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Rights Offerings in Bankruptcy

Negotiating and Executing a Deal for Restructuring and Exit Financing

WEDNESDAY, FEBRUARY 8, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Chapter 11 Rights Offerings - Overview

Rights Offerings in Bankruptcy – Tougher Creditor Challenges, Closer Court Scrutiny

Strafford Publications CLE Webinar – February 8, 2012

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Key Concepts

- A rights offering made through a chapter 11 plan is an offer made to creditors or equity holders of rights to purchase a designated amount of new securities (notes or equity) in the reorganized debtor.
  - Right is an integral component of the chapter 11 plan treatment for the creditor or shareholder.
  - Right is available for a much shorter term than warrants or other contractual purchase rights, typically 1 or 2 months.

Key Concepts

- Offerees receive the right to purchase their pro rata share of the designated amount of new securities, subject to their ability to exercise over-subscription rights if available.
- The designated new securities are offered to existing creditors/shareholders at a discounted purchase price (i.e., at a purchase price that is a discount from the value otherwise attributed to the new securities).

Key Concepts

- Tension between the amount of discount, the cost to the company, and the level of subscription. The greater the discount, the greater the likelihood that the offering will be fully subscribed, but the greater the cost to the company.
- Offerees who believe that the offering price represents a sufficient discount in relation to the value of the reorganizing company have a incentive to participate in the rights offering, in order to reduce dilution of the recovery they otherwise are receiving on account of their claim.

Key Concepts

- Over-subscription rights: when the offering is undersubscribed, permits offerees to purchase more than their pro rate share of new securities if available, in direct proportion to their original holdings.
  - Need to be mindful of securities law exemption issues. (see discussion below)
- Over-allotment rights: when the offering is fully subscribed, permit offerees to purchase a pre-determined amount of additional new securities, on a pro rata basis.

Key Concepts

- Underwritten, or backstopped, rights offering: a third party guarantees its purchase of any designated new securities not otherwise sold.
  - Third party typically negotiates a an underwriting fee, payable by the reorganizing debtor in cash or new securities, to compensate for the risk that offering will be undersubscribed.
  - Recent underwriting fees have ranged from 2.5 – 6%.
  - Recent break-up fees have ranged from 1 – 5%.
  - Recent offering discounts have ranged from 12 – 60%

Key Concepts

  - Credit-worthiness of underwriter impacts pricing and underwriter's ability to negotiate backstop terms, including: underwriting fee; governance and veto rights; break-up fee and expense reimbursement; material adverse change provisions; releases of claims by debtor, creditors and other parties to chapter 11 case.
- Uninsured offering: where no party has underwritten the rights offering.
  - Likely will create feasibility issues in connection with chapter 11 plan confirmation.

Key Concepts

- Creative use of over-subscription and over-allotment rights, combined with various provisions and protections sought by underwriter, may provide parties with tools to negotiate valuation disputes and other plan objections.
- Increasing number of rights offerings has helped to identify “market” terms for various rights offering provisions, which can be used by debtors and plan supporters to anticipate and address, if not resolve, potential plan objections.

Strategic Considerations

- May encourage plan acceptance by providing offerees an opportunity to enhance recoveries otherwise resulting from distribution of property or new securities solely in exchange for existing claim or equity.
- Permits reorganizing debtor to satisfy feasibility plan confirmation requirement by providing exit financing and/or enhanced capitalization for reorganizing company.
- Where the new securities are equity, provides reorganized debtor ability to emerge from bankruptcy less leveraged than if company were to obtain plan / exit and working capital financing.

Strategic Considerations

- May provide indication to capital markets of likelihood of successful restructuring.
- May provide an ability for emerging debtor to issue new securities exempt from federal securities registration requirements. (see discussion below)
- May provide debtor and other plan supporters with ability to consensually resolve valuation disputes and other confirmation objections by extending rights offering to other classes of claims or equity, or specifically to objecting parties.
  - Alternatively, valuation objections may be overcome by submitting underwriting to court-authorized auction process.

