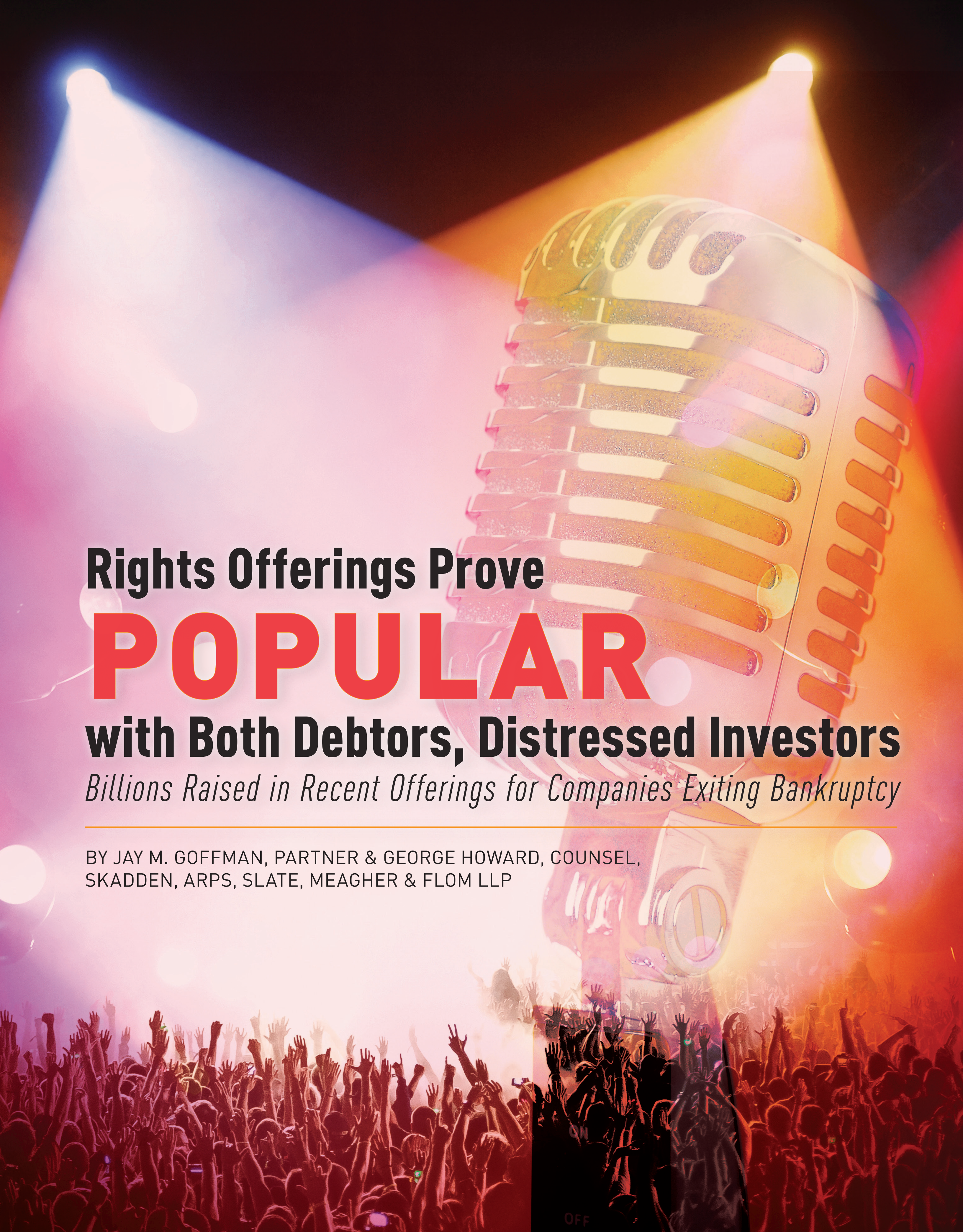

Rights Offerings Prove POPULAR with Both Debtors, Distressed Investors

Billions Raised in Recent Offerings for Companies Exiting Bankruptcy

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The past few years have brought a number of large rights offerings in bankruptcies in the energy, healthcare, and retail sectors. Between January 1, 2015, and December 1, 2017, more than $5.5 billion was raised through rights offerings or private placements in more than two dozen large bankruptcy cases.

