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RIGHTS OFFERINGS IN CHAPTER 11 BANKRUPTCIES

Rights offerings are an important way for injecting capital into reorganizing businesses and can play an important role in the chapter 11 plan confirmation process. In this article, the authors describe rights offering strategies from debtor and creditor perspectives, the details of rights offerings in practice, including backstop commitments, and registration exemptions. They close with case studies examining in detail some of the challenges faced by debtors in having rights offerings approved.

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Given recent tectonic events in the worldwide economy brought on by the spread of COVID-19, legions of companies now face unforeseen liquidity issues and may ultimately have to turn to chapter 11 to restructure their debt — with or without government bailouts. Rights offerings, which had already become a popular tool in chapter 11 cases prior to the COVID-19 outbreak thanks to the benefits they offer both debtors and their creditors, will likely continue to be an important capital raising tool for those companies forced to file for chapter 11 protection.

Put simply, rights offerings in chapter 11 allow companies to raise capital through the issuance of debt or equity securities, often using certain statutory exceptions from securities registration requirements. Importantly, chapter 11 offers a unique environment in which rights offerings provide stakeholders with an opportunity to invest new capital at a discount in a capital structure de-leveraged as a result of the chapter 11 process. Between 2016 and 2019, debtors in 41 large chapter 11 cases (i.e., those in which the debtors had liabilities in excess of $10 million) completed rights offerings, through which investors injected almost $10.5 billion of capital, in addition to nearly $3 billion of add-on private placement direct investments.[1] Due to the flexibility of rights offerings in terms of both structure and application, chapter 11 debtors and their creditors will likely continue to use rights offerings as a mechanism for injecting capital into reorganizing businesses.

This article provides an overview of the uses, characteristics, and challenges of rights offerings in the chapter 11 context. The article begins with an overview

[1] Joshua Friedman, Brian Darsow, and Rong Ren, *Debtwire Restructuring Data Report: Rights Offerings (2016-2019)* (“Debtwire Rights Offering Report”) pp. 8-10. *Available at* https://www.debtwire.com/restructuringdb/article_assets/articledir_12336/6168206/ro%202016%20to%202019%20final_asset_5e56a528eeda7.pdf (access required).

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FORTHCOMING

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of the various strategies and goals debtors and their creditors pursue using rights offerings. Next, it discusses the structural, economic, and legal nuances of rights offerings. The article then provides case studies to elucidate some of the practical nuances of using rights offerings in chapter 11. The article concludes with some practical takeaways for practitioners and stakeholders in cases involving rights offerings.

I. RIGHTS OFFERINGS STRATEGIES

A. Company Perspective

Chapter 11 rights offerings often function as a source of exit financing, allowing debtors to raise capital to fund emergence costs and plan distributions, or to ensure that the company has sufficient liquidity post-emergence in a de-leveraged capital structure. That capital often takes the form of new equity, thus allowing reorganizing companies to avoid taking on unnecessary (or unwanted) debt. Put another way, rights offerings consummated in a chapter 11 court process allow new money investments in a clean capital structure. Given these advantages, debtors thus can use rights offerings to calibrate the amount of post-emergence debt that their reorganized company will need to carry on its balance sheet, and ensure a right-sized capital structure typically not attainable out of court. Moreover, since rights offerings are almost universally accompanied by a backstop commitment, debtors can commence a rights offering and chapter 11 plan process with assurance that the necessary funds will be available.

Indeed, as exit financing vehicles, rights offerings play an important role in the chapter 11 plan confirmation process, particularly in building necessary consensus. Typically, the debtor procures a plan support agreement in conjunction with negotiation of a rights offering with a class of creditors. In turn, with this support, the debtor then may have flexibility to negotiate additional recoveries or a percentage of participation rights in the rights offering for junior constituents, including prepetition equity holders. The consensus-building value of rights offerings thus allows debtors and other key stakeholders to shape the governance of the post-emergence company, including where preserving the prepetition control structure is a priority.

Finally, as new capital infusions, rights offerings can assist debtors in satisfying the plan feasibility requirement under Bankruptcy Code section 1129(a)(11).[2] New capital from rights offerings allows debtors to put on direct evidence that the reorganized enterprise will have sufficient liquidity to meet plan funding requirements and future business projections.

