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Assessing the Reasonableness of Rights Offerings Raising Exit Financing in the Context of a Chapter 11 Bankruptcy Proceeding

By Marti P. Murray

One of the public policy objectives underlying business reorganisation under Chapter 11 of the U.S. Bankruptcy Code is that a bankrupt company (also referred to as a "debtor" or a "debtor in possession") ought to be afforded a "time-out" from its pre-petition financial obligations. Once freed from this burden, the debtor should have the chance to address any deficiencies in its business, operations, and finances and to take the appropriate steps towards rehabilitation, so that it can ultimately emerge from bankruptcy with a "fresh start".[1]

As part of achieving a fresh start, the debtor must formulate a feasible plan of reorganisation that, in addition to meeting a myriad of legal requirements under applicable law and subject to court supervision, fundamentally addresses how legacy liabilities will be satisfied in whole or in part and how the company will be capitalised post-emergence.

A debtor may be required to raise new capital to finance its exit from bankruptcy (referred to as "exit financing"), with funds deployed to pay off legacy creditors and/or to have sufficient cash on hand at emergence to finance ongoing operations. It may be challenging for a debtor to obtain exit financing through traditional means, by, for example, raising new debt financing or issuing equity securities through the capital markets. Traditional debt and equity investors may not be interested in investing new capital into a company just emerging from bankruptcy, particularly if the reason for the bankruptcy related to a challenging environment for the debtor's industry.

In such a circumstance, a debtor may look to legacy stakeholders to provide exit financing. Investors who already hold debt or equity in a debtor can be the most natural party for a debtor to turn to for exit financing. Such investors have typically been involved with the company for some time and are knowledgeable about its investment profile and management team.[2] These investors may also have an incentive to provide the financing, because it is often raised to pay off existing obligations these same investors hold against the debtor.

Generally, by the time a bankrupt company is considering raising exit financing, many of its original creditors have sold out, and the debtor's investor base will consist of hedge funds and private equity firms that specialise in investing in distressed and bankrupt companies ("distressed debt investors"). These distressed debt investors are looking for ways to leverage market inefficiencies to make attractive returns for their clients. These inefficiencies can arise because traditional investors may be limited by mandate from maintaining investments in companies of low credit quality or are otherwise not comfortable maintaining an investment in a bankrupt company.

Distressed debt investors are highly sophisticated, familiar with the bankruptcy process, and many are willing to take an active role to effectuate the outcome of a bankruptcy reorganisation, as opposed to simply being a passive investor. In fact, in the context of exit financing, it is not unusual for investors to proactively approach a debtor with a proposal for exit financing.

Rights Offerings as Exit Financing

Conducting a rights offering as part of a bankruptcy proceeding is one well-established and effective technique to raise exit financing. In a rights offering, stakeholders are given the right, but do not have the obligation, to invest additional money into a company.

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Historically, rights offerings were used by public companies with reasonably concentrated equity ownership that were seeking to raise additional equity capital. The use of rights offerings for this purpose has declined over time, and currently, rights offerings are most often associated with bankruptcy cases of middle-market and large corporations. Since 2002, there have been approximately 70 rights offerings completed in bankruptcy cases, with deals ranging in size from $20 million to $2.8 billion, as measured by the amount of exit financing raised. For example, Lyondell, one of the largest chemical companies in the world, conducted a rights offering in 2010, raising $2.8 billion. In that same year, American Media, the holding company of the National Enquirer, also conducted a rights offering as part of its bankruptcy plan, raising $140 million. More recently, there have been several rights offerings undertaken in the energy industry, including for Breitburn Energy Partners (exploration and production) and Peabody Energy (coal). During 2016 and 2017 there were over $4.5 billion in rights offerings, with over half of them in the oil & gas sector.[3]

In the bankruptcy context, the rights are generally granted to creditors. Because creditors have an option but not an obligation to invest additional funds, in order to ensure that the requisite amount of capital is raised, certain parties must agree to purchase any unsubscribed portion of the rights offering, thus assuring that the rights offering is fully funded at emergence. The commitment to buy up the undersubscribed portion of a rights offering is referred to as a "backstop commitment" and the party who provides it as the "backstop party".[4] In exchange for the backstop commitment, the backstop party receives substantial fees, paid in the form of either cash or reorganised company securities.