In 2017 alone, seven companies raised $300 million or more through rights offerings. The largest offering was completed by Peabody Energy Corporation, with the company raising $1.5 billion through a $750 million rights offering of common stock and a $750 million private placement of preferred shares.

Absent a cash crunch that forces a quick sale under Section 363 of the Bankruptcy Code, and with plenty of investors having liquidity to invest, rights offerings are an efficient way for a distressed company to raise money, right-size its capital structure, and provide recoveries to creditors.

Rights offerings also allow an investor to put more money to work in an existing investment as opposed to seeking new opportunities in a relatively tight distressed market. Moreover, for those willing to backstop a rights offering, there is a potential to earn significant backstop fees, have expenses paid, and otherwise influence the outcome of the debtor's Chapter 11 case, post-emergence capital structure, and corporate governance.

The use of rights offerings over the past several years may be partially attributable to the fact that otherwise strong companies, with good assets and solid management teams, were forced into bankruptcy by a downturn in commodity prices. As commodity prices improve and weaker companies are forced out of business, the equity value of companies that remain and are delevered should recover. However, an equity investment is fraught with risk, even for a partially delevered company. If commodity prices and business trends fail to live up to expectations, equity holders in the reorganized business could lose all or substantially all of their investment.

While rights offerings have many positive aspects for both companies and investors, they also raise a series of unique legal issues. This article explores some of those topics from a high level with an eye toward arming potential debtors and distressed investors with a basic understanding of this popular tool.

What is a Rights Offering?

A typical rights offering provides existing creditors or equity holders the opportunity to purchase a pro rata share (based on their existing claim or interest) of new securities in the reorganized company, often for a discounted price. While the discount (if any) varies widely from case to case, the discount to the agreed valuation under a Chapter 11 plan has often settled in the 20 to 25 percent range in recent rights offerings.

Assuming the agreed valuation under the Chapter 11 plan is an accurate reflection of the company's true value, those with the right to invest at a discount should realize a gain if they decide to participate in the rights offering. For example, if each share in the company is worth $10 per share at plan valuation and the rights offering allows participants to purchase shares for $8 per share (*i.e.,* a 20 percent discount), each "right" is worth $2. As discussed in greater detail later, the valuation issues around rights offerings are relevant to several different legal issues.

While both debt and equity securities may be offered, the most common offering involves the sale of common stock in the reorganized company. Usually a rights offering is consummated as part of a Chapter 11 plan and participation in the rights offering is solicited simultaneously with the solicitation of votes on the Chapter 11 plan. Though less common, participation in a rights offering also can be solicited after a Chapter 11 plan is confirmed but before the plan's effective date.

Securities Law Exemption Issues

One major benefit of a rights offering in bankruptcy is that a debtor can issue new securities under an exemption to the registration requirements of U.S. securities laws and relevant state laws if the conditions set forth in Section 1145 of the Bankruptcy Code are satisfied. The registration process is time-consuming and expensive, so qualifying for the exemption provided by Section 1145 usually is an important consideration when structuring a rights offering.

Section 1145(a)(1) of the Bankruptcy Code, Section 5 of the Securities Act of 1933, 15 U.S.C. Section 77e, and state and local law equivalents requiring the registration for offer or sale of a security do not apply to the offer or sale of a security under a Chapter 11 plan (i) "in exchange for a claim against, or interest in, or a claim for an administrative expense in the case concerning, the debtor" or (ii) "principally in such exchange and partly for cash or property." 11 U.S.C. Section 1145(a)(1). Section 1145(a)(2) of the Bankruptcy Code extends the exemption to the offer of securities through warrants, options, rights to subscribe, or conversion privileges.

A rights offering needs to fall under the "principally in such exchange" category since stakeholders are investing new money in the business in connection with the offering (*i.e.,* they are not simply receiving new securities in exchange for their claim or interest). Phrased another way, for a rights offering to qualify for an exemption under Section 1145(a)(2) of the Bankruptcy Code, the amount

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to be raised in the rights offering (*i.e.*, the new money invested) needs to be less than the value of the claims of creditors who are receiving the right to participate. While there is no definitive rule, no-action letters from the Securities and Exchange Commission (SEC) have suggested that the amount of cash raised cannot be more than 75 percent of the value of the relevant claim. See Bennett Petroleum Corporation, SEC No-Action Letter, 1983 WL 28907 (Dec. 27, 1983); Jet Florida System, Inc., SEC No-Action Letter, 1987 WL 107448 (Jan. 12, 1987).

