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## RIGHTS OFFERINGS: THE NEW PIPES?

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The continuing dislocation of the capital markets has led to an increased interest in rights offerings. Market participants, including cash-starved issuers, intermediaries and other advisors, are beginning to explore the viability of using a rights offering as a means of raising capital. A rights offering can be fairly characterized as a hybrid PIPE and registered direct (RD). One important aspect of a rights offering is that it can be structured so it is not subject to an exchange's 20% shareholder approval rule.

Historically, rights offerings were the province of specialty finance and other financial service companies. Outside of the financial services sector, rights offerings were shunned by management who feared a potential short-term, adverse impact on a company's stock performance.

Lately, however, the number of rights

offerings by companies across many industries, and issuers' interest in them, has been on the rise. With stock prices so widely depressed, the concern over further downward price pressure from a rights offering may dissipate this fear. Moreover, rights offerings may be structured in a way that invites short-term demand and a commensurate rise in the market price by investors wanting to establish a position by the record date so they can participate in the offering. These market dynamics, combined with investors' renewed strong desire for liquid investments, may make rights offerings the new "flavor of the month" for capital raising.

This article focuses on a rights offering with, rather than without, a backstop commitment. Without a backstop, there is no commitment or certainty as to the amount of capital that will be raised. With a backstop, the backstop party (or parties) commits to buy some or all of the securities not purchased by the other shareholders, thereby assuring that the issuer will receive a certain level of capital. Since there are several permutations of the rights offering process, the variations described in this article are those most relevant to the PIPE/RD community.

### Overview

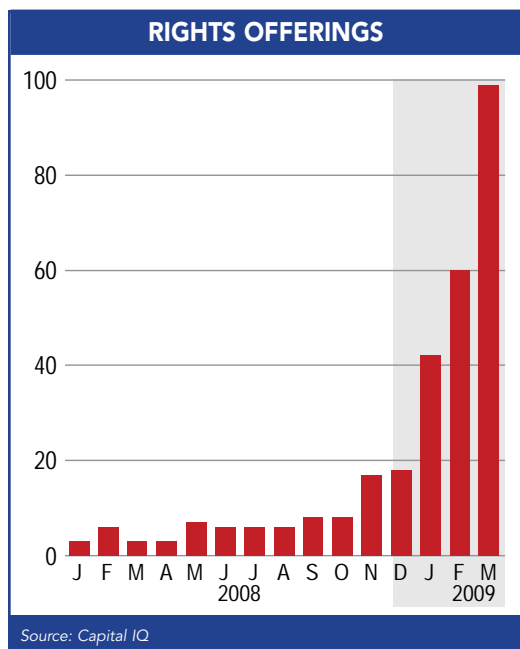
In a typical rights offering with a backstop commitment, the process begins with the assembly of the "team," which principally includes the issuer, its counsel and auditors, and the issuer's investment bank and its counsel. At this stage, the process is quite similar

to an RD, with the team commencing work on the registration statement and the marketing plan at the outset. While the registration statement is being drafted, the issuer and its investment bank under cover of confidentiality present the investment opportunity to existing or new investors to serve as the backstop. The providers of the backstop commitment agree to buy all or some portion of the securities that are not bought by the issuer's shareholders pursuant to the exercise of the rights. The backstop commitment is finalized (but typically not funded at that juncture) and the registration statement is then filed with the Securities and Exchange Commission.

When the registration statement is declared effective, the issuer's board sets a record date for the distribution of the rights, and once distributed, the issuer's shareholders typically have 16 to 30 days to exercise. Upon conclusion of the exercise period, the issuer receives the proceeds from the exercise of the rights, and then closes the backstop, thereby receiving the balance of the proceeds. The securities are issued pursuant to the effective registration statement, and are therefore in registered form, as with an RD, rather than restricted form, as with a PIPE.

### Description of the Rights

The rights entitle shareholders of record on the record date to purchase the issuer's securities on a pro rata basis. Unlike a PIPE, the securities to be issued upon exercise of the rights are at the time of issuance registered and readily re-salable pursuant to an effective registration statement. The rights are distributed by way of a dividend declared by the issuer's board. Unless the rights are transferrable,



## FEATURE STORY

## Rights Offerings

the distribution of the rights themselves does not require an SEC filing because it is a distribution to existing shareholders for no consideration. As with all other dividends, the board sets the record date to fix the shareholders who are entitled to receive the rights.

Typically, shareholders receive one right per share of common stock. The right entitles the holder upon exercise to purchase another security of the issuer, which most often is common stock, but can also be, for example, a unit exercisable for common stock and warrants or convertible preferred stock. The exercise price is set immediately before the registration statement is declared effective, and is typically set at a discount to then current market. The exercise period usually lasts for 16 to 30 days (subject to extensions authorized by the issuer); this timing is to an extent dictated by exchange rules.

The rights offering can allow for oversubscription, which permits holders who fully exercise their subscription rights to buy, on a pro rata basis with other fully exercising holders, any securities not subscribed for in the offering. There may also be a step-up privilege, which allows exercising holders to round up their purchase to the nearest whole number of shares, to avoid fractional share calculations.

Depending on the rights offering, the rights can be transferrable by their holders. Note, however, that there are important pros and cons to transferability, such as the possibility of arbitrage, increased volatility in the issuer's stock and offering shareholders the ability to profit from trading in the rights.