The form of securities to be issued is most frequently new common stock, but could also be preferred stock, convertible notes, or other forms of debt instruments. An important component of a rights offering is the price at which investors have the option of purchasing the new securities (the "rights offering price"). For securities with an equity component, the rights offering price is set at a discount to what the price would otherwise be based on the valuation of the debtor, as determined by its investment banker/financial advisor (the "reorganisation value"). The reason for the discount is to provide an inducement for the investment.

In order for a debtor in possession to proceed with a rights offering, the terms must first be approved in bankruptcy court. There can be objections from certain stakeholders who do not find the transaction to be fair and reasonable. The most typical areas for controversy include the following: whether or not the debtor sufficiently explored the possibilities for alternative, less costly financing; whether the amount of the backstop fee is appropriate and justified; whether other creditors have been excluded from the backstop group, and thus the lucrative fees that the backstop parties will earn; whether the debtor's agreement to pay those fees essentially amounts to the debtor's improperly "buying the votes" of the backstop parties in order to gain the approval of a particular class of creditors; and whether the rights offering will result in unequal treatment of similarly situated creditors.

Evaluating the Key Elements of Rights Offerings

While it is clear that rights offerings can be an important tool to effectuate corporate reorganisations, the process around rights offerings can often be opaque. It can be difficult to assess whether other options were available that may have been less costly for the company and the other stakeholders, or whether the pay-

ment of sizable backstop fees was necessary at such high levels to induce a backstop party.

In a transparent, competitive market, one might assume that if the terms of a given rights offering were too expensive, including with respect to the backstop fees to be paid, other parties would emerge with a less costly alternative for the debtor. In reality, a fully transparent and open process in bankruptcy can be difficult to achieve at times for a variety of reasons, including because the opportunity to backstop a rights offering has not been fully exposed to the market (referred to as conducting a "market test") or due to the particular incentives of various stakeholders. In reality, investors who are proactive, willing to become restricted, and who are ready, willing, and able to write a sizable check to be a backstop party and fund a plan of reorganisation may be in a strong position to bargain both for attractive terms for the new securities to be issued and for the backstop fees to be earned.[5]

In evaluating the reasonableness of rights offering terms, there are a number of key elements to consider. These are discussed below, together with some observations gathered through a review of 15 selected completed rights offerings undertaken between 2007 and 2018.

Did the Debtor Conduct a Market Test?

Did the debtor go out into the market and evaluate other options to emerge from bankruptcy, including potentially engaging in any M&A processes that might have established a range of valuations, or did the debtor explore an alternative capital raise or rights offering proposal from a qualified alternative backstop party? A debtor who performs a market test and makes disclosures to parties in interest is providing more transparency to the parties so that they can assess the reasonableness of the rights offering terms before them. In approximately 50% of the rights offerings observed, debtors did not explicitly disclose whether any type of market test was conducted.

How was the Discount to Plan Value Determined?

As described, plan value is determined by the debtor's investment banker using generally accepted valuation methodologies, such as the discounted cash flow method, the comparable public company method, or the precedent transactions method. Equity securities issued through a rights offering are issued at a discount to plan value. The higher the discount, theoretically the better the deal will be for those who would be receiving the rights or backstopping the rights offering. Of the 15 rights offerings observed between 2007 and 2018, the median discount to plan value was 32%.

Is the Level of Fees Being Paid to the Backstop Parties Fair and Reasonable?

In exchange for providing the backstop commitment, the backstop party is entitled to receive a backstop fee. This fee is either paid in cash or in the form of the newly issued securities, which can also be issued at a discount to plan value. The backstop fees observed ranged from 2.5% to 28.6% of the rights offering amount, with a median of 7%. However the actual fee could be higher or lower than the stated fee percentage to the extent the fee is paid in the form of newly issued securities. If the dollar amount of the fee is paid with discounted securities, then the back stop party will be paid with more securities than it would otherwise have received if the fee was calculated based off of plan value for the new securities. If the newly issued securities trade above the price at which they were issued, then the effective backstop fee could be even higher than the stated fee. Of course, the fee could also turn out to be lower than 7% if the newly issued securities were to trade at a price below the discounted rights offering price.

It can be a challenge to determine whether the level of the backstop fee is truly justified. The reason to pay a fee is to ensure that the rights offering is fully subscribed, so that the debtor can receive all the funding it requires to successfully emerge from bankruptcy. However, if everyone who receives the rights were to exercise them, there would have been no need to have a backstop party and therefore no need to pay backstop fees.

