

Registered Subscription Rights Offerings: The Most Democratic Capital Raising Transaction



Elements of a Rights Offering
and
Legal and Practical Considerations

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Who We Are

- Olshan Frome Wolosky is a leading New York law firm recognized for its expertise in corporate and securities law including shareholder activism, registered securities offerings and mergers and acquisitions.
- Spencer Feldman is a partner in Olshan's corporate and securities practice specializing in initial public offerings, rights offering, shelf takedowns and uplistings.
- Ken Schlesinger is a partner in Olshan's corporate and securities practice with an emphasis on complex capital markets transactions and mergers and acquisitions.
- RHK Capital, an Advisory Group Equity Services company, is a full-service investment banking firm with a special expertise in handling small cap financings and, in particular, registered subscription rights offerings and structured credit.
- Rich Kreger is the Senior Managing Director of RHK Capital's investment banking department. Rich is a nationally known authority on rights offerings having handled more than 200 financing transactions over the past 20 years.

Three Common Scenarios

1. After multiple rounds of escalating venture capital and a successful IPO on Nasdaq, a small cap issuer has a setback with its lead product, missing traditionally-important early stage company milestones and then faces liquidity issues. Its stock price drops below its IPO price and it needs funding, likely to be with PIPE funds that are not current stockholders at a deep discount to the market price in the form of convertible debt or preferred stock with warrants that contain reset provisions, investor price protections and numerous restrictive covenants.
2. A cash-intensive Nasdaq listed company with prospects for near-term profitability has exhausted its trailing 12-month “baby shelf” offering limit and seeks to raise additional capital and strengthen its financial position (e.g., to fund its next clinical trial). The company’s board and financial advisors have evaluated potential alternatives for raising equity capital, but are concerned about preserving the company’s ability to utilize the tax benefits of its current net operating losses to reduce future tax payments due to changes in ownership resulting from the financing transaction.
3. A global publicly traded company with distinct multi-industry operations seeks to conduct a tax-free spin-out of one of its subsidiary business segments as a “pure play” industry leader to its shareholders, but in the process would like to (i) distribute the shares so that only those shareholders that have a particular interest in the specific business segment remain as shareholders and (ii) raise a portion of the transitional capital needed by the new independent publicly traded company to establish stand-alone operations.

Top Rationales for Rights Offerings

1. To be fair to all shareholders, in the event of reduced common stock price levels, the issuer can first offer existing shareholders the opportunity to finance the company to avoid the ownership percentage dilution that would result.
2. Alternative financing choices may be limited – because there is a bear market for small cap financings under current market conditions or, after discussions with investment bankers, there is a perceived failure to receive the interest of institutional investors at this stage of development.
3. Allows issuers to offer securities at a discount to market without shareholder approval even if the issuance constitutes more than 20% of the company's outstanding shares. By contrast, a PIPE financing resulting in the issuance of more than 20% of a company's outstanding shares (or securities issuable or convertible into more than 20% of a company's outstanding shares) requires shareholder approval under Nasdaq rules.
4. Financial sponsors and other controlling shareholders seeking to invest equity sometimes structure the investment as a rights offering to avoid allegations from the public that the terms of the investment were not fair.
5. Due to tax rules on ownership changes of control, funding from existing shareholders enables issuers to retain all or a significant amount of their NOL carryforwards to offset projected taxable income.

Features of a Registered Rights Offering

Overview

- Issuer grants “rights” to current shareholders pursuant to an effective registration statement covering the sale of the “rights” and underlying securities. The registration form is a Form S-1 or S-3 for a U.S. issuer and F-1 or F-3 for a foreign issuer.
- Sometimes, the “rights” are alternatively structured as short-term warrants.
- The rights enable shareholders to purchase additional shares of common stock (or preferred stock, or a unit with common stock or preferred stock and a warrant) at a fixed price in proportion to their existing equity percentage interest.
- Example, a shareholder may purchase one additional share for every four shares the holder owns.
- Sometimes, holders of warrants and stock options may receive rights, along with shareholders, to purchase shares in relation to the number of shares underlying their vested warrants and options.
- Shareholders are not required to exercise their rights.
- The Issuer’s Board of Directors will recommend that shareholders exercise their rights.

