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Rights Offerings: Right for Right Now

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When it comes to raising capital, rights offerings have had a steady presence, but never enjoyed "rock-star" status. In the last year, however, that appears to have changed.

Rights offerings have been around for centuries. They have been used regularly in jurisdictions where pre-emptive rights are either popular or required or both.

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For a good part of 2008 the public markets were closed to most issuers due to an unprecedented period of market volatility. Now that the economy appears to be moving from financial crisis to recovery, the markets remain volatile and issuers that need to raise capital are careful to do so through securities offerings designed to minimize the possibility for front running by investors and mitigate the possibility of resulting in aberrational trading in their stocks.

During this period of continued instability, financial intermediaries and advisers continue to recommend that issuers consider a variety of hybrid financing alternatives, such as private investment in public equity (PIPE) transactions, registered direct offerings, at-the-market offerings and rights offerings. All of these financing alternatives may be more attractive than a fully marketed traditional underwritten public offering.

A rights offering provides an issuer's existing stockholders the opportunity to purchase a pro-rata portion of additional shares of the issuer's common stock at a subscription price, which is typically set at a discount to the trading price of the common stock. In the United States (in contrast to other jurisdictions), there are generally few or no prescriptive rules or regulations governing the rights offering process.

This provides an issuer and its advisers with a good deal of flexibility. Usually, an issuer will keep the rights offering open for a period of 16 to 30 days (counting from the day on which the issuer's registration statement relating to the shares underlying the rights is declared effective by the U.S. Securities and Exchange Commission). An issuer may choose to make the rights transferable or non-transferable. Stockholders can then trade transferable rights in the secondary market during the offering period.

Though this may seem appealing, an issuer should realize that a market may develop for transferable rights and may create arbitrage opportunities between the issuer's common stock and the rights or volatility in the issuer's common stock. As a result, nontransferable rights are more popular.

From an issuer's perspective, a rights offering provides a capital-raising opportunity. An issuer may be able to achieve its financing objectives through an offering to its existing stockholders, without the need to commit management time and effort to marketing. Also, an issuer may undertake a rights offering with or without a financial adviser.

If the issuer engages a financial adviser, the fees are usually significantly less than the agency fee or underwriting fee that would be paid to a placement agent or an underwriter in connection with a more traditional public offering. To the extent that the rights are nontransferable, it is unlikely that the offering will have any negative impact on the issuer's stock price nor result in greater volatility.

Given that there is no assurance that stockholders will choose to exercise their rights in the offering, an issuer that must raise a specified amount may enlist a "standby purchaser." An existing stockholder or a third party (including an investment bank) may agree to act as a standby purchaser in connection with the rights offering and purchase any shares that are not subscribed for by the stockholders. This is also referred to as a "backstop commitment."

Through the standby or backstop arrangement, the issuer will ensure that it will raise the necessary capital. The standby purchaser does not have be a registered broker-dealer. It may purchase the unsubscribed for shares for investment purposes or, in the case of an investment bank, with an intent to distribute them subsequent to the completion of the rights offering.

An issuer also should recognize that since all stockholders have an opportunity to participate in the offering, rights offerings may help to avoid certain types of shareholder litigation. From a stockholder's perspective, a rights offering provides a good opportunity to make an additional investment — usually at a discount to the market price of the issuer's common stock. A rights offering also enables a participating stockholder to avoid being diluted by the issuance of the new equity.

By contrast, existing stockholders may not have the opportunity to participate if the issuer chooses to finance through a PIPE transaction, a registered direct offering or another public offering and may suffer dilution as a result of any such financing. The issuer may structure the rights offering with a step-up privilege, which permits a stockholder that fully exercises its rights to subscribe for one additional full share in lieu of fractional shares.

The issuer also may choose to make an over-subscription privilege available for stockholders that fully exercise their rights and would like the opportunity to subscribe for additional shares. Usually, an over-subscription privilege is subject to allotment and shares are allocated on a pro rata basis if an allotment does not exist to fulfill all subscription requests.

Many hybrid securities offerings are subject to the securities exchange regulations that require that the issuer obtain prior stockholder approval in connection with a "private offering" (this may include a registered direct offering) completed at a discount to the greater of the book value or market price that results in the issuance of shares in excess of 20 percent of the total shares outstanding on a pre-transaction basis. These regulations are frequently referred to as the "20 percent rules." Oftentimes, an issuer may choose to cap an issuance at 19.9 percent to avoid the need to bring the matter for stockholder approval and this may prevent the issuer from raising sufficient funds.

Otherwise, an issuer will be required to incur the cost and timing delays associated with preparation of proxy materials and a stockholder vote. There is no stockholder approval for a rights offering even if the offering results in an issuance of common stock that exceeds the 20 percent threshold. The securities exchanges do have certain notice filing requirements in connection with rights offerings; however, these are relatively straightforward and not time-consuming.

All of this helps explain why rights offerings are, in fact, right for right now. The intriguing question is whether when times change and the U.S. capital markets begin to function as they did before the financial crisis, rights offerings will continue to occupy an important place among capital-raising techniques.

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