B. Creditor Perspective

Rights offerings allow creditors to pursue a variety of strategies in the chapter 11 process. As noted, rights offerings give creditors an opportunity to purchase new equity or debt securities within a de-leveraged capital structure at a discount to plan value. Although discounts to plan value typically range between 10 and 25 percent, many cases involve rights offerings at discounts in excess of 30 percent and as high as 80 percent.[3] In part, these discounts provide investors with a hedge as to the long-term prospects of the emerging company. And while there is often spirited debate in bankruptcy cases regarding the amount of the discount, creditors negotiating rights offerings historically insist on discounts to compensate for risks associated with companies emerging from distressed situations or which are in a volatile industry reliant on commodity prices, such as coal production or oil and gas exploration.[4] The most recent drop in oil prices resulting from the price war between Russia and Saudi Arabia now make discounts in previous oil and gas rights offerings seem inadequate.

Rights offerings can also play an important role in the inter-class dynamic in chapter 11 cases. In particular, rights offerings can be a means for settling valuation disputes brought by junior creditors vying for larger recoveries. By participating in (and/or backstopping) rights offerings, junior constituents can “put their money where their mouth is” and demonstrate their belief in a

[2] Section 1129(a)(11) requires that the debtor show that confirmation of the plan of reorganization is not likely to be followed by liquidation or further reorganization not otherwise proposed in the plan.

[3] Debtwire Rights Offering Report, 15.

[4] The vast majority of chapter 11 rights offerings since the beginning of 2016 in terms of both number of cases and dollar amount involved debtors from the oil and gas sector (including both exploration/production companies and companies that provide oil and gas services).

higher valuation by funding payoffs to senior creditors, effectively neutralizing the senior class in a valuation fight, since such senior creditors cannot refuse a cash-out at par.

By increasing the value available to the reorganizing company, rights offerings may provide an indirect benefit to non-participating creditors, since this additional value may allow the debtors to fund or increase the recoveries of those creditors. In particular, general unsecured creditors may stand to benefit from the capital injected by rights offering participants. As discussed above, these recoveries may be essential to allowing debtors to retain some of their prepetition corporate governance structure by making it possible for prepetition equity holders to receive equity in the reorganized debtor under a plan of reorganization.

Finally, rights offerings provide creditors with an opportunity to add to their plan recoveries by providing value to the debtors in the form of a backstop commitment, which, as noted above, gives debtors the assurance that a rights offering will raise the intended amount of capital. As discussed below, backstop parties often receive significant consideration in exchange for their agreement to backstop a rights offering, often in the form of additional securities. Through a backstop commitment, a creditor willing to commit capital up front can secure an even larger share of the overall issuance — and the upside of the reorganizing company — at an even steeper discount.

II. RIGHTS OFFERINGS IN PRACTICE

A. Structure, Documentation, and Approval Process

In a rights offering, debtors grant subscription rights to a class (or classes) of creditors (or equity holders) in conjunction with a chapter 11 plan of reorganization. Most commonly, the offering is of equity securities in the debtors, although debt or convertible securities may be issued in some cases. Sometimes, the securities are issued by a non-debtor entity. To complement a rights offering, debtors may use private placements, which involve the direct issuance of securities to certain creditors (typically, a subset of a class or an *ad hoc* group) who have already agreed to participate in the issuance prior to the placement. As noted previously, rights offerings are nearly always accompanied by a backstop agreement (often in the form of an equity commitment or securities purchase agreement that includes commitment and breakup fees, among other protections) under which a subset of the rights offering participants commits to fund the rights offering if not fully subscribed. Plan support agreements from backstop parties, which ensure the debtor will have necessary support for its chapter 11 plan, are also common.

Debtors typically seek bankruptcy court approval of rights offering procedures and certain features of the accompanying documents (i.e., the fees and protections contained in backstop agreements and plan support agreements) in conjunction with seeking court approval to solicit plan votes at a disclosure statement hearing. Generally, approval of these documents occurs pursuant to Bankruptcy Code section 363 and thus is subject to the deferential business judgment rule. Rights offering procedures set forth the key ground rules for the issuance, including: (1) who is eligible to participate and their respective subscription allocations; (2) how and when participants can make certifications as to their eligibility; (3) the dates for the commencement and conclusion of the subscription period; (4) procedures for over-subscriptions and under-subscriptions; (5) rules for the transfer of subscription rights; (6) procedures for funding and escrowing the consideration paid in the securities purchase; and (7) the manner of determining the record date for eligibility.