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Strategic Considerations

- Provides investment opportunities to existing creditors or shareholders at a discount from the value of the new securities on the date of issuance.
  - May provide a "second chance" for existing creditors or investors to invest in company with restructured capital structure.
  - Permits funds to re-invest into an investment that fits the fund investment profile.
- May provide an ability for emerging debtor to issue new securities exempt from federal securities registration requirements. (see discussion below)

Securities Law Exemption – Section 1145(a)(1)

- The rights offering may be exempt from registration requirements pursuant to bankruptcy code sec. 1145(a)(1), and the purchased new securities freely traded, in two instances.
- Sec. 1145(a)(1)(A): "the offer or sale of a security of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor of the debtor under the plan must be <u>in exchange for</u> a claim against, an interest in, or a claim for an administrative expense in the case of the debtor or such affiliate."

-- or --

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Securities Law Exemption – Section 1145(a)(1)

- Sec. 1145(a)(1)(B): the offer or sale is "principally in such exchange and partly for cash or property."
- What satisfies the principally / partly test?
  - The consideration for the new security must consist principally of the existing claim and partly for new cash paid by the offeree.
  - The value of the offeree's claim must exceed the value of the cash (or other property) purchase price the offeree is paying for the new security.
  - The primary purpose of the transaction must not appear to be an effort to raise new capital.

Securities Law Exemption – Section 1145(a)(1)

- There is no bright-line test for determining the amount by which the value of the existing claim must exceed the cash paid for the new security.
  - Greater than 50% should be sufficient.
  - A SEC no action letter suggests that the cash purchase price may be as much as 75% of the value of the existing claim.
  - The closer the cash purchase price is to the claim value, the greater the likelihood that the Sec. 1145(a)(1) exemption will be found to not apply.

Securities Law Exemption – Section 1145(a)(1)

- Sec. 1145(a)(1) does not apply to underwriters. Debtor usually relies on the private placement exemption.
- The shares of any purchaser of new securities as a result of the rights offering that holds more than 10% of the outstanding securities is a statutory underwriter under Sec. 2(11) of the Securities Act of 1933, and, therefore, such shares are not exempt.
- Accordingly, any shares greater than 10% purchased by the rights offering underwriter or backstop purchaser are not exempt.
- Exemption is not available where the rights may be sold or transferred independent from the existing claim or equity interest.

Mechanics

- The actual process by which new securities are sold and offerees pay their consideration may impact the success of the offering, or determine whether it is under or fully subscribed.
- Rights offerings conducted through The Depository Trust Company (DTC) must follow DRC procedures and customary practices.
- The timing of end of subscription period must take into account DTC processes for receiving instructions and funds from offering participants.

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Mechanics

- Offering should take into account customary methods used by participating banks and brokers to communicate to their beneficial holders.
- Certain investment funds (including CLOs) may have internal restrictions that preclude their participation in rights offerings.
- Solicitation may occur simultaneously with plan voting or during designated period following plan confirmation.

In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- The bankruptcy court denied confirmation of chapter 11 plan embodying a “global settlement” with major creditor and regulatory constituencies, where global settlement was found to be reasonable and acceptable but rights offering violated certain confirmation requirements, among other deficiencies the bankruptcy court found with the proposed chapter 11 plan.
- The bankruptcy court upheld an objection to the proposed rights offering by a creditor in the class of creditors entitled to participate in the rights offering who was denied participation because his claim was less than a threshold amount required for participation.

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In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- Proposed plan purported to provide approximately $7.5 billion available for distribution to creditors and interest holders.
- All classes of creditors but the lowest class were expected to receive payment in cash in full plus post-petition interest.
- The lowest class of creditors were expected to receive approximately 75% of the claims plus the right to participate in an offering of stock in the reorganized debtors, although creditors holder less than the $2 million threshold amount were precluded from participating in the rights offering.

In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- A creditor holding less than the threshold participation amount, therefore unable to participate in the rights offering, argued that he was receiving discriminatory treatment, in violation of Sec. 1123(a)(4), because he was receiving less value than the other creditors in the class with claims about the threshold amount.
- The debtor and other plan supporters argued that the offering was made only to the larger claimants in the class to avoid the administrative burden of issuing stock to small holders.
- The bankruptcy court ruled that nothing in Sec. 1123(a)(4) permitted discrimination for administrative convenience.

