

# Rights Offerings Get Popular—and Contentious



BY JANE LEE VRIS  
AND ALEXANDRA S. KELLY

**R**IGHTS OFFERINGS are everywhere these days. Although used for years in bankruptcy cases without much fanfare, in more recent cases, they have become front and center. In the last five years alone, rights offerings have constituted a critical part of the proposed exit capital<sup>1</sup> for a number of large Chapter 11 cases, including *Delphi*, *DURA Automotive*, *Northwest Air-*

*lines*, *Lyondell Chemical*, *AbitibiBowater*, *Charter Communications*, *Extended Stay*, *Six Flags*, *Visteon*, *General Growth Properties*, *Spansion*, *Tronox* and *Washington Mutual*.<sup>2</sup>

By their very nature, rights offerings are a useful tool for raising capital in a tight credit market: They allow existing creditors to keep control of the restructured entity; they provide investors with opportunities to purchase positions in companies often at a significant discount; and they are typically structured as equity, allowing the reorganized company to remain significantly deleveraged after emerging from bankruptcy.

Rights offerings have also become more contentious, drawing an increasing number of objections from creditors on a variety of grounds.

Until recently, objectors have not been successful in blocking them. However, in the recent *Washington Mutual* opinion by Judge Mary Walrath in the Bankruptcy Court for the District of Delaware, the rights offering proposed by the debtors in their plan of reorganization was struck down by the court<sup>3</sup> and as a consequence has been removed from the most recent iteration of the debtors' plan as of Feb. 14, 2011, the date of this writing.<sup>4</sup>

As described in this article, the objections raised in the *Washington Mutual* case were commonly raised, although not sustained, in many of the recent high profile rights offerings. It may be too soon to tell whether *Washington Mutual* is a bellwether, indicating increased scrutiny by courts of the economics and circumstances surrounding rights offerings. But at the very least, it suggests that the challenges will continue.

### How They Work in a Chapter 11 Case

In a Chapter 11 case, a rights offering raises capital from creditors who are given the right, as part of their treatment under a proposed plan, to buy equity in the reorganized company at a fixed price, sometimes at a discount to the estimated new value.

Pricing the shares is a balancing act: Deepening the discount increases the cost to the company but also increases participation by creditors, who subscribe to the shares when voting on the plan. Because of the uncertainty regarding whether the offering will be fully subscribed and whether those subscriptions will be honored, frequently debtors will secure a commitment from a creditworthy party or group (which often consists of parties already involved in the case), referred to as a backstop commitment, to buy all the shares not purchased by creditors.

In addition to a commitment fee or the ability to purchase a guaranteed portion of shares at the applicable discount or some combination of both, the backstop providers frequently negotiate for

JANE LEE VRIS is a partner in the New York office of Vinson & Elkins, in the restructuring and reorganization group. ALEXANDRA S. KELLY is an associate in that group.

other “goodies” as part of the price of the commitment, including governance rights, break-up and professional fees, and releases of claims. With this commitment in hand, the debtor can assure the court and all interested parties that a guaranteed amount of capital will be available upon emergence. Both the rights offering and the backstop can draw objections.

### Three Main Categories of Objections

The most common objections can broadly be described in three categories.

*No Market Test/Valuation.* One of the most frequently raised objections is a challenge to the projected enterprise valuation posited by the plan proponent.

In theory, a rights offering can be a useful mechanism for warding off allegations that a plan proponent has undervalued the reorganized entity by permitting would-be objectors to buy in at a discount to the enterprise value. The rights offering can still draw a valuation objection, though, by those constituents who cannot participate.

Objections to enterprise valuation were raised in *Washington Mutual*, *Spansion*, *Six Flags*, *Lyondell*, *Northwest* and *Extended Stay*. In most cases, the objectors were parties not invited to participate in the rights offering, and such disputes were, in nearly every case, resolved prior to a court ruling<sup>5</sup> or overruled by the court.<sup>6</sup>

In *Washington Mutual*, however, Judge Walrath sustained the objection of a creditor group in finding that the reorganized company would have a valuation in excess of the enterprise valuation set by the debtor’s expert.<sup>7</sup> Valuation is also relevant when the backstop provider is guaranteed a block of discounted shares or when management-level executives are perceived to be getting a sweetheart deal in connection with the rights offering.<sup>8</sup>

Subjecting the proposed equity investment to a market test has been one means to combat valuation disputes. In *Extended Stay*, the debtors sought authority to enter into an investment agreement whereby the investors would commit \$450 million in equity, \$225 million of which was part of a backstopped rights offering.<sup>9</sup> After numerous objections were raised, including by parties who offered equity commitments on better terms, the debtors sought authority to “auction off” the right to serve as the plan investor through a motion approving bidding procedures. The auction process effectively negated the valuation objections

of numerous parties and resulted in significantly more value to creditors than the original plan investment.

