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ASSESSING THE REASONABLENESS OF RIGHTS OFFERINGS:

Raising Exit Financing in a Chapter 11 Proceeding

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Historically, one of the public policy objectives of business reorganization under Chapter 11 of the U.S. Bankruptcy Code was that a bankrupt company be afforded a "time-out" from its pre-petition obligations so as to have a chance to address deficiencies in its business, operations and finances, and then take appropriate steps towards rehabilitation. Ultimately, the entity would emerge from bankruptcy with a "fresh start," providing greater long-term benefit to stakeholders than it would have if liquidated.

As part of the Chapter 11 reorganization process, debtors are often required to raise new capital to finance their exit from bankruptcy (referred to as "exit financing") with funds deployed to pay off legacy creditors and/or to have sufficient cash on hand on emergence to finance ongoing operations. However, it may be challenging for a debtor to obtain exit financing through traditional means; for example, by 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 in a company just emerging from bankruptcy, particularly if the reason for the bankruptcy stemmed from a challenging environment for the debtor's industry.

In such a circumstance, a debtor may look to legacy stakeholders to provide exit financing. Investors that already hold debt or equity in a debtor may be the most natural parties 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 exit financing, which is often used to pay off existing obligations of the debtor to the same investors, among others.

Generally, by the time a bankrupt company considers exit financing, many of its original creditors have sold out and its investor base consists of hedge funds and private equity firms specializing 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. Such inefficiencies can arise because traditional investors may be limited by mandate from maintaining investments in companies of low credit quality or otherwise uncomfortable with investing in bankrupt companies.

Distressed debt investors are highly sophisticated and familiar with the bankruptcy process and many are

1 The author wishes to acknowledge Julia Zhu, of The Brattle Group, for assistance with preparation of this article.

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.

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willing to play an active role to effect the outcome of a bankruptcy reorganization, as opposed to simply being passive investors. In fact, in the context of exit financing it is not unusual for investors to proactively approach debtors with proposals for exit financing.

Rights Offerings as Exit Financing

Conducting a rights offering as part of a bankruptcy proceeding is a well-established and effective technique to raise exit financing. In rights offerings, stakeholders are given the right, but do not have the obligation, to invest additional money in a company. Historically, rights offerings were used by public companies with reasonably concentrated equity ownership that desired to raise additional equity capital. The use of rights offerings for this purpose has declined over time and currently is most often associated with bankruptcy cases of middle-market and large corporations. Since 2002, there have been approximately 70 rights offerings completed in Chapter 11 cases, with deals ranging in size from $20 million to $2.8 billion, 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 that raised $2.8 billion. In the same year American Media, 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 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 and gas sector.[3]

In the bankruptcy context, the rights are generally granted to creditors. Due to the fact that creditors have an option but not an obligation to invest additional funds, in order to ensure the requisite amount of capital is raised, certain parties must agree to purchase any unsubscribed portion, thus making sure the rights offering will be 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 that provides it is referred to 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 the reorganized company's 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 "plan value"). The purpose of the discount is to provide an inducement to investors.

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:

- whether or not the debtor sufficiently explored 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 improperly "buying the votes" of the backstop parties in order to gain approval from 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 in carrying out corporate reorganizations, the process around rights offerings is often opaque. It can, for example, be difficult to assess whether other options were available that might have been less costly for the company and other stakeholders, or whether the payment of backstop fees at such high levels was necessary 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 at times be difficult to achieve 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 a "market test"), or because of the particular incentives of various stakeholders. Nonetheless, investors that are proactive, willing to become restricted in order to review material, non-public information, and ready, willing and able to write a sizable check to be a backstop party and fund a plan of reorganization, may be in a strong position to bargain both for attractive terms for the new securities

3 Debtwire, 2016-2017 *Rights Offerings Restructuring Data Report*.
4 The backstop party can be one entity or entities working as a group.

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, including the following questions:

- Did the debtor conduct a market test?
- How was the discount to plan value determined?
- Is the level of fees being paid to the backstop party fair and reasonable?
- What are the terms and potential limitations to the backstop party's commitment?[6]

These are discussed below, together with some observations gathered through a review of 15 selected completed rights offerings undertaken between 2007 and 2018. The 15 cases are recent, high profile transactions of interest, selected from among 69 identified rights offerings between 2002 and 2018 with diversity across industries.