B. Backstop Commitments and Consideration

Nearly all rights offerings are fully backstopped pursuant to agreements between the backstop party (or parties) and the debtors. Under a backstop agreement, backstop parties commit to purchase a certain amount of securities offered under the plan and to purchase additional securities if the issuance is under-subscribed. If there are multiple backstopping parties, the obligation to backstop the rights offering may be on a joint or several basis with the typical construct being joint, and includes provisions for addressing issues with defaulting backstop parties.

As consideration for their commitment to backstop a rights offering, backstop parties may seek to negotiate a package of consideration that may include:
(1) minimum allocations in the rights offering;
(2) direct-purchase rights in an add-on private placement; and (3) backstop fees in the form of cash or securities. In recent deals, backstop fees typically range between three and nine percent of the total rights offering, with fees averaging approximately seven percent.[5] Breakup fees may be payable if the debtor chooses to partner with a different group of backstop parties, and are paid upon the execution or consummation of the alternative transaction. Typically,

[5] Debtwire Rights Offering Report, 16.

breakup fees mirror backstop fees in amount but are paid in cash rather than in securities, as would have been the case had the original deal closed. Backstoppers generally also receive reimbursement for their transaction expenses.

C. Backstop Protection and Challenges

In addition to a consideration package, backstop parties may negotiate for certain protections, including: (1) restrictions on the debtor's business operations prior to the consummation of the rights offering; (2) conditions precedent to consummation of the rights offering, including heavily negotiated "material adverse event" qualifiers; (3) representations and warranties from the debtor; (4) shelf registration requirements to allow the future sale of issued securities; (5) transferability restrictions for other rights offering participants; and (6) limited restrictions on the debtor's solicitation of alternative proposals.

Parties in interest seeking to challenge the consideration package and backstop protections under a backstop agreement typically raise their initial objections at the disclosure statement hearing, when backstop protections are approved by the bankruptcy court. While, as noted above, approval of a backstop arrangement is a business judgment inquiry, courts will focus on the timing of the transaction, fee triggers, the marketing process, and the burden on the estate of soliciting alternative backstop commitments while having a "bird in the hand." Backstop agreements must balance the tension between giving the debtor a solid commitment (justifying backstop fees), providing the backstop parties a sufficiently attractive investment opportunity (justifying backstop protections), and allowing the debtors flexibility in pursuing higher or better proposals (justifying breakup fees).

D. Registration Exemptions

Chapter 11 debtors raising capital through rights offerings typically do so while availing themselves of registration exemptions under section 1145 of the Bankruptcy Code and/or section 4(a)(2) of the Securities Act. These exemptions allow debtors to avoid the delay and expense of registering issued securities with the Securities Exchange Commission. However, each type of exemption has specific requirements and limitations. To overcome some of the limitations of the two exemptions, debtors may use both in tandem as part of a single rights offering.

Section 1145 Exemption. Section 1145(a)(1) of the Bankruptcy Code permits the offer or sale of unregistered securities where the offer or sale is either (1) in exchange for a party's claim or equity interest or (2) "principally" in exchange for a party's claim or equity interest, and "partly" for cash or property. Because debtors typically use rights offerings to raise capital rather than to merely satisfy claims, they most often use the "principally/partly" approach. Still, the "principally/partly" requirement limits the amount of cash that the debtor can raise. SEC no-action letters suggest that that the "principally/partly" requirement is met when the cash purchase price is no more than 75% of the value of the underlying claim.[6] This means that a rights offering that raises more than $75 million in cash in exchange for $100 million in distributable value may not qualify for the section 1145(a)(1) exemption. The "principally/partly" test is applied using the economic value of the claim (rather than the face value), which may be determined by the value of the plan distribution to the participating class. Section 1145(b)(1) does not permit the offer or sale of unregistered securities to statutory "underwriters."[7]

Section 4(a)(2) Exemption. Section 4(a)(2) of the Securities Act provides a registration exemption for "transactions by an issuer not involving any public offering," but is limited to the issuance of securities to "accredited investors" (including qualified institutional buyers or "QIBs")[8] and up to 35 non-accredited investors who, either alone or with their purchasing representatives, meet a legal standard for "knowledge and experience in financial and business matters." This

[6] *See Bennett Petroleum Corporation*, SEC No-Action Letter, 1983 WL 28907 (Dec. 27, 1983); *Jet Florida System, Inc.*, SEC No-Action Letter, 1987 WL 107448 (Jan. 12, 1987).

