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A legal update from Dechert's Corporate and Securities Group

# Rights Offerings: The Time is Right

Due to the recent turmoil in the capital markets, an increasing number of U.S. companies are seeking alternative means of raising capital. While rights offerings represent an important and relatively common capital raising strategy among European issuers, due in part to the existence of statutory preemptive rights in favor of shareholders, rights offerings for U.S. companies other than closed-end funds have generally been viewed as a less favorable alternative to a capital raise from new investors through an underwritten public offering. Recently, share sales to sovereign wealth funds at substantial discounts to market value have attracted controversy, causing high-profile financial institutions to reconsider the use of rights offerings to raise needed capital without upsetting existing shareholders. The time is right to consider the rights offering as a respectable capital raising technique.

## Structure of Rights Offerings

Rights offerings typically provide an issuer's existing shareholders the opportunity to purchase a *pro rata* portion of additional shares at a specific price per share, often at a discount to the current market price. Because a rights offering is extended to all existing shareholders on a *pro rata* basis, there is no dilutive effect to shareholders who exercise the rights issued to them. Shareholders typically have 15 to 20 days from the designated record date in which to exercise their rights and forward payment to an escrow agent.

Rights are typically transferable and traded on the same securities exchange on which the issuer's common stock is listed. Shareholders not exercising their rights are therefore able to mitigate the dilutive effect of the rights offering by selling such rights on the open market.

Rights offerings may also be structured to include a "backstop," or a standby commitment by a third party (usually an investment bank or affiliate), to purchase any shares that are not subscribed for by existing shareholders (or their transferees) upon exercise of the rights. In the absence of a backstop, shareholders who exercise their rights may be entitled to subscribe, subject to certain limitations and to allotment, for additional shares that remain unsubscribed.

## Advantages of Rights Offerings

Rights offerings offer several potential advantages to issuers over follow-on offerings of common stock. Some issuers appreciate the egalitarian method of offering all existing shareholders the opportunity to purchase shares. Rights offerings that are backstopped provide an issuer with certainty of execution. In addition, rights offerings are exempt from the shareholder voting requirements imposed by the national securities exchanges in connection with issuances of common stock representing 20% or more of the voting power outstanding before issuance because they are deemed to

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constitute "public offerings for cash."[1] Conversely, certain private investment in public equity (PIPE) transactions and large private issuances typically do require shareholder approval, the receipt of which is not a certainty and may involve significant delay. For example, in connection with its recent $7 billion capital infusion, Washington Mutual, Inc. issued convertible Series T preferred stock which cannot be converted until receipt of shareholder approval since such stock, on an as-converted basis, will represent greater than 20% of Washington Mutual's voting power. A rights offering, however, would not require such approval.

Many rights offerings feature a dealer manager to coordinate the rights offering and assist the issuer in garnering interest in the rights. Sales commissions associated with this role are typically lower than underwriting discounts for follow-on offerings. This is particularly true for European issues. In addition, because rights offerings are targeted at existing shareholders, roadshow expenses are generally lower than those associated with a follow-on offering of common stock. Alternatively, a rights offering, often distributing non-transferable rights, may be completed without the assistance of a dealer manager thereby eliminating sales commissions and maximizing proceeds to the issuer.

## Recent Rights Offerings

Several prominent European financial institutions have recently completed rights offerings in part to maintain sufficient regulatory capital and also to allay market concerns regarding their exposure to mortgage-backed securities. Royal Bank of Scotland Group plc and UBS AG, for example, are raising approximately $24 billion and $15 billion, respectively, through fully underwritten rights offerings being conducted at steep discounts to trading prices in the secondary market. These offerings have been managed by the European affiliates of several major U.S. investment banks including Goldman Sachs, Merrill Lynch, and Morgan Stanley.

In the U.S. domestic market, several closed-end funds, including Ares Capital Corp., Kohlberg Capital Corp., MCG Capital Corp. and TICC Capital Corp., and KKR Financial Holdings LLC, a specialty finance company, have completed rights offerings in the past several months, and two high-profile issuers, MBIA Inc. and Blockbuster Inc., have announced proposed rights offerings over the past several months. Commercial bond insurer MBIA entered into an agreement with Warburg Pincus in December 2007 pursuant to which Warburg Pincus agreed to invest $1 billion in MBIA through a direct purchase of common stock and to backstop a subsequent rights offering. The backstop arrangements in the initial agreement were modified in February 2008 and expired unutilized following the completion of a $1 billion offering of common stock.

Subsequently, in April 2008, Blockbuster, in connection with its $1.35 billion all-cash offer to acquire Circuit City Stores, Inc., announced it would potentially undertake a rights offering, possibly backstopped by affiliates of Carl Icahn, to finance the transaction rather than seeking extensive debt financing. Due to the size of the pending transaction compared to Blockbuster's market capitalization, both a PIPE transaction and primary common stock issuance would likely trigger contractual change-of-control provisions in Blockbuster's debt instruments and potentially *Revlon* duties under Delaware law. Also, a PIPE transaction would require shareholder approval. Instead, the proposed rights offering would allow Blockbuster to avoid triggering change-of-control provisions and shareholder vote requirements while still raising the necessary capital to finance the proposed transaction.

Although the proposed rights offering by MBIA was abandoned and the Blockbuster offering appears to be on hold pending the possible consummation of its acquisition of Circuit City, these contemplated offerings together with other rights offerings in the market collectively indicate that the negative perception often associated with rights offerings is dissipating. The time is right for the rights offering to be viewed as a viable capital raising technique for U.S. issuers.

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1 If the offering is backstopped, the NYSE will generally view the issuance to the standby purchaser pursuant to a standby purchase agreement to be part of a public offering for cash, and therefore exempt from the applicable NYSE shareholder approval requirements. However, if the standby purchaser is a current shareholder of the company, the NYSE takes the position that the standby purchaser may not participate in the rights offering, unless there is an oversubscription privilege, in which case such shareholder/standby purchaser would be permitted to participate in the rights offering but not in the oversubscription.

## Practice group contacts

For more information please, contact one of the Dechert lawyers listed or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/corporateandsecurities.


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