Background of Selected Rights Offerings

The 15 selected transactions consist of public and private companies across nine industries. The highest concentration of rights offerings was in the Oil & Gas sector, representing five out of the 15 rights offerings evaluated. Industry classifications of the selected deals are as follows:

Aerospace - 1

Casinos - 1

Chemicals - 3

Coal - 1

Construction - 1

Healthcare - 1

Oil & Gas - 5

Publishing - 1

Retail - 1

The number of deals by year are as follows:

2007 - 1

2009 - 2

2010 - 2

2016 - 5

2017 - 5

Nine of the 15 companies were publicly traded prepetition, seven of which emerged as public companies with two transitioning to private ownership upon emergence from bankruptcy. Six of the 15 companies were privately owned prepetition; three of them remained private while the other three were taken public upon emergence.

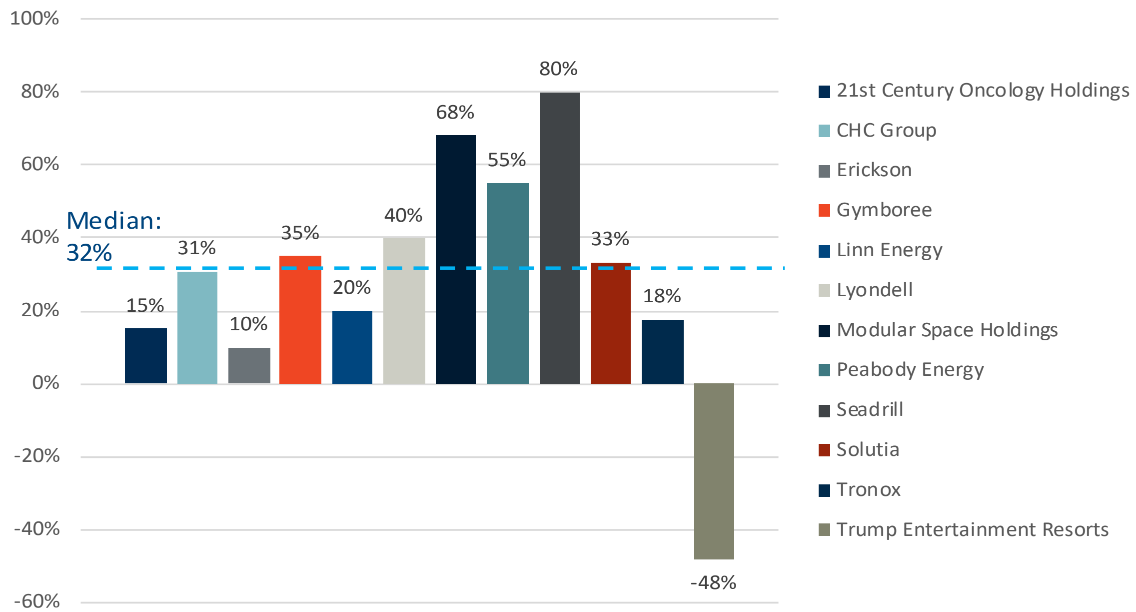
Did the Debtor Conduct a Market Test?

In evaluating the reasonableness of rights offering terms, it is important to consider whether the debtor conducted a market test. A market test would involve

5 Backstop parties will 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.

6 In addition, consideration might also need to be given to whether or not it could be argued in a particular case that the proposed rights offering would result in unequal treatment of similarly situated creditors.