In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- The plan supporters also argued that there was no discriminatory treatment to the small holders because the rights offering had no value, in that the rights offering did not provide for any discount in the purchase price of the reorganized debtor's stock.
- Other creditors had the right to accept stock in lieu of cash for their claims, and, at the time of the confirmation hearing, the debtors were unable to advise how many creditors would be choosing the stock option because the deadline for them to choose had not yet passed.
- At the time of the confirmation hearing, only $31 million of stock had been purchased, out of a total of $100 million of stock which had been designated for the rights offering.

In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- The debtors presented testimony as to the enterprise value of the reorganized debtors, but since the debtor was unable to inform the court on the amount of shareholders in the reorganized debtors, the court was unable to determine whether the participants in the rights offering received a discount.
- The court also concluded that the reorganized debtors had a value in excess of the enterprise value set by the debtors' expert because he did not consider that the reorganized debtors might start or acquire another business, while "the fact that the Reorganized Debtor is raising new capital through the rights offering suggests otherwise."

In re Washington Mutual, Inc.

442 B.R. 314 (Bankr. Del. January 7, 2011)

- The court also found that if the reorganized debtors were a public company as a result of the number of creditors who accepted stock instead of cash plus the creditors who participated in the rights offering, a public company would have additional value in its ability to raise capital and acquire (or be acquired by) other businesses.
- Accordingly, the court ruled that it "cannot accept, as the Plan Supporters contend, that the rights offering is of no value."
- The rights offering component was removed from the subsequently modified chapter 11 plan in connection with a series of modifications made to satisfy the confirmation requirements and comply with the bankruptcy court's directions.

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Other Recent Cases

- *In re Point Blank Solutions, Inc.* (Bankr. DE, Case No. 10-11255 (PJW): Bankruptcy court upheld equity committee's objections that rights offering contained provisions for the benefit of the offering underwriters which were inappropriate under the circumstances or which violated the bankruptcy court, admonishing the parties that "this case is starting all over."
- *In re Harry & David Holdings, Inc.*, (Bankr. DE, Case No. 11-10884 (MFW): In response to official unsecured creditors' committee's objections to rights offering plan (including DIP financing proposed by offering underwriter), debtor and underwriter negotiated substantive modifications to rights offering in exchange for the committee's withdrawal of its objections.

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Creditor Challenges to Chapter 11 Rights Offerings

Presented By:

Thomas R. Fawkes

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February 8, 2012

What are the most common objections to rights offerings in chapter 11?

Six major categories of objections:

1. Unfair discrimination
2. Lack of market testing
3. Investor protections excessive and/or improper
4. Rights offering constitutes a *sub rosa* plan
5. Self-dealing
6. Rights offering is akin to improper lock-up

Objection 1: Unfair Discrimination

- A common objection to proposed rights offerings is that they unfairly discriminate against classes or sub-classes of creditors, or creditors holding smaller claims, who are not offered the ability to participate in the offering.
- These creditors contend that all similarly situated creditors – regardless of how they are classified in the plan or the size of their claims – should be entitled to participate in a rights offering.

Objection 1: Unfair Discrimination

- In re Premier Int'l Holdings, Inc. (Six Flags) (Bankr. D. Del. 09-12019)
  - In Six Flags, an informal committee of senior noteholders asserted that the proposed rights offering unfairly discriminated against them because it permitted a subset of those noteholders to convert the proposed cash recovery on their claims into common stock of the reorganized debtor.
  - Six Flags, in response, asserted that such treatment was reasonable and did not result in disparate treatment of similarly-situated class members for purposes of section 1123(a)(4).

Objection 1: Unfair Discrimination

- Six Flags (cont.)
  - Indeed, Six Flags argued, the construct was merely administrative in nature, allowing the noteholders investing new equity to "use the currency of their holdings," which were being repaid under the plan, to purchase the equity.
    - Additionally, the indenture trustee of Six Flags senior notes argued that the proposed rights offering unfairly discriminated against non-accredited holders of claims, who were not permitted to participate in the rights offering.