The auction process does not, however, eliminate all risk of objection. In *AbitibiBowater*, the debtors specifically sought and obtained authority to auction off the right to serve as a backstop party in their proposed \$500 million rights offering.<sup>10</sup> Although the challenges to the bidding procedures were ultimately overruled, creditors found objectionable certain incentives and protections provided to the stalking horse bidder, including a multi-million dollar break-up fee and the release of a large fraudulent conveyance action.<sup>11</sup> By way of contrast, the *Delphi* court specifically found that no auction for higher and better bids against the proposed investment agreement, or the incentives and protections contained therein, was required in order to approve the agreement.<sup>12</sup>

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In a Chapter 11 case, a rights offering **raises capital** from creditors who are given **the right**, as part of their treatment under a proposed plan, **to buy equity** in the **reorganized company** at a **fixed price**, sometimes at a discount to the estimated new value. Until the ‘Washington Mutual’ ruling, however, objectors **had not been successful in blocking them**.

*Excessive Investor Incentives/Protections.* Backstop providers typically negotiate for, and receive, an investment commitment package of various incentives and protections. Financial incentives can range substantially, and may include a commitment/backstop fee, ranging from 2.5 percent to 6 percent,<sup>13</sup> a fixed block of shares provided at a discount of 12 percent to 60 percent,<sup>14</sup> a break-up fee ranging from 1 percent to 5 percent,<sup>15</sup> and various levels of expense reimbursement.

In addition, backstop providers may receive governance rights, typically in the form of guaranteed board seats and veto rights on various corporate actions. Finally, releases of claims, along with related indemnities, may be granted to the backstop parties and their advisors in connection with the commitment.<sup>16</sup>

In nearly every recent rights offering, some or all of the investor provisions have come under attack. Financial incentives, such as break-up and commitment fees, are frequently criticized as excessive, and as a result, tantamount to an impermissible lock-up. In both *GGP* and *Northwest*, objections on these grounds were resolved through negotiation, while the courts in the *Dura*, *Spansion* and *Visteon* matters overruled them.

Investor protections are also targeted when the commitment appears illusory. In *Visteon*, the prepetition term agent unsuccessfully objected to a group of agreements, including a backstop agreement, because the agreements allegedly placed no enforceable commitments on the investors, while the debtors took on onerous obligations.<sup>17</sup> The investors had no time frame for raising capital and were permitted to walk away without penalty if they failed to do so.

Investor commitment packages with broad releases for investors or for management also draw fire, particularly if claims have already been asserted. Objections on these grounds were raised in both *AbitibiBowater* and *Extended Stay*.

In *Extended Stay*, numerous stakeholders objected to the release for officers, directors and managers provided in the backstop agreement that would eliminate a \$100 million claim asserted in pending litigation.<sup>18</sup> These objections were moot once the debtors withdrew their motion for approval of the investment agreement and instead filed a motion to approve bidding procedures to auction off the right to serve as the plan investor.<sup>19</sup>

*Unfair Discrimination.* Finally, rights offerings have come under criticism by equity holders and creditors for constituting unfair discrimination in violation of Bankruptcy Code §1129(b)(1). Unfair discrimination is alleged when the right to participate is limited (size of claim, class, type of investors, use of allowed claims) or when as a practical matter the opportunity is not open to all.

For example, a union in *Delphi* objected that employees did not have the wherewithal to participate. The objection was ultimately resolved by permitting the holders of the rights to transfer them to third parties for value.<sup>20</sup>

In *Visteon Corp.*, two shareholders objected to the proposed rights offering on the basis that only certain shareholders who were members of the ad hoc equity committee were permitted to participate. After the court overruled their objections

on the basis that the ability to participate in the rights offering was not part of such equity holders' "treatment" under the plan, but instead a side deal with a third party, the individual shareholders appealed to the district court.<sup>21</sup> The matter was ultimately resolved through the payment of more than \$2 million to the objecting shareholders in settlement of the objections.

In *AbitibiBowater*, a group of holders of disputed claims originally objected to the proposed rights offering on the ground that only holders whose claims were already allowed could participate. To resolve the discrimination objections, the debtors next proposed to allow holders of disputed claims to participate by funding the purchase price into escrow and waiting until the claims disputes had been resolved before issuing the purchased shares. The objecting parties maintained that even this mechanism was discriminatory, but this time, on process grounds.<sup>22</sup>

Objections on the basis of unfair discrimination were also raised in *DURA Automotive*, which was ultimately overruled by the court, and in *Six Flags*, which was resolved by the parties through negotiations.

In *Washington Mutual*, an individual creditor objected to the plan on the grounds that only creditors in his class willing and able to invest a minimum of \$2 million could participate in the rights offering. In ruling that the treatment was in fact discriminatory, the bankruptcy court dismissed the debtor's claims that including all parties was administratively difficult and that the value of the stock being distributed through the rights offering was negligible. (As noted above, the debtors have recently removed the rights offering from their proposed plan.)