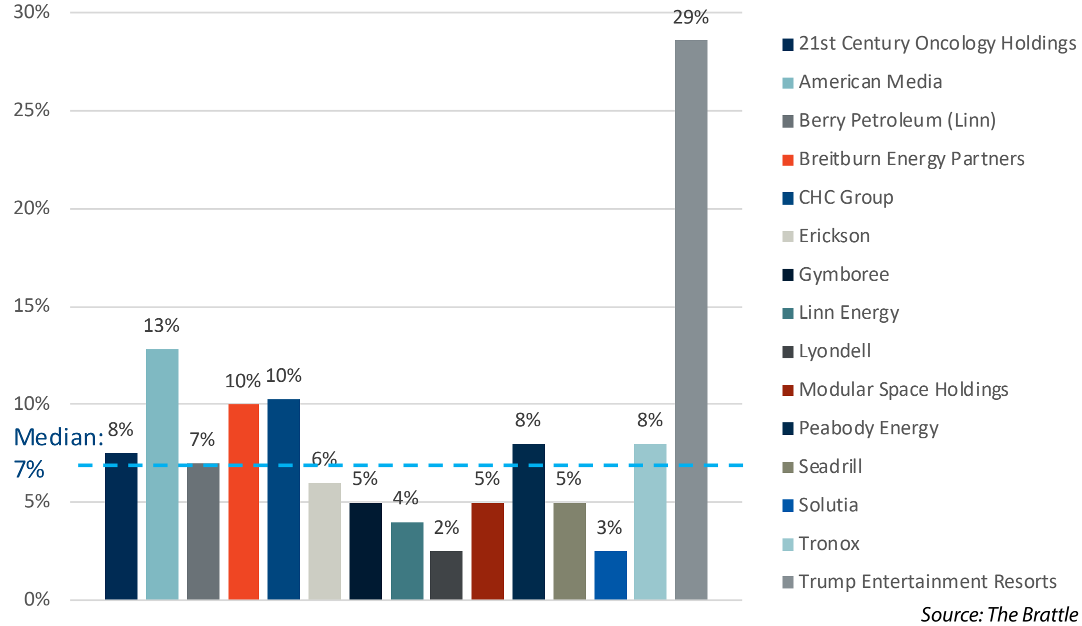
Exhibit 1: Selected Rights Offerings Discount to Plan Value



Source: The Brattle Group.

Notes: Discounts for American Media, Berry Petroleum (Linn), and BreitBurn are not available. American Media conducted a "notes offering." No plan equity value was available for Berry Petroleum (Linn). BreitBurn's rights offering was to purchase 100% of equity and therefore a discount was not applicable.

Exhibit 2: Backstop Fee as Percent of Rights Offering Amount



Source: The Brattle Group

the debtor engaging with the market and seriously evaluating other options to emerge from bankruptcy. These options could include potentially engaging in an M&A process for all or part of the debtor in order to establish a valuation range, or otherwise exploring an alternative capital raise or rights offering proposal from a qualified alternative backstop party. A debtor that performs a market test and makes disclosures about the contours of the test is providing more transparency to the parties in interest so 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, comparable public company method or 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 that receive the rights or backstop the rights offering. Of the 15 rights offerings observed in the study, the median discount to plan value was 32%, as shown in Exhibit 1 on p.37.

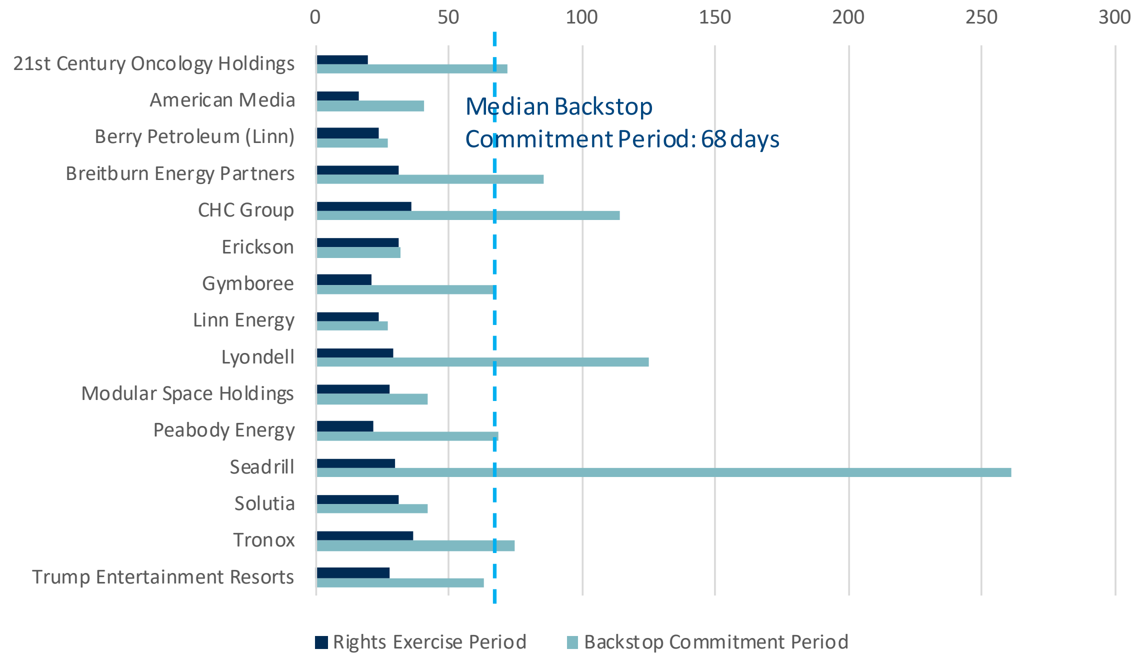
Is the Level of Fees Being Paid to Backstop Parties Fair and Reasonable?