- Practice Pointer: If a company wishes to use a pre-existing Form S-3 shelf registration statement for the rights offering, the ability to issue rights (among the list of covered securities) should be registered as part of the shelf registration statement. Depending on its non-affiliate public float, the Issuer needs to be cognizant of the “baby shelf” rules that may limit the size of the rights offering.
- The rights may be non-transferable or transferable. If the rights are transferrable during the exercise period, the securities underlying the rights may not be separated and the rights should be listed for trading on a stock exchange to avoid state blue sky review. The controlling shareholder would generally prefer to make rights non-transferable to maximize its ability to purchase in the offer, while other shareholders who are uninterested in subscribing might prefer transferable rights in order to sell them, potentially increasing the likelihood of a full subscription.
- Before rights offering begins, consider: pre-publicity, polling major shareholders to gauge interest, press releases, investor conference calls, bridge financings and board and/or committee minutes.

Two Kinds of Rights

Basic Subscription Right

- Part of the guaranteed right to purchase “X” number of shares of common stock for every “Y” shares of common stock owned.
- There are typically no fractional rights issued.

Over-Subscription Right

- Not all current shareholders will exercise their basic subscription right; therefore, this right enables participating shareholders to purchase part of that unsubscribed portion.
- Over-subscription will be allocated on a pro rata basis – in proportion to the total number of shares purchased by shareholders through exercise of basic subscription rights, or based on the amount of each over-subscription request, or based on the original number of shares of common stock held (or rights allocated). The allocation selected will impact small and large shareholders differently.
- Required disclosure: (1) can over-subscribers revoke their exercise, (2) when must they pay for their exercise, (3) when/how will they learn of the number of shares they will be allocated, and (4) will they be entitled to interest on payments in excess of their actual allocation and when will the overpayment be returned?
- Practice Pointer: There must not be a “distribution” or an “offering” of unexercised subscription rights to over-subscribing shareholders. The SEC will take the position that it is a second and distinct unregistered offering. Shareholders need to make one investment decision.

Subscription Price

- Typically, at a discount to the current market price.
- The subscription price is typically fixed in the rights offering prospectus as of the record date; infrequently, it is pegged at a variable price tied to a percentage discount off of the company’s stock price on the final day or VWAP during the last three to five days of the subscription period.

- Determined by Issuer's Board of Directors, in consultation with dealer-manager and financial advisor.

Rights Offering Period

- Anywhere from 10 to 30 days after mailing.
- The offering must remain open for a minimum of 16 days under NYSE rules (see Rule 703.03 for 10-day notice to holders before the record date for the distribution of rights). Nasdaq and OTC have no such minimum time period. If OTC, need to consider blue sky timing.

Expiration Date Extension

- The initially-scheduled expiration date can be extended under the original terms of the rights offering or pursuant to a public announcement to such effect, but need to indicate latest date to which the offering may be extended.
- Changes to the subscription price can be handled similarly as the expiration date. If there is a repricing, it is virtually always a price decrease.

Method of Exercise

- Delivery to the subscription agent prior to the expiration date of (i) properly completed and duly executed right certificate, (ii) any required signature guarantee and (iii) full payment of the subscription price.

Listing Application

- File a listing application with the NYSE or Nasdaq, if possible, before the time of effectiveness.

Method of Payment

- Payment of the subscription price is typically made by wire transfer of immediately available funds to the subscription agent (which is typically the company's transfer agent).

Guaranteed Delivery

- Shareholders electing to exercise their rights who cannot timely deliver the subscription rights certificate to the subscription agent prior to the expiration date can instead deliver payment of the subscription price, together with a "protect" guaranteed delivery of the rights certificate, within three trading days after the date of the protect.