### Backstop

The backstop is the feature that closely aligns the rights offering with the PIPE/RD world. Through the backstop, new or existing investors have the opportunity to capitalize a publicly traded issuer, typically, at a discount to market. The backstop investor commits to buy all or a portion of

the unsubscribed securities. The backstop commitment is memorialized in a definitive purchase agreement between the issuer and each backstop party. The agreement is executed before the filing of the registration statement covering the rights offering and is filed either as an exhibit thereto or to a Form 8-K. A backstop party may receive a fee from the issuer in exchange for its commitment, similar in form to a commitment fee paid to a bank for a credit facility. Payment of a fee, however, may subject a rights offering to an exchange's shareholder approval rules if the offering exceeds 20% of the outstanding voting securities. The backstop commitment is consummated following the expiration of the subscription period for the existing shareholders, whereby the investor funds its investment in exchange for registered shares.

For the investor, the transaction is similar to a PIPE, except the backstop investor receives registered shares (to the extent they are included in the registration statement for the rights offering) at the time its investment is funded and has greater influence in determining the price, terms and allocation.

The backstop party can be any combination of existing shareholders, new investors, or an investment bank. When a backstop is provided by an investment bank (more common for larger market capitalization, seasoned issuers), the bank exposes its balance sheet by agreeing to purchase the unsubscribed securities in the hope that it can resell them. The investment bank will either fulfill the commitment directly or form an underwriting syndicate to do so. In either case, the investment bank is acting as an underwriter of the offering, and is subject to certain regulatory obligations with respect to its conduct.

Larger, well capitalized issuers typically do not need a backstop because there is sufficient liquidity and interest among existing investors to provide such an issuer with the desired level of capital. A rights offering without a backstop

is typically referred to as a "direct" rights offering.

### Registration Statement

Since the securities issued upon exercise of the rights are registered, the issuer must have an effective registration statement before commencement of the rights offering. The rights offering can be conducted pursuant to either an existing, effective shelf registration statement or a registration statement filed specifically for the rights offering. Typically, the registration statement will be on Form S-3, since market cap is not an eligibility requirement for rights offerings under the Form S-3 rules so it is more easily available to issuers for this process than for resale registrations. If the issuer's securities are not listed on the NYSE, Nasdaq or the American Stock Exchange, or if the issuer does not meet the other eligibility requirements of Form S-3, then the issuer will have to use Form S-1. As with any registered offering, a comfort letter is important, especially if there is an investment bank involved in the offering.

### Exchange Rules

In addition to allowing for registered securities, one of the important features of a rights offering is that it is not necessarily constrained by an exchange's "20% rule." The three U.S. exchanges all restrict their issuers from privately raising more than 20% of their outstanding voting securities at a discount without first obtaining shareholder approval. For these rules, a discount means a security issued below the greater of market price or book value per share. Today, remarkably, the market cap of an increasing number of issuers is well below their book value. A PIPE or RD priced at or above market may nevertheless be considered a discounted deal, because the issuer's book value may be greater than its market capitalization. Consequently, an increasing number of PIPE and RD deals are becoming subject to shareholder approval.

Rights offerings are deservingly

treated differently by the exchanges. The exchanges' shareholder approval rules are intended to protect the public against unwanted dilution. Since the rights offering is available to all stockholders on a pro rata basis, a stockholder may protect itself against the threat of forced dilution. Thus, an issuer whose securities are traded on an exchange may raise more than 20% of its market capitalization, even at a discount to market, through a rights offering. However, payment of a fee to a backstop party may subject a rights offering to the exchange's shareholder rules under some circumstances.

The exchanges prescribe a number of other rules applicable to rights offerings, which mostly tend to influence the timing and other procedural aspects of the offering process, and need to be reflected in the offering's timeline. Certain of the exchange rules also dictate the information that an issuer must provide to its shareholders in connection with a rights offering. Knowledgeable investment bankers and counsel can easily navigate an issuer through these rules, and assist the issuer with proper planning.

### Preparation

As with any offering, issuers should carefully prepare themselves. The conduct of a rights offering is generally regarded as material non-public information. An issuer must comply with Regulation FD with

respect to the offering before it is publicly announced. The issuer also should confirm before commencement of the process that it has sufficient authorized shares to fulfill the subscription rights. If that is not the case, then an issuer may need to seek shareholder approval to amend its certificate of incorporation before commencement of the rights offering.

### Offering Team

In addition to counsel and accountants, the other members of an issuer's team in a rights offering would typically include a dealer manager, an information agent and a subscription agent.

The dealer-manager manages the offering process for the issuer, serving as "quarterback" for the entire team of professionals to ensure that the process runs smoothly. The dealer-manager may also locate and negotiate with backstop parties. Typically, the dealer-manager role is performed by an investment bank, which most often receives a flat fee for its services, and can receive a commission with respect to the backstop parties. If there is a backstop, the investment bank assisting with or providing the backstop would usually serve as dealer-manager.

Issuers also often engage a subscription agent to conduct the mailing of the prospectus and related transmittal materials to the existing shareholders. The subscription agent may also collect the

completed exercise forms and payments from such shareholders. The subscription agent may be the same entity as the information agent.

The information agent's role is to respond to questions from shareholders regarding the rights offering.

### Conclusion

Rights offerings have many of the same ingredients as PIPEs and RDs. They provide investors with a registered security when their investment is funded and they are typically priced at a discount to market. For issuers, a rights offering provides issuers with an opportunity to raise capital without diluting existing shareholders and without obtaining shareholder approval pursuant to an exchange's "20% rule." Given investors' growing liquidity concerns with PIPEs and the issuers' need to raise more than 20% of their market cap, rights offerings may provide a seemingly familiar and viable financing solution in today's challenging market environment. ■

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