Objection 1: Unfair Discrimination

- In re AbitibiBowater (Bankr. D. Del., 09-11296)
  - In this case, certain noteholders filed a motion for temporary allowance of their claims in order to participate in a proposed rights offering.
  - Under a motion filed by the debtors, holders of claims were only permitted to participate if allowed prior to a pre-confirmation deadline (which, the debtors admitted, was prior to the anticipated conclusion of the claims reconciliation process).

Objection 1: Unfair Discrimination

- In re Dana Corp. (Bankr. S.D.N.Y., 06-10354)
  - Dana proposed a proposed stock rights offering that limited participation to sophisticated creditors holding claims above a specified aggregate amount.
  - The official committee of unsecured creditors, as well as creditors ineligible to participate, objected on the grounds that in light of the value of the participation right, similarly-situated creditors were being treated unequally in contravention of section 1123(a)(4).

Objection 1: Unfair Discrimination

- Dana Corp. (cont.)
  - Dana, in response, argued that the limitation on participation was necessary in order to prevent corporate governance from becoming unmanageable and to promote participation by sophisticated investors. Moreover, it argued that ineligible creditors would benefit in that their claims may be bought by eligible investors at a premium.
  - Nevertheless, in order to resolve the objections, Dana agreed to create a settlement fund that ineligible creditors could participate in under certain circumstances.

Objection 1: Unfair Discrimination

- In Washington Mutual, discussed later in this presentation, several unfair discrimination objections caught the attention of the Court and led (in part) to the denial of confirmation of the debtors' proposed plan of reorganization.

Objection 2: Lack of Market Testing

- In a number of cases, creditors and other parties have objected to rights offerings on grounds that the value of the securities being issued is artificially low, and that a market test of the securities is necessary to determine their true value.

Objection 2: Lack of Market Testing

- In re Accuride Corp. (Bankr. D. Del., 09-13449)
  - In this case, an official committee of equity security holders aggressively fought against a proposed rights offering, arguing that a lack of market testing by the debtors resulted in a situation in which existing equity would effectively be left out of the money, despite having an alternate financing proposal on the table that would leave existing equity holders with over 25% of the equity in the reorganized debtor.

Objection 2: Lack of Market Testing

- In re Extended Stay Inc. (Bankr. S.D.N.Y., 09-13764)
  - Here, the official committee of unsecured creditors argued that the debtors did not participate in a traditional marketing process with respect to the rights offering, and did not provide other interested investors with an opportunity to submit higher and better bids.
  - The asserted lack of a marketing effort prompted the committee to file a cross-motion for authority to solicit higher and better proposals through its retained investment banker.

Objection 2: Lack of Market Testing

- In re J.L. French Automotive Castings, Inc. (Bankr. D. Del., 06-10119)
  - In this case, the official committee of unsecured creditors argued that a proposed rights offering backstopped by the existing second lien lenders, which was to be conducted on a tight time table, left no opportunity for the proposal to be market-tested.
  - That the proposal left general unsecured creditors out of the money stood as further evidence of the need to shop the deal.

Objection 3: Excessive or Improper Investor Protections

- Creditors have lodged objections in several cases to protections – generally proposed to be granted to the backstop investor – that are excessive or improper.
- In such cases, objecting creditors have asserted that the excessive or improper protections render the backstop too costly to the estate, or render the backstop commitment illusory.

Objection 3: Excessive or Improper Investor Protections

- Release of claims against backstop investor: In AbitibiBowater, several creditors objected to the debtors' proposed release of a fraudulent transfer claim against one of the proposed backstop investors. These creditors argued that the consideration to be received was inadequate given that:
  - the backstop investor receiving the release – which was valued at almost $200 million – was only committed to purchase $110 million of notes at most

Objection 3: Excessive or Improper Investor Protections

- strong evidence existed concerning the validity of the fraudulent transfer claim
- the cost of the proposed release would be borne by unsecured creditors (other than the creditor being released)
- the six other backstop investors would not receive the benefit of a similar release, yet were undertaking identical commitments to the released party

- Ultimately, the proposed release was approved, provided that if (i) a plan of reorganization was not confirmed or (ii) the releasee committed a breach of its backstop commitment, the fraudulent transfer claim would be reinstated and could be pursued by the creditors' committee.