When determining the value of the creditors' claims for purposes of Section 1145(a)(2), the important measure is the *economic* value of the claims, not their face value. Economic value is typically measured by the total value to be distributed on account of the claims under the debtor's proposed Chapter 11 plan. That includes the value of the "right" itself, typically measured by the amount of the discount from plan equity value, plus any other consideration received on account of the creditor's claim under the chapter plan. Thus, the value of the "right" itself can have important implications for whether the rights offering can qualify for exemption under Section 1145.

When Section 1145 of the Bankruptcy Code does not apply, a debtor may still issue new securities as a private placement under Section 4(a)(2) of the Securities Act and related rules without needing to register the securities with the SEC. However, among other requirements for a private placement, the types of investors that may receive securities in a private placement are limited, and such securities also bear a restrictive legend and are subject to restrictions on transfer.

Finally, underwriters are specifically excluded from the exemptions provided by Section 1145 of the Bankruptcy Code. Therefore, any person meeting that definition, which may include the backstop participants described in the next portion of this article, must generally rely on a private placement exemption to avoid registration requirements.

Backstop Agreements

Customarily, a rights offering is "backstopped" by one or more third parties to ensure that the debtor raises sufficient capital to consummate its Chapter 11 plan. Pursuant to a backstop agreement, one or more existing creditors or equity security holders agree to serve as backstop parties and purchase any securities to the extent the rights offering is undersubscribed. The price for that backstop is a premium, which often is paid in either cash and/or additional securities.

Backstop premiums, on average, have fallen between 3 and 7 percent of the total offering, although the exact premium varies widely from case to case based on the facts and circumstances. Absent a backstop, a Chapter 11 plan dependent on a cash infusion from a rights offering could be challenged on feasibility grounds.

Similarly, because a rights offering and backstop may be formally or informally shopped to ensure the debtor is receiving the best available pricing, the backstop parties usually require a breakup fee as part of the backstop agreement. Breakup fees in backstop agreements tend to range between 3 and 5 percent of the total offering but, again, can vary widely depending on the facts and circumstances of a particular case.

As noted earlier, because backstop parties can be deemed to be "underwriters" and would need to rely on a private placement exemption from securities law registration requirements to resell the securities they receive, backstop agreements may also require the reorganized company to register the shares within a specified period of time after the offering is complete. Once the registration process is complete, the backstop parties can freely sell their shares to the public.

Backstop agreements can contain numerous additional provisions, including: (i) oversubscription or overallotment rights, allowing backstop parties to purchase a minimum number of shares or more than their pro rata share; (ii) limitations on the transferability of commitments; (iii) restrictions on the operation of the debtor's business pending consummation of the rights offering; and (iv) conditions precedent to the consummation of the rights offering, including a usually heavily negotiated material adverse event clause.

Because of the important protections afforded to backstop parties, it is almost universally required that the debtor obtain Bankruptcy Court approval of the backstop agreement before moving forward with the rights offering and plan confirmation process. Often, a debtor seeks approval of the backstop agreement at the same time it seeks approval of procedures for the rights offering itself and a disclosure statement for the plan confirmation process. Generally, the debtor's entry into a backstop agreement is reviewed under a business judgment standard.

Recent Litigation

Rights offerings in 2017 generated litigation around several key issues, most notably the right of creditors to participate in a backstop agreement and whether a rights offering creates unequal treatment between creditors in the same class.

Right to Participate in a Backstop.

Several cases in the past year have addressed whether the opportunity to participate in a backstop must be made available to all similarly situated creditors. The courts that addressed the issue have held that there is no such requirement.

In the bankruptcy of CHC Group Ltd., Case No. 16-31854 (Bankr. N.D. Tex.), noteholders shut out from participating in the backstop objected on fairness grounds. These parties cited Section 1123(a)(4) of the Bankruptcy Code, which says each claim or interest in a particular class must be provided equal treatment. The objecting noteholders argued they were given disparate treatment, despite holding more than $100 million (10 percent) of the outstanding secured notes, because they were not allowed to participate in the backstop. Their position was that the backstop parties, collectively holding approximately 67.5 percent of the secured notes, led the plan creation process and would receive a "windfall" through the backstop, which they "did not want to share...with others."

The company and the backstop parties argued that equal treatment applies only to the parties' prepetition claims and not to their post-petition contributions. The commitment to backstop a rights offering, they argued, was a post-petition contribution and not treatment on account of prepetition claims. The court sided with the company and the backstop parties and approved the backstop agreement.