[7] An "underwriter" is a party that: (1) purchases a claim against, or an interest in, the debtor for the purpose of distributing the securities received; (2) offers to sell securities offered or sold under the plan for the holders of these securities; (3) offers to buy the securities with the intent to distribute them under an agreement made in connection with the plan; and (4) is an "issuer" for the purposes of section 2(a)(11) of the Securities Act.

[8] An "accredited investor" includes a litany of sophisticated parties including, among others, the issuer, its directors and executive officers, banks, registered brokers or dealers, insurance companies, registered investment companies, corporations with total assets in excess of $5,000,000, and natural persons with net worth in excess of $1,000,000 or individual income in excess of $200,000 (or $300,000 combined with one's spouse) for the previous two years. "QIBs" include several types of entities that own and invest on a discretionary basis at least $100 million in securities issued by non-affiliates.

limitation on who may participate in an issuance means that unaccredited "retail" investors generally may not participate in rights offerings that use the section 4(a)(2) exemption. As discussed below, debtors may have to offer alternate treatment for such retail holders to overcome unequal treatment plan objections. Securities issued under section 4(a)(2) are "restricted securities" subject to transferability restrictions and will contain a legend describing such restrictions. To mitigate the effect of these transferability restrictions, the debtor may agree to a shelf registration of the issued securities, which effectively preregisters the securities for sale after chapter 11 emergence.

III. CASE STUDIES

Following below is a discussion of key cases involving chapter rights offerings, examining in particular some of the different challenges faced by debtors in having rights offerings approved. There are certain themes that run throughout the challenges discussed in each case, and understanding these themes is instructive for parties seeking to have a chapter 11 rights offering approved. First, because backstop consideration is often challenged, it is essential that consideration offered to backstop parties be an exercise of the debtor's sound business judgment (at the disclosure statement stage). This means that debtors must conduct appropriate marketing efforts and demonstrate that the market conditions justify the consideration offered to commitment parties. Second, the special benefits given to backstop parties frequently invite unequal treatment objections based on section 1123(a)(4) of the Bankruptcy Code.[9] The key to defeating these arguments is demonstrating that the backstop consideration compensates parties for valuable commitments to the debtor, rather than compensating them on account of their prepetition claims. Third, debtors must be prepared to defend against accusations that the plan was not proposed in good faith, particularly where the consideration given to backstop parties is labeled by objectors as vote-buying.[10] Finally, debtors must consider whether and how to compensate parties not participating in a rights offering or private placement due to limitations in the applicable securities registration exemption that prevent those parties from participating. Without sufficient compensation, excluded creditors may argue that they were unfairly treated.

A. Peabody Energy

The first case involves Peabody Energy Corp., the largest private-sector coal company in the world, whose $1.5 billion capital raise led to the only circuit-level decision analyzing rights offerings in the chapter 11 context.[11] The key thread in the Peabody Energy case is recognition of the fact that backstop parties in a chapter 11 rights offering give the debtor meaningful value in the form of assurance that the capital raised will bring in the intended amount of capital.

Transaction Structure. After mediation to resolve a prepetition creditor dispute, Peabody Energy proposed to raise $1.5 billion from certain unsecured noteholders and second-lien noteholders (the "Noteholders") through a $750 million rights offering of new common stock accompanied by a $750 million private placement of new preferred stock. The discounts to plan value in the rights offering and private placement were 45 percent and 35 percent, respectively. To participate in the private placement, a qualifying creditor needed to: (1) make commitments under a private placement agreement; (2) agree to backstop the rights offering; and (3) sign a plan support agreement. Backstop parties received a commitment premium equal to eight percent of the rights offering (totaling $60 million) and a "ticking premium" worth 2.5 percent of the rights offering ($18.75 million), each payable in common stock upon closing. In the first phase of the private placement, noteholders who participated in the mediation (the "Noteholder Co-Proponents") received the exclusive right to purchase 22.5 percent of the preferred equity after signing the relevant agreements (prior to their filing with the court). Second, after the agreements were filed, the broader group of qualifying creditors was given a three-day window to sign the relevant agreements to participate in five percent of the private placement. Third, the remaining eligible creditors could elect to participate following the bankruptcy court's approval of the relevant agreements to participate in the final 72.5 percent of the private placement.