Several elements relating to the way rights offerings are structured, as well as the paucity of information with respect to subscription levels, make it difficult to make this determination. To begin, rights distributed to stakeholders in a bankruptcy are generally not transferable separately from the security to which they attach. That means that a market for the rights can never develop separately. If it could, it might provide additional information with respect to the appetite for the newly issued security at the discounted price. It may be the case that the involvement of the backstop party gives other market participants added confidence to subscribe to the rights. However, it could also be the case that, due to the discount at which the new securities are offered in the rights offerings, investors would subscribe for them anyway, even in the absence of the backstop party.

Rights offerings in bankruptcy typically also do not permit a rights holder to oversubscribe by asking for more of the newly issued securities than their entitlement based on their holdings of the legacy securities. It is possible that if rights holders were able to oversubscribe, there would be less of a need for the backstop party, and therefore less of a requirement to pay all or part of the backstop fees.

There is limited information available with respect to historical participation levels in rights offerings. Of the 15 rights offerings observed, it was only possible to obtain information on subscription levels for four of them. Limited transparency makes it difficult to evaluate the extent to which backstop parties were actually called upon to provide additional funding in excess of their pro-rata share of the rights offering before considering any backstop commitment. If rights offerings historically have had very high subscription rates before having to call on the backstop party to take up any unsubscribed rights, it would tend to argue against the need to pay high fees to the backstop party because in actuality they would have received payment to guarantee a full subscription that was likely to occur in any event.

What are the Terms and Potential Limitations of the Backstop Party's Commitment?

The backstop commitment period is the length of time that the backstop parties are exposed to the funding obligation. The longer the time period, the more risk and opportunity cost the backstop party may have, and therefore, the more the backstop

Key Elements of Rights Offerings

	Company	Rights Offering			
		$ Amount to be Raised	Security	Discount to Plan Value	Rights Transferable?
1	21st Century Oncology Holdings	$275,000,000	New Preferred Equity + New Second Lien Notes	15.0%	No
2	American Media[1]	$140,000,000	New Second Lien Notes	N/A	No
3	Berry Petroleum (Linn)[2]	$335,000,000	Reorganized Berry Preferred Stock	N/A	No
4	Breitburn Energy Partners[3]	$775,000,000	New Common Stock	N/A	No
5	CHC Group[4]	$300,000,000	New Second Lien Convertible Notes	30.8%	No
6	Erickson	$20,000,000	New Common Stock	10.0%	No
7	Gymboree	$80,000,000	New Gymboree Common Shares	35.0%	No
8	Linn Energy	$530,000,000	Reorganized Linn Common Shares	20.0%	No
9	Lyondell	$2,800,000,000	Class B Shares	39.8%	No
10	Modular Space Holdings	$90,000,000	New Common Equity	68.0%	No
11	Peabody Energy[5]	$750,000,000	Reorganized PEC Common Stock	55.0%	No
12	Seadrill	$167,000,000	New Seadrill Common Stock + NSNCo New Secured Notes	80.0%	No
13	Solutia	$250,000,000	New Common Stock	33.3%	No
14	Tronox	$185,000,000	New Common Stock	17.6%	No
15	Trump Entertainment Resorts	$225,000,000	New Common Stock	-48.1%	No
	Max	$2,800,000,000		80.0%	
	Min	$20,000,000		-48.1%	
	Median	$250,000,000		32.0%	
	Mean	$461,466,667		29.7%	

(1) Rights offering was referred to as a notes offering, with option for creditors to put New Second Lien Notes to backstop parties. Backstop fee
(2) Based on maximum rights offering amount including $35 million increase. No plan equity value available for Berry.
(3) Comprised of a $310mm direct placement to backstop parties and a $465mm general rights offering to unsecured creditors. Non-backstop
(4) Subscription includes that of backstop parties. Non-backstop subscription was 33%.
(5) Excludes private placement of $750mm of preferred equity. Backstop parties were also entitled to an additional 2.5% backstop fee per month beginning April 3, 2017, approximately one month after the rights expired, until the Effective Date.

