Rights Offerings Increase in Popularity as a Method of Raising Capital

With the recent decline in equity markets, many companies are searching for alternative methods to raise capital. One method, often overlooked, is a rights offering. While the traditional underwritten public offerings remain a popular method of raising capital for U.S. public companies, recently rights offerings have become more understood and more widely used.

What is a rights offering?

A rights offering provides stockholders with the opportunity to purchase additional shares of a publicly traded company’s common stock at a specified price—the “subscription price.” To attract stockholder interest in a rights offering, the subscription price is usually set at a discount to the current market price. Although stockholders are not required to purchase additional shares, they are given the opportunity, or “right,” to purchase these shares based on the number of shares they own on the record date. The rights offering may or may not be underwritten with or without a commitment by the underwriter (or investor) to buy those shares that are not subscribed.

What is a right?

A right is an opportunity granted by a company to existing stockholders of the company to subscribe to shares of newly issued common stock, usually for a very short period of time (e.g., 30 days). Rights may either be transferable or non-transferable.

What is the history of rights offerings?

Rights offerings have been used in Europe since the commencement of the London Stock Exchange in the late 17th Century. In England, rights offerings are commonplace, representing an integral part of capital markets, and are typically well regarded by stockholders. Historically rights offerings have not been as popular in the United States. More recently rights offerings have become more popular in the United States, with approximately 40 conducted in 1999 and 2000, raising approximately $3.4 billion, including Metro-Goldwyn-Mayer Inc.’s rights offering, which raised $721 million in October 1999.
What are non-transferable rights versus transferable rights?

Non-transferable rights are not tradable on any exchange and have no value other than that they may be exercised by the original holder. An offering of non-transferable rights does not provide the opportunity to receive additional consideration so that non-subscribing stockholders would experience both ownership and price dilution. Transferable rights are tradable, often on an exchange, affording non-subscribing stockholders the option to sell their rights. Selling the transferable rights allows a non-subscribing stockholder to receive consideration, thus diminishing the price dilution that would otherwise occur. Sometimes rights may not be transferable separately but may transfer only with the common stock. Non-transferable rights offerings are more prevalent than transferable rights offerings.

What are the advantages of rights offerings over other financing alternatives?

A rights offering provides the existing stockholders with the opportunity to avoid dilution of their holdings by participating in the issuance on a pro rata basis. A rights offering may enable a company to raise capital that could not be raised by a traditional public offering.

What are the different methods that are used to offer rights?

Generally speaking, there are two methods that a public company can use to raise additional capital through the sale of rights: the direct offering method and the underwritten method. If the price discount is sufficiently large and the company is well established, the company may decide to handle the offering itself. Alternatively, a rights offering may be conducted on an underwritten basis. If underwritten on a firm basis, an underwriter agrees to purchase, at the subscription price, all the shares offered that the stockholders did not purchase. In assuming this “standby” risk, the underwriter receives a commission on all shares covered by the rights offering. In some instances, the underwriter may act on a best efforts basis with respect to the unsubscribed portion of the rights offering. Standby purchasers (generally institutions) sometimes subscribe for a minimum and maximum portion of the rights offering in the event the rights offering is not fully subscribed by the stockholders.

What are secondary subscription rights?

Sometimes a rights offering includes secondary subscription rights. In that event, a stockholder indicates the number of shares it desires to purchase above those that the stockholder is entitled to purchase in the primary rights offering. If all of the primary rights are not exercised, the unsold shares are allocated among those who elected to exercise their secondary subscription rights. This feature is particularly desirable in the event the offering is not underwritten.

How is a rights offering dilutive?

Ownership percentage dilution is experienced by stockholders who do not fully exercise their rights. To avoid this type of dilution, a stockholder must fully subscribe for all of the shares made available to him or her. Furthermore, price dilution results from issuing new shares below the then-current fair market value of the stock. If a stockholder does not exercise his or her rights, but instead sells the rights, the stockholder will decrease its price dilution.
Follow-Up

Companies frequently require generation of capital to achieve their business and growth objectives. At Katten Muchin Zavis Rosenman, we regularly represent companies, as well as investment banks and major shareholders, in connection with these capital-raising activities.

Our securities practice encompasses a broad spectrum of securities transactional matters, including representing issuers and investment banks in IPOs and a variety of other types of public and private offerings of equity and debt securities. We also counsel many clients - public and private - regarding registration, SEC compliance, disclosure and other securities-related issues and assist numerous public companies in complying with ongoing reporting and other requirements imposed by the securities laws and stock market listing rules. If you have any questions regarding these issues or if you wish to be on our distribution list for future Client Advisories relating to securities or capital raising alternatives, please contact one of us.

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