Signature Guarantees

- If the shares of common stock are to be delivered to an address or issued in the name of a person other than the record holder of the subscription rights, the shareholder's signature on the rights certificate must be guaranteed by an eligible guarantor institution.

No Revocation

- Once exercised, the basic subscription right and over-subscription right cannot be revoked, and even through expiration date extension. Often, this is a prospectus risk factor.

No Affiliate Transfers of Rights

- Any rights that affiliates may sell in a transaction not involving a public offering would be considered “restricted securities” within the meaning of Rule 144(a)(3).

NOL Tax Benefit Preservation

- Practice Pointer: The Issuer should reserve the right to cutback large shareholders’ subscriptions if necessary to avoid occurrence of a change of control or loss of the Issuer’s ability to utilize its net operating loss carryforwards to offset future taxable income.

Issuer’s Right of Withdrawal

- At any time prior to the expiration date, the Issuer may cancel the rights offering in its sole discretion by issuing a public announcement.

Blue Sky Considerations

- Practice Pointer: Most states have registration exemptions for rights offerings to existing shareholders, even for non-exchange traded companies, assuming no commission is paid and the rights are non-transferable. Certain states restrict the number of shares available for over-subscription requests. Federal law generally provides a blanket exemption from state law registration if the underlying securities are listed on the NYSE or Nasdaq. Special care should be given to warrants.

Taxation

- Pro rata distribution of the subscription rights will not result in taxable income to the recipients.

Broker-Dealers

- Only registered broker-dealers can solicit responses from shareholders in connection with the rights offering. Issuer's employees typically do not. They are not permitted to receive compensation if they do.

Fees and Expenses

- Shareholders do not pay any brokerage commissions in purchasing shares.
- An investment bank serving as "dealer-manager" for the rights offering will typically receive a financial advisory fee based on a percentage of the aggregate subscription price of the rights. A financial advisory fee is usually considered to be a payment for services and advice rendered in connection with structuring the offering, valuation of the Issuer's business and financial advice before and during the offering.
- A dealer-manager can set-up a syndicate or selling group made up of registered broker-dealers with whom existing shareholders maintain their accounts. These broker-dealers can thereby participate in the rights offering syndicate and receive a selling concession based on their customer's exercise of rights.
- Issuer pays subscription agent, information agent and printing and mailing fees and expenses.

Standby Underwriting and Backstop Commitments

Standby Purchaser: A standby purchaser agrees, on a privately-negotiated basis, to purchase shares not taken up by the Issuer's shareholders in the basic subscription or over-subscription.

- Frequently, the standby purchaser is the controlling shareholder or an affiliate or group of affiliates of the Issuer. The SEC will require disclosure of the standby purchaser's name and the circumstances involved.
- Sometimes, a third-party standby purchaser negotiates for certain corporate governance rights including the right to a board seat or to approve certain extraordinary corporate transactions.
- Under certain circumstances, the payment of a fee for a backstop commitment may require shareholder approval.

Standby Underwriting: In a standby underwritten rights offering, an underwriter purchases the shares underlying the rights that were not purchased by current shareholders at an underwriter's discount. If the underwriter purchases shares pursuant to the standby agreement, it will do so typically at a 5% to 7% discount, depending on the aggregate offering size.

- As in a standard underwritten offering, the underwriter may engage in stabilizing, syndicate covering transactions or other transactions that maintain or sustain the market price of the shares. See SEC Regulation M.
- Underwriter will be indemnified against liabilities arising out of any material misstatements or omissions in the prospectus, and the underwriter will have standard market and "material adverse change" outs.

- Standby underwriters may prefer transferable rights.
- Practice Pointer: As a practical matter, a publicly solicited backstop can be structured via the rights offering's over-subscription privilege. The prospectus should clearly disclose that the over-subscription will be allocated based on the amount of each shareholder's over-subscription request, enabling small shareholders to magnify their ownership position significantly in the offering. Hedge funds have utilized this strategy to gain market share at a discount to current values, especially in post-reverse merger companies where legacy shareholders either ignore the offering or choose not to participate.