	Company	Backstop						Rights Exercise Period	Backstop Commitment Period	Disclosure of Market Test?
		# of Backstop Parties	Backstop Fee		Oversubscription Privilege	Actual Subscription	Actual Backstop			
			$	% R.O						
1	21st Century Oncology Holdings	Unknown	$20,625,000	7.5%	No	Unknown	Unknown	20	72	N/A
2	American Media[1]	2	$17,950,000	12.8%	No	35.0%	65.0%	16	41	Yes
3	Berry Petroleum (Linn)[2]	Unknown	$23,450,000	7.0%	No	Unknown	Unknown	24	27	N/A
4	Breitburn Energy Partners[3]	12	$77,500,000	10.0%	No	Unknown	Unknown	31	86	Yes
5	CHC Group[4]	8	$30,814,815	10.3%	No	98.9%	1.1%	36	114	Yes
6	Erickson	8	$1,200,000	6.0%	No	53.7%	46.3%	31	32	N/A
7	Gymboree	Unknown	$4,000,000	5.0%	No	Unknown	Unknown	21	68	N/A
8	Linn Energy	Unknown	$21,200,000	4.0%	No	Unknown	Unknown	24	27	N/A
9	Lyondell	3	$69,750,000	2.5%	No	Unknown	Unknown	29	125	Yes
10	Modular Space Holdings	11	$4,500,000	5.0%	No	Unknown	Unknown	28	42	N/A
11	Peabody Energy[5]	17	$60,000,000	8.0%	No	Unknown	Unknown	22	69	Yes
12	Seadrill	6	$8,350,000	5.0%	No	Unknown	Unknown	30	261	Yes
13	Solutia	6	$6,250,000	2.5%	Yes	Unknown	Unknown	31	42	N/A
14	Tronox	28	$14,800,000	8.0%	No	Unknown	Unknown	37	75	Yes
15	Trump Entertainment Resorts	13	$64,285,714	28.6%	No	0.1%	99.9%	28	63	N/A
	Max	28	$77,500,000	28.6%		98.9%	99.9%	37	261	
	Min	2	$1,200,000	2.5%		0.1%	1.1%	16	27	
	Median	8	$20,625,000	7.0%		44.3%	55.7%	28	68	
	Mean	10	$28,311,702	8.1%		46.9%	53.1%	27	76	

Despite the effectiveness of rights offerings in the bankruptcy context, it is important to ensure that their economic terms are fair and reasonable and do not result in an inappropriate transfer of value to the backstop parties, an issue that is often disputed in bankruptcy courts.

party might be entitled to additional compensation. The median backstop commitment period observed in the sample set is 68 days.

The conditions under which a backstop party can terminate its back stop commitment would also be an important factor to consider in establishing the overall reasonableness of the terms of the rights offering. The value of the backstop commitment might decline if the contracts provide conditions under which the backstop party can terminate its commitment.

A detailed data analysis of these key elements is outlined on the left.

Conclusion

Rights offerings will continue to play an important role in corporate restructurings, as companies seek risk capital to emerge from bankruptcy to pay off legacy creditors and to invest in the future. Rights offerings represent a transfer of valuable consideration between parties. A bankrupt company is receiving critical financing in order to effectuate a successful emergence from bankruptcy, while the rights offering subscribers are being granted an option to increase their ownership position at a discount to the plan value. At the same time, the company is paying substantial fees to the backstop party to provide assurance that the deal will ultimately happen.

Despite the effectiveness of rights offerings in the bankruptcy context, it is important to ensure that their economic terms are fair and reasonable and do not result in an inappropriate transfer of value to the backstop parties, an issue that is often disputed in bankruptcy courts. Greater transparency about the process would allow all parties in interest to have greater confidence to conclude that the terms of a proposed rights offering are fair and reasonable.

1. This differs from a Chapter 7 bankruptcy, in which the debtor is liquidated and therefore does not continue as a going concern. Some would argue that this public policy consideration has been eroded to a certain extent in recent years due to a shortening of the exclusivity period in bankruptcy, which governs how long the debtor has the exclusive right to file a plan of reorganization before competing stakeholders can propose their own plan. Also of concern has been the issue, for retailers in particular, that debtors have less time to determine whether to accept or reject executory contracts such as store leases.
2. There is generally less sell-side analyst coverage of companies in bankruptcy relative to more financially stable competitors in the industry. Typical investors in a particular industry may be unfamiliar with the idiosyncrasies of investing in the debt or equity securities of bankrupt companies and may shy away.
3. Debtwire, 2016-2017 Rights Offerings Restructuring Data Report.
4. The backstop party can be one entity or entities working as a group.
5. Backstop parties will also typically have to agree to restrict themselves from trading for a period of time, to the extent they are in receipt of material non-public information.