Similarly, in the bankruptcy case of Peabody Energy Corporation, Case No. 1642529 (Bankr. E.D. Mo.), various parties argued, among other things, that it was improper to allow the initial backstop parties to receive greater rights than those signing up subsequent to the announcement of the backstop agreement or those who were unable or unwilling to join the backstop and also sign the plan support agreement. The objectors again focused on the requirements of Section 1123(a)(4) of the Bankruptcy Code.

The debtors, on the other hand, argued that the compensation for the backstop commitment was on account of new money equity commitments and not on account of the backstop parties' prepetition claims. Again, the court sided with the debtors and approved the backstop.

Comparable arguments were raised and rejected in the bankruptcy case of SunEdison Inc., Case No. 16-10992 (Bankr. S.D.N.Y.). In SunEdison, several affiliated holders of unsecured convertible notes objected at several

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stages of SunEdison's bankruptcy case, including at plan confirmation, to a backstop commitment provided by certain holders of second lien claims for a $300 million rights offering. The objectors argued that the plan was not filed in good faith, that the backstop arrangements constituted vote buying, that certain settlements key to the success of the plan and the rights offering were unreasonable, and that the plan was not feasible.

Following a two-day contested confirmation hearing, the Bankruptcy Court overruled the objectors' plan objections and, in a bench decision, stated that the objections "are a thinly disguised effort to force the debtors and the other backstop purchasers to allow [the objector] to participate in the [backstop]." The court, citing *Peabody*, noted that debtors are free to offer the opportunity to provide exit financing to anyone on a preferential basis and that doing so does not constitute bad faith or vote buying.

The court also found it important that the general unsecured creditor class, as a whole, overwhelmingly accepted SunEdison's plan of reorganization, which incorporated mediated settlements with the unsecured creditors' committee and provided approximately $66 million of value to general unsecured creditors.

These cases should serve as a cautionary tale for distressed investors. Those unwilling or unable to restrict themselves from trading for a period of time to negotiate with a debtor may end up watching the investors who do agree to restrict themselves receive a larger share of the equity in the reorganized company by participating in a backstop for a rights offering. At least to date, courts have been unwilling to force backstop parties to share those better returns with other creditors, even if they hold claims in the same class as the backstop parties.

However, companies should remain vigilant. Just because the courts that have addressed the issue in the past year have ruled in favor of debtors and the backstop parties based on the facts and circumstances of those particular cases, this is no guarantee that another court, faced with a different set of facts, would necessarily reach the same conclusion.

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Unequal Treatment Issues. While the unequal treatment issue can be raised in the backstop context, it also has been raised with respect to the rights offering itself. Typically, a creditor alleges that a rights offering violates Section 1123(a)(4) of the Bankruptcy Code when some members in a class are entitled to participate in a rights offering and others are not.

In the bankruptcy case of GulfMark Offshore Inc., Case No. 17-11125 (Bankr. D. Del.), certain investors who were not eligible to participate in a rights offering because they were not accredited investors objected to confirmation of the debtors' Chapter 11 plan on the grounds that they were being treated unequally as compared to accredited investors in the same class. Accredited investors in the class were entitled to participate in a rights offering being conducted under a safe harbor of Section 4(a)(2) of the Securities Act of 1933. Nonaccredited investors, who were ineligible to participate, instead received cash consideration with a value equal to the purported value of the right to participate in the rights offering.

The debtors argued that Section 1123(a)(4) of the Bankruptcy Code requires equal treatment, not identical treatment. Since the value of the cash consideration was the economic equivalent of the rights to participate in the rights offering, the plan complied with Section 1123(a)(4) of the Bankruptcy Code. The Bankruptcy Court agreed and confirmed the debtors' Chapter 11 plan. In this case, properly calculating the value of the right itself was important in crafting a Chapter 11 plan that could satisfy the confirmation requirements under the Bankruptcy Code.

Devil Is in the Details

Investors or companies looking to effectuate a rights offering must take care to seamlessly integrate what is often a complex capital markets transaction with the timeline of a bankruptcy case and various requirements under the Bankruptcy Code and securities laws. The foregoing summary highlights some of the key considerations at a high level, but to successfully complete a rights offering and simultaneously confirm a Chapter 11 plan, the devil will always be in the details.