Creditor Challenges. An *ad hoc* group of noteholders representing approximately three percent of the debtors' funded debt (the "Ad Hoc Group"), who elected not to participate in the initial mediation and private placement, filed an objection to the rights offering at the disclosure

[9] Section 1123(a)(4) requires that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such claim or interest."

[10] Votes not obtained in good faith could be designated (i.e., not counted) upon motion under section 1126(e) of the Bankruptcy Code.

[11] *In re Peabody Energy Corp.*, Case No. 16-42529 (BSS) (E.D. Mo.).

statement approval stage. In its objection, the Ad Hoc Group argued that the valuations underlying the debtors' private placement and rights offering were flawed, resulting in excess value being shifted to creditors who initially agreed to participate in the private placement. The Ad Hoc Group further argued that the commitment fee for the backstop parties was too high and that the participation structure of the private placement was coercive and constituted premature plan solicitation. In conjunction with its objection, the Ad Hoc Group presented the debtors with an alternative rights offering proposal. The debtors rejected this proposal because (1) the proposal could not accomplish the debtors' restructuring goals and (2) it could not be pursued without imposing significant costs on the estates. At the disclosure statement hearing, the bankruptcy court rejected these arguments, leaving it to the debtors' creditor constituencies to decide whether the economics of the rights offering were flawed.[12] The court noted that, by approving the relevant agreements at the disclosure statement stage, it was not making a decision on plan confirmation requirements.

Confirmation Ruling and District Court Appeal. At confirmation, the Ad Hoc Group resurfaced, arguing that (1) the private placement treated creditors within the same class unequally, violating Bankruptcy Code section 1123(a)(4) and (2) the plan was proposed in bad faith. The bankruptcy court confirmed the debtors' plan over the Ad Hoc Group's objection, holding that the backstop consideration was given for valuable commitments by the Noteholder Co-Proponents and was not treatment on account of their prepetition claims. The court further held that neither the discounts and consideration offered under the private placement, nor the process by which the debtors sought rights offering participation, were evidence of bad faith. On appeal, the district court affirmed the bankruptcy court's rulings and dismissed the Ad Hoc Group's appeal as equitably moot, as the plan had been substantially consummated.

Eighth Circuit Ruling. On further appeal, the Eighth Circuit affirmed the lower courts' substantive rulings (declining to rule on mootness), making it the first circuit court to rule on the subject.[13] In its decision, the court specifically rejected the Ad Hoc Group's argument that the rights offering ran afoul of the Supreme Court's holding in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*.[14] In distinguishing *203 North LaSalle*, the court highlighted three specific points: (1) the Ad Hoc Group had the opportunity to participate in the mediation but declined to do so; (2) the Initial Support Noteholders gave the debtors meaningful value in exchange for backstop consideration; and (3) the debtors had considered and, in their business judgment, rejected alternative financing proposals. The court also found no violation of section 1123(a)(4), concluding that the backstop consideration was compensation for the Noteholder Co-Proponents' valuable commitments to support the plan and backstop the rights offering, rather than treatment for the Noteholder Co-Proponents' claims. The court also remarked that the consideration offered under the private placement aided the debtors in attaining "tremendous consensus" around the plan, which had the support of 95 percent of unsecured creditors. While the Eighth Circuit noted that it was "somewhat sympathetic" to the Ad Hoc Group's argument that the debtors used a coercive process to garner plan support, it was convinced that the debtors' process was driven by the need to close a transaction quickly.

B. SunEdison

The next case involves SunEdison, which at the time of its chapter 11 filing was the world's largest renewable energy developer.[15] In *SunEdison*, the court's treatment of creditor objections demonstrates the importance of building consensus to move a chapter 11 case forward. As in *Peabody Energy*, a vocal minority was unable to derail a largely consensual plan process.