The Canadian Rights Offering Regime

The Canadian Securities Administrators (CSA) implemented a streamlined rights offering prospectus exemption. Significantly, the CSA eliminated any requirement for prior regulatory review of the rights offering circular. The new rights offering exemption requires reporting issuers to file a notice with regulators that must be sent to shareholders with instructions on accessing the rights offering circular online. The rights offering circular form is in a Q&A format which must be filed on SEDAR (like EDGAR in the U.S.) but is not required to be sent to shareholders.

Once the notice is sent and the circular is filed, the reporting issuer may commence its rights offering. The offering must remain open for a minimum of 21 days and a maximum of 90 days, and there is a total dilution limit of 100% of the applicable class of securities. The CSA regime also includes a separate prospectus exemption for securities issued to a "standby guarantor" that is not a current shareholder.

U.S. securities advisory committees have pointed the SEC to the Canadian rights offering experience in support of both eliminating regulatory review of the offering document and, for smaller issuers, eliminating any need for state blue sky compliance.

- Practice Pointer: For foreign issuers, a rights issue is not an unusual method for raising capital outside the U.S. due to statutory preemptive rights in many countries. See, e.g., UniCredit SpA.

Key Timing Events for Subscription Rights Offering

Assuming the Issuer has a pre-existing shelf registration statement on Form S-3 on file with the SEC, the rights offering can be consummated in about 25 to 30 days from commencement. If a pre-existing shelf registration statement is not on file with the SEC, additional time will be needed to prepare and file the registration statement and have it declared effective by the SEC. Key timing events for a shelf-registered rights offering are as follows:

- Issue press release announcing the rights offering, the targeted gross proceeds the Issuer is seeking to raise, the dividend date of the rights, the record date for holders and the subscription period.
- Negotiate the terms of a dealer-manager agreement with the investment banking firm and prepare documentation for the rights offering.
- Commence rights offering period by mailing prospectus supplement.
- Close rights offering period.
- Closing relating to standby underwriting or purchase agreement, if applicable.
- Closing plus 7 days: Closing relating to over-subscription privilege.

Trading Timing Detail

The following timeline sets forth the key rights offering dates if the Issuer has a pre-existing shelf registration statement and can thereby utilize a prospectus supplement:

Pre-Market on Trading Day 1 (“Announcement Day”) - Pricing, deal size, dividend details and press release announcing the Rights Offering with the details of the timeline for the Rights Offering; the Issuer files a Form 8-K within one Trading Day.

Trading Day 10 - Each shareholder receives one Subscription Right for every one share of common stock (or warrant) that each holder owns on the last day to buy common stock and receive Subscription Rights (“Ownership Day”), which is nine trading days following the Announcement Day. (1)

Trading Day 11 - Issuer’s shares of common stock trade Ex-Rights one trading day following the Ownership Day (“Ex-Right Day”). (1)

Trading Day 13 - “Record Date” is two trading days following the Ex-Right Day. (1)

Trading Day 14 to 25 - Prospectus Supplement is filed with the SEC detailing the terms of the Rights Offering, and the “Subscription Period” will remain open for a minimum of the greater of 12 trading days or 16 calendar days following the Record Date. (2)

Trading Day 25 -“Expiration Date” and time will be 12 trading day following the Record Date at 5:00 p.m., Eastern time. (2)

(1) Assumes three trading days for settlement.

(2) Unless the offering is extended by the Issuer’s Board of Directors pursuant to advice from the Dealer Manager and officers of the Issuer. On Trading Day 25, the Issuer may elect to extend the offering for an additional period of time (“Extension Period”). Once that final Extension Period expires, and if the offering is not fully subscribed, the Dealer Manager would then begin the standby underwriting period for up to 45 trading days to sell any remaining unsubscribed shares to the public (“Standby Period”).

Thank You

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