LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
WEDNESDAY, AUGUST 2, 2023
PERSPECTIVE

DR. T ON SECURITIES

Rights offerings - another capital raising tool

By Sara L. Terheggen

There are many different capital raising options for companies but one option that is often overlooked by companies is a registered rights offering. Outside of the United States, rights offerings have been a long-utilized and well-regarded capital raising tool and there have been times in the United States when rights offerings have been more prevalent. In general, they tend to be more pervasive in times of downturn or when access to capital markets for a standard underwritten offering is difficult to obtain. However, they can also be utilized by companies where a large offering, pricing discount or both would cause their existing shareholders to experience considerable dilution. A registered rights offering affords a company an option in this case to offer a more equitable form of financing.

A rights offering is where a company distributes rights to purchase securities (most often common stock) to existing shareholders pursuant to an effective registration statement at a fixed price during a set offering period (e.g., 16-30 days is quite typical). Such rights afford existing share holders the right to maintain their percentage ownership in the company through exercise of the rights granted to them in the offering, or they can choose to be diluted by not exercising their right. The fixed price of the right is often at a discount to the company's recent trading price as a means of enticing shareholders to participate. Companies still need to navigate both SEC and trading exchange rules, but a rights offering can be an advantageous option for both companies and shareholders.

Components of a rights offering

Generally speaking, and compared to other types of capital raising options that companies can bring to the market, rights offerings typically contain some key characteristics. Let's break down the key components of a rights offering and the options available to companies in undertaking one.

Subscription Rights: There are two kinds of subscription rights. The first is the fundamental right granted by the company to an existing shareholder to purchase a certain number of shares of common stock for every certain number of shares owned. This is called the subscription ratio. The second type of subscription right is the oversubscription right. Despite a fixed price at a discount, certain existing shareholders will not participate in the offering and will instead choose to transfer their rights (if possible) and be diluted. To combat this, companies will offer an oversubscription right which allows shareholders who exercised their fundamental right to purchase additional shares from those shareholders who chose not to exercise. Oversubscription is also pro rata such that all shareholders who wish to purchase additional shares and exercise their oversubscription right will share pro rata in those shares with other shareholders. The decision to exercise the fundamental right and the oversubscription right must be made in one investment decision to avoid creating a second and distinct unregistered offering.

Transferability: Transferability is a characteristic that is often used to entice shareholders to exercise their rights. If the rights are transferable, this means that shareholders who do not wish to exercise their subscription right can sell their rights to others who wish to participate. The rights are typically listed on the applicable stock exchange on which the company's common stock trades to facilitate transferability. Existing shareholders who choose to sell their rights do so in order to minimize price dilution. While existing shareholders like to have transferability, many companies will make the rights non-transferable because it can increase overall volatility of the company's stock price because a market can develop for the rights themselves.

Backstop Commitment: Many rights offerings include a backstop commitment which provides that a third party (typically an investment bank or a large shareholder of the company) agree to buy any shares that are not exercised by existing shareholders. This provides insurance that the amount of capital sought by conducting the rights offering in the first place will indeed be raised. While a backstop commitment is not required in order to conduct a rights offering, they are often implemented as a means of communicating confidence to the market.

Executing a rights offering

Similar to a typical follow-on, rights offerings are executed in a similar fashion with some nuance. If the company has a pre-existing S-3 on file that provides for the ability to issue rights, such an offering can be consummated in about 25 to 30 days. To the extent the company has to file a Form S-3 or amend their S-3 to allow for the issuance of rights, some additional execution time may be factored in depending on SEC review and comment. To undertake a rights

Sara L. Terheggen, *Ph.D., J.D. ("Dr. T"), is the founder and managing director of The NBD Group, Inc. Dr. T has advised on transactions with an aggregate value of more than $110 billion.*

offering, companies will file a preliminary prospectus supplement typically about 12-15 days after announcement of the rights offering, which announcement will typically include record date and size.

In terms of corporate actions, companies need to make sure they have sufficient authorized shares in order to accommodate the number of shares to be issued in the rights offering.

To the extent the rights are intended to be transferable, a company may wish to list the rights on the applicable stock exchange which can require some lead time as a listing application will need to be submitted and approved.

Finally, to the extent there is a backstop commitment, the company will negotiate such arrangements with the backstop party and be prepared to include all relevant information in the prospectus supplement to be filed in connection with commencement of the rights offering.

Equitable financing, difficult execution

Rights offerings can be advantageous for both companies and investors. Unfortunately, they have historically not been highly regarded as a capital raising option in the United States except in times of downturn. However, given it is likely one of the most equitable forms of financing for a company given the reduced impact of dilution on existing shareholders, it can be a valuable capital raising tool for companies that need options.