Transaction Structure. Following a successful multi-party mediation, SunEdison sought to raise up to $225 million through a rights offering of new common stock and new Class A shares of non-debtor yieldco subsidiary TerraForm Power ("TERP"), which operated SunEdison's U.S.-based renewable energy projects, at a 2.4 percent discount to plan value. Participation in the rights offering was available to (1) certain second lien creditors (90 percent of the offering) and (2) general unsecured creditors (10 percent of the offering). The rights offering was accompanied by a backstop commitment from supporting lenders holding 68 percent of the second-lien debt, who would also have the

[12] "Let the creditor body vote and tell me that the expenses are too high, the valuation is not right . . . we didn't solicit the market for the best price for the loans, et cetera." Jan. 26, 2017 Hr'g. Tr. 273:21-25, *In re Peabody Energy Corp*.

[13] *In re Peabody Energy Corp.*, 933 F.3d 918 (8th Cir. 2019).

[14] *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999).

[15] *In re SunEdison, Inc.*, Case No. 16-10992 (SMB) (Bankr. S.D.N.Y.).

opportunity to purchase an additional $75 million in reorganized SunEdison common stock and TERP Class A shares. These lenders had previously executed non-disclosure agreements with the debtors and were subject to trading restrictions. As consideration for their backstop commitment, the supporting lenders received a put premium of seven percent of the total equity commitment upon consummation of the rights offering (payable in common stock in the reorganized debtor and TERP). In addition, the supporting lenders would receive a graduated breakup fee equal to three percent of the total equity commitment ($9 million), which under certain circumstances would be reduced to 1.5 percent ($4.5 million).

Creditor Challenges. At the disclosure statement approval stage, a holder of convertible notes (who was outside of the second-lien class) and certain non-participating second-lien lenders (the "Objecting Parties") objected to the proposed rights offering and backstop agreement. The Objecting Parties argued that the consideration offered to the backstop parties constituted vote-buying and insisted that the debtors must consider a competing backstop proposal from the Objecting Parties allegedly offering better recoveries to unsecured creditors. The bankruptcy court approved the rights offering procedures and backstop agreement over these objections, holding that the debtors exercised business judgment in entering the equity commitment agreement. In particular, the court noted that the breakup fee was reasonable in light of the benefits of the equity commitment agreement to the debtors. Moreover, because the commitment fee was payable in stock, it did not impact the debtors' liquidity. The court also noted that the debtors were free to negotiate a better deal with third parties and credited testimony from the debtors' CEO and investment banker regarding marketing and valuation efforts. Finally, the court left the issues of unequal treatment and vote-buying for the confirmation stage.

Confirmation. Prior to the confirmation hearing, the debtors negotiated a deal with the previously objecting second-lien lenders — who were already part of the second-lien class to which the rights offering was made — to allow these lenders to also participate in the backstop. Thus, the convertible noteholder was alone in objecting to the rights offering at the plan confirmation stage. In its objection, the convertible noteholder argued that the plan failed the 1129(a)(3) "good faith" requirement because the backstop consideration constituted vote-buying. The bankruptcy court confirmed the debtors' plan (and the settlements integrated therein) over the convertible noteholder's objections. The court rejected the objecting noteholder's vote-buying argument, noting that "the entire purpose of chapter 11 is to foster negotiation, resulting in a plan that everyone will support."[16] The court further remarked that the benefit received by backstop parties was for their commitment to backstop the rights offering, undercutting the notion that the backstop parties were being "bribed" to vote a certain way and that the backstop consideration was on account of the backstoppers' claims. It is notable that the same judge presiding over the SunEdison bankruptcy had previously designated (i.e., set aside) the votes of certain creditors on account of vote-buying in the Quigley bankruptcy. Unlike in SunEdison, the consent for plan confirmation in Quigley was specifically procured through special payment made outside of the plan process. In SunEdison, the court framed the convertible noteholder's real complaint as being the fact that they were not the chosen backstop parties, stating that "[t]he debtors are free to offer to anyone on a preferential basis, the opportunity to provide exit financing." Finally, the court noted the importance of the rights offering within the context of a global settlement that garnered significant consensus (including 81 percent of unsecured claims in amount; 77 percent in number), allowing for the debtors' restructuring to proceed.