### Looking to the Future

As the use of rights offerings continues, it is reasonable to expect that all parties will become more sophisticated in the negotiation and execution of rights offerings in future cases.

The auction concept utilized by the debtors in *Extended Stay*, *AbitibiBowater* and *GGP*, already standard for asset sales, may be more frequently used and if properly executed, resolve valuation and other disputes.

Furthermore, the spate of recent rights offerings has created more market data for comparing investor incentives and protections to better inform the court and all parties of what is "market."

Finally, there is a growing body of knowledge regarding how objections such as the ones described herein ultimately fare: whether they are resolved through negotiated resolutions, overruled by the court or sustained. While *Washington Mutual* stands alone as the only recent high profile case where objections were sustained, it is unclear to what extent the *Washington Mutual* decision will effectuate a change in judicial thinking on rights offerings at this point. It does serve as a warning, though, that a rights offering can be discriminatory and the valuation successfully challenged, at least when the offering itself is not essential to the proposed reorganization.



1. In certain of these cases, the rights offering concept was not ultimately a component of the confirmed plan.

2. See *In re Delphi Corp.*, Case No. 05-44481 (RDD) (Bankr. S.D.N.Y. 2005); *In re DURA Automotive Systems Inc.*, Case No. 06-11202 (KJC) (Bankr. D. Del. 2006); *In re Northwest Airlines Corp.*, Case No. 05-17930 (ALG) (Bankr. S.D.N.Y. 2005); *In re Lyondell Chemical Co.*, Case No. 09-10023 (REG) (Bankr. S.D.N.Y.); *In re AbitibiBowater Inc.*, Case No. 09-11296 (KJC) (Bankr. D. Del. 2009); *In re Charter Communications Inc.*, Case No. 09-11435 (JMP) (Bankr. S.D.N.Y. 2009); *In re Extended Stay Inc.*, Case No. 09-13764 (JMP) (Bankr. S.D.N.Y. 2009); *In re Premier International Holdings Inc.*, Case No. 09-12019 (CSS) (Bankr. D. Del. 2009); *In re Visteon Corp.*, Case No. 09-11786 (CSS) (Bankr. D. Del. 2009); *In re General Growth Properties Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. 2009); *In re Spansion Inc.*, Case No. 09-10690 (KJC) (Bankr. D. Del. 2009); *In re Tronox Incorporated*, Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. 2009); *In re Washington Mutual Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. 2008).

3. *Washington Mutual*, Docket No. 6528, at 98.

4. *Washington Mutual*, Docket No. 6696.

5. For example, in *Northwest*, the equity committee and the debtors entered into a settlement just prior to plan confirmation that resolved the objections of the equity committee to, among other things, company valuation.

6. In each of *Lyondell*, *Six Flags* and *Spansion*, the court overruled objections on the basis of valuation. The objecting creditor group in *Spansion* has appealed the confirmation order on the grounds of, among other things, improper valuation. That appeal is currently pending before the U.S. District Court for the District of Delaware.

7. *Washington Mutual*, Docket No. 6528, at 98.

8. In both *Six Flags* and *Spansion*, objections to valuation were combined with a challenge to the size of the equity stake being granted to management in connection with the rights offering.

9. *Extended Stay*, Docket Nos. 768, 798. Ultimately, the auction process resulted in the removal of the rights offering from the proposed plan.

10. *AbitibiBowater*, Docket No. 2794.

11. *AbitibiBowater*, Docket Nos. 2201, 2297, 2298, 2401, 2452.

12. *Delphi*, Docket No. 7118 (Hearing Transcript, Jan. 12, 2007).

13. See *Delphi* (commitment fee of 2.5 percent), *Lyondell* (commitment fee of 2.5 percent), *AbitibiBowater* (commitment fee of 6 percent), *Foamex* (commitment fee of 6.33 percent).

14. See *Northwest* (discount to plan value equal to 12 percent), *AbitibiBowater* (discount to plan value equal to 56.9 percent).

15. See *Northwest* (break-up fee of 1 percent), *Foamex* (break-up fee of 5 percent).

16. Backstop packages have also been attacked as sub rosa plans where the backstop party is granted broad powers to dictate the form of the reorganization, including classification, and the post-emergence capital structure of the company.

17. *Visteon*, Docket Nos. 3146, 3427.

18. *Extended Stay*, Docket No. 812.

19. *Extended Stay*, Docket Nos. 894, 975.

20. *Delphi*, Docket Nos. 11013, 11289.

21. *Taub and Shirley v. Visteon Corp.*, C.A. No. 10-00770 (MMB) (D. Del. Sept. 28, 2010).

22. The rights offering was ultimately terminated after additional exit financing was secured. Docket No. 3361.