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%, as shown in Exhibit 2. 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 backstop party will be paid with more securities than it would otherwise have received if the fee was calculated based on 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 the debtor can receive all the funding it requires to successfully emerge from bankruptcy. However, if it were clear that everyone who received rights was going to exercise them, then there would be no need to have a backstop party and therefore no need to pay backstop fees.

Several factors related to the way rights offerings are structured, as well as the paucity of information with respect to subscription levels, make it difficult to determine whether the level of backstop fees is justified. To begin with, rights distributed to stakeholders in a bankruptcy are generally not transferable separately from the security to which they attach. This means a market for the rights cannot 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

Exhibit 3: Backstop Commitment Period



Source: The Brattle Group

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.

In addition, rights offerings in bankruptcy typically do not permit a rights holder to oversubscribe by asking for more of the newly issued securities than is 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.

Limited information is available about 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. This 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 based on their holdings of legacy securities. 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: they would in essence be receiving 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 party might be entitled to additional compensation. The median backstop commitment period observed in the sample set is 68 days, as shown in Exhibit 3.

The conditions under which a backstop party can terminate its backstop 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

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Marti P. Murray, a principal of The Brattle Group, has had a 35+ year career in the financial services industry, serving in leadership roles at both alternative investment management and financial advisory firms, on numerous boards of directors, and as a court-appointed SEC Receiver for an investment advisor accused of fraud. Earlier in her career, she founded Murray Capital Management, an SEC-registered distressed debt hedge fund firm, which she ran from 1995 until the distressed debt business was acquired by Babson Capital in 2008. Ms. Murray taught graduate-level courses at the NYU Stern School of Business for over a decade and has spoken at conferences worldwide.

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party can terminate its commitment, for example, a material adverse change provision that is broadly defined.

A detailed analysis of key elements for the selected transactions is presented in Exhibit 4.

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. Increased transparency about the process would allow all parties in interest to have greater confidence in determining whether terms of a proposed rights offering are fair and reasonable.

Exhibit 4: Analysis of Data for Key Elements of Selected 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	$140,000,000	New Second Lien Notes	N/A	No
[3] Berry Petroleum (Linn)	$335,000,000	Reorganized Berry Preferred Stock	N/A	No
[4] Breitburn Energy Partners	$775,000,000	New Common Stock	N/A	No
[5] CHC Group	$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	$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%	

Company	Backstop						Rights Exercise Period	Backstop Commitment Period	Disclosure of Market Test?
	# of Backstop Parties	Backstop Fee $	Backstop Fee % R.O	Oversubscription Privilege	Actual Subscription	Actual Backstop			
[1] 21st Century Oncology Holdings	Unknown	$20,625,000	7.5%	No	Unknown	Unknown	20	72	N/A
[2] American Media	2	$17,950,000	12.8%	No	35.0%	65.0%	16	41	Yes
[3] Berry Petroleum (Linn)	Unknown	$23,450,000	7.0%	No	Unknown	Unknown	24	27	N/A
[4] Breitburn Energy Partners	12	$77,500,000	10.0%	No	Unknown	Unknown	31	86	Yes
[5] CHC Group	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	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	

Source: The Brattle Group. Analysis based on company filings.

Notes:

[2]: Rights offering was referred to as a notes offering, with option for creditors to put New Second Lien Notes to backstop parties. Backstop fee was paid in 5% of New Common Stock + cash equaled to 5% of 2L face.

[3]: Based on maximum rights offering amount including $35 million increase. No plan equity value available for Berry.

[4]: Comprised of a $310mm direct placement to backstop parties and a $465mm general rights offering to unsecured creditors. Non-backstop eligible offerees may subscribe by the Early Election Date and receive 10% Early Election Premium in shares. Rights offering was to purchase 100% equity and therefore discount to plan value not applicable.

[5]: Subscription includes that of backstop parties. Non-backstop subscription was 33%.

[11]: 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.