C. Pacific Drilling

Pacific Drilling is a company that provides ultra-deepwater drilling services to the oil and gas industry.[17] The path to court approval of Pacific Drilling's rights offering and accompanying private placement is remarkable because it was the bankruptcy court, rather than a creditor constituency, raising the most vocal concerns about the terms of the capital raise. However, the court's ultimate approval of Pacific Drilling's capital raise despite its concerns further underscores the importance of consensus in the approval process for a chapter 11 rights offering. Although the court approved the rights offering, the concerns raised by the court are instructive for future cases.

Initial Transaction Structure. Following a multi-party mediation, the debtors selected a plan construct proposed by an *ad hoc* group of prepetition secured creditors (the "Ad Hoc Group"). Pursuant to this construct, the debtors would issue new equity at a 46.9 percent discount to plan value through a $400 million rights offering for holders of certain secured notes and prepetition term loan debt (the "Eligible Secured Claims"), accompanied

[16] July 25, 2017 Hr'g Tr. 85:1-8, *In re SunEdison, Inc.*

[17] *In re Pacific Drilling S.A.*, Case No. 17-13193 (MEW) (Bankr. S.D.N.Y.).

by a $100 million private placement for the Ad Hoc Group. The rights offering would be backstopped by the Ad Hoc Group, in exchange for a backstop consideration package that included a commitment fee equal to eight percent of the total issuance (payable in new equity), in addition to expense reimbursement and indemnification.

Alternative Transaction and Global Settlement. The debtors' majority shareholder, Quantum Pacific, proposed an alternative structure under which it would replace the Ad Hoc Group as backstop party, receiving consideration that would include (1) the right to participate in a $100 million private placement but at a higher valuation, thus having a less dilutive effect on other creditors' recoveries and (2) a seven percent backstop fee. The bankruptcy court declined to allow Quantum Pacific to propose an alternative plan, but ordered the parties to engage in further mediation. The debtors, the Ad Hoc Group, and Quantum Pacific later reached a global settlement that included a revised equity issuance consisting of a $350 million rights offering open to holders of the Eligible Secured Claims, plus a $100 million private placement for the Ad Hoc Group and a $50 million private placement for Quantum Pacific. The backstop arrangement with the Ad Hoc Group did not change under the revised proposal.

Court's Rejection of the Settlement. The court refused to approve the debtors' proposed issuance and backstop agreement, describing the arrangement as a "plum opportunity for certain large creditors" whose support was needed for the plan.[18] The court raised concerns that the private placement for the Ad Hoc Group was really a disguised mechanism for giving those creditors unequal treatment in violation of section 1123(a)(4), rather a standalone financing arrangement. Moreover, the court suggested that the private placement was a way to buy off potential objectors to the debtors' plan. Finally, the court disapproved of the commitment fee owed to the Ad Hoc Group, expressing skepticism about the debtors' marketing process and commenting that the fee seemed disproportionate and unnecessary in light of the discount to plan value offered in the private placement.

Further Revised Transaction Structure and Approval. Following the court's rejection of the transaction contemplated in the global settlement, the debtors proposed a revised equity issuance composed of a $460 million rights offering open to holders of Undersecured Claims, accompanied by a $40 million private placement for Quantum Pacific. The commitment fee was reduced to the sum of eight percent of the uncommitted portion of the rights offering and five percent of the remaining equity issuance (consisting of the Ad Hoc Group's pro rata share of the rights offering and the Quantum Pacific private placement). The court again expressed skepticism of the transaction structure, stating his concern that the evidence of risk owing to volatility in oil prices was not consistent with the 46.9 percent discount. The court also questioned the application of the business judgment standard to fees payable in stock, since the real impact is on the creditors who are diluted. While noting the danger of large creditors getting together to divide up value without regard to smaller creditors, the court nonetheless approved the new equity issuance construct, remarking that it had broad creditor support and faced no objections. It is worth noting that, given the lack of recovery in the oil and gas market, the discounts and fees that were viewed as steep at the time the Pacific Drilling confirmation hearing may not have been steep enough.

D. Washington Mutual and Gulfmark Offshore

Prior to its chapter 11 filing in 2008, Washington Mutual was the largest savings and loan association in the United States.[19] Gulfmark Offshore is a global offshore marine services company that provides support and transportation services to the offshore oil and gas industry.[20] The Washington Mutual and Gulfmark Offshore bankruptcy cases showcase the challenges involved in using the section 4(a)(2) registration exemption, which, as discussed above, has the effect of excluding unaccredited retail investors from a rights offering.

