercise of the rights) received by a creditor or shareholder must be valued and compared with the valuation of the other consideration being received by such creditor and/or shareholder under the plan of reorganization. If the value of the stock being offered through the rights offering exceeds the value of the other consideration being received by such a creditor and/or shareholder under the plan of reorganization, then the rights offering will not be exempt from registration under Section 5 of the Securities Act.<sup>4</sup> In addition, if the rights are to be freely transferable (separate from the underlying claim or interest), then the rights offering must be registered.

In a reorganization or Chapter 11 scenario, it is common for there to be a backstop purchaser or purchasers. Frequently, the backstop purchaser or purchasers are large creditors of

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<sup>4</sup> This is what is known colloquially as a Barry Jewelers problem. Barry Jewelers is a no action letter issued by the Securities Exchange Commission (“SEC”), a copy of which is attached hereto, which sets forth the analysis that must be done by the plan proponent. If the rights offering will not be exempt from registration under Section 1145 of the Bankruptcy Code, then the company’s options are to file a registration statement for the rights offering (which is costly and time consuming), limit the rights offering a small number of accredited investors so that it will qualify under the private placement exemption or give up on the concept of a rights offering.

the company or a fund or funds interested in acquiring a large amount of stock of the reorganized company. The backstop purchaser or purchasers will buy any shares of stock of the reorganized company which are not subscribed for in the rights offering. The backstop purchaser or purchasers will either be paid a fee for acting as the backstop purchaser or contract for the right to buy any unsubscribed shares of stock of the company at a price which is lower than the price offered in the rights offering.