Exclusion without Compensation (*Washington Mutual*). Washington Mutual sought to raise $100 million through a chapter 11 rights offering restricted to parties holding claims in excess of a $2 million minimum claim value threshold. A creditor whose claim fell below the minimum threshold objected, arguing that he was deprived of the valuable right to participate in the rights offering in violation of section 1123(a)(4). The debtors argued that the restriction avoided the administrative burden of issuing stock to small holders and that there was no unequal treatment because the offering was of no value, since the stock was not being

[18] Sept. 18, 2018 H'rg Tr. 27:16-22, *In re Pacific Drilling S.A.*

[19] *In re Washington Mutual, Inc.,* Case No. 08-12229 (MFW) (Bankr. D. Del.).

[20] *In re Gulfmark Offshore, Inc.,* Case No. 17-11125 (KG) (Bankr. D. Del.).

offered for a discount.[21] The court disagreed with both of these arguments, holding that there is no administrative convenience exception to section 1123(a)(4). The court further reasoned that the subscription right was not valueless even if there was no discount to par, since the value of a subscription right includes the possibility that the security will appreciate in value.[22] The debtors subsequently removed the rights offering component from the subsequently modified chapter 11 plan that was eventually confirmed.

Exclusion with Compensation (*Gulfmark Offshore*). The debtors in the Gulfmark Offshore bankruptcy, seeking to utilize the section 4(a)(2) exemption, proposed to limit participation in a $125 million rights offering to unsecured noteholders who were accredited institutional investors. In lieu of subscription rights, unsecured noteholders who were not accredited investors would receive a payment (in cash, common stock, or warrants) based on the size of their holdings. The compensatory payment of $69.41 per $1,000 of noteholder claims was calculated by multiplying (1) the number of shares allocated to each $1,000 of notes held (5.75) by (2) the per-share discount in the rights offering ($12.07 or 36.7 percent).[23]

Certain retail noteholders who were unable to participate in the rights offering filed an objection, arguing that the rights offering violated section 1123(a)(4), because creditors who were not accredited investors were unable to participate, and the size of the compensatory payment was not large enough. The court found that the compensatory payment represented the value of the opportunity to participate in the rights offering, stating that "the key inquiry under section 1123(a)(4) is not whether all of the claimants in a class obtain the same thing but whether they have the same opportunity."[24] The compensatory payment in *Gulfmark Offshore* shows how debtors can comply with the limitations of the section 4(a)(2) registration exemption without running afoul of the Bankruptcy Code's equal treatment requirement.

IV. CONCLUSION

In what we expect to be an active chapter 11 environment, it will be important to pay attention to the lessons learned from the evolution of rights offerings. Perhaps the most significant of these lessons is the importance of building consensus. Even with misgivings about a transaction construct, bankruptcy courts have declined to undo the product of consensus-building exercises by debtors and other key stakeholders in designing a rights offering at the heart of a company's restructuring. As a general matter, bankruptcy courts tend to evaluate transactions within the context of the overall restructuring process and avoid disrupting momentum towards a successful emergence from bankruptcy. Still, it is important that debtors conduct sound processes for negotiating and approving rights offerings. Arm's-length negotiations and robust marketing efforts reinforce the fair economics of a transaction; a light record on the negotiations or marketing efforts may raise red flags and invite litigation. Finally, courts have shown a willingness to reward stakeholders who make real financial commitments that facilitate the debtor's restructuring. Meanwhile, creditors who fail to take initiative in working with the debtor by refusing to get restricted to move the restructuring forward may be dismissed as free-riders when they try to gain a seat at the table late in the process, when the hard work of conducting diligence and negotiating a transaction is already complete. Keeping in mind the lessons of past transactions can help accomplish a smoother, faster, less costly restructuring. ■

[21] *In re Wash. Mut. Inc.*, 442 B.R. 314, 360 (Bankr. D. Del. 2011).

[22] *Id. at* 360-61.

[23] Oct. 4, 2017 Hr'g. Tr. 36:18-21, *In re Gulfmark Offshore, Inc.*

[24] Oct. 4, 2017 Hr'g. Tr. 74:12-22, *In re Gulfmark Offshore, Inc.*

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