Objection 3: Excessive or Improper Investor Protections

- Excessive governance rights given to backstop investor: In In re Dura Automotive Systems, Inc. (Bankr. D. Del., 06-11202), the senior subordinated notes trustee objected to Dura's proposal to grant the lone backstop investor as many as 3 of the 7 seats on the reorganized debtors' board of directors (with an influence over an additional 2 seats).

Objection 3: Excessive or Improper Investor Protections

- Illusory termination rights: Again, in Dura, the senior subordinated notes trustee objected to the termination provision in the backstop agreement, which would give the backstop the right to back out – without penalty – for a multitude of reasons, including disagreement with Dura's plan, proposed exit facility, composition of the board, organization documents, etc.
- In the trustee's view, this – coupled with the backstop's ability to demand specific performance – rendered the agreement completely one-sided and untenable.

Objection 3: Excessive or Improper Investor Protections

- Excessive fees: Again, in Dura, the senior subordinate notes trustee argued that the fees proposed to be paid to the backstop investor, including (i) a $2 million "approval" fee; (ii) a $4.8 million break-up fee; (iii) expense reimbursement of $1 million; and (iv) a $6.4 million commitment fee.
  - In particular, the trustee argued that the break-up fee was unwarranted (because the backstop investor was already a significant creditor) and would undoubtedly chill bidding.

Objection 3: Excessive or Improper Investor Protections

- Excessive fees: In Extended Stay, a creditor, as well as the official committee of unsecured creditors, argued that a commitment fee (which it claimed was effectively a break-up fee) of 8.6% of the commitment was excessive and unprecedented.
- This creditor further noted that the fee became payable if aggressive plan confirmation deadlines were not met, but not if the Court denied plan confirmation, creating a potentially perverse situation in which the debtors would be forced to intentionally tank the plan in order to avoid incurring the fee.

Objection 4: Sub Rosa Plan

- In cases where a rights offering is not being proposed as part of a plan of reorganization, but rather, is proposed pre-plan, creditors have objected on the grounds that the rights offering constitutes an improper *sub rosa* plan.
- Such objections are similar to those lodged in cases involving section 363 asset sales outside of a chapter 11 plan – but similar to *sub rosa* challenges to section 363 sales, have largely been unsuccessful.

Objection 4: Sub Rosa Plan

- Dura: In Dura, holders of senior subordinated notes argued that a motion to authorize Dura to enter into a backstop rights purchase agreement outside of a chapter 11 plan constituted a *sub rosa* plan in violation of section 1125 and 1129 of the Bankruptcy Code.
  - This was the case, the noteholders argued, because the backstop rights agreement would dictate the terms of any future plan of reorganization
  - Additionally, because of Dura's proposal to allow management to participate in the rights offering, Dura should not be permitted to rely on the business judgment rule

Objection 5: Self-Dealing

- This objection is frequently raised when the proposed backstop investor is an insider or otherwise related to the debtors.
- In such cases, creditors have argued that the backstop investor is receiving an unwarranted discount – not to mention fees and other investor protections – that are not being afforded non-insider participants in the rights offering.

Objection 5: Self-Dealing

- Extended Stay: The official committee of unsecured creditors objected to a proposed rights offering that would result in:
  - consideration of $130 million to an insider, consisting of (i) $30 million in cash to the backstop investors and (ii) release of a $100 million "bad boy" guarantee
  - significant "change in control" payments to the debtors' officers and directors, despite them remaining in the employ of the investors

Objection 6: Improper Lock-Up

- Finally, parties have objected to backstop commitments on grounds that they operate as a “lock-up” preventing competing backstops (who may commit on better terms) from entering the process.
- Unsecured creditors argue that this “lock-up” inhibits value creation and harms their interests.

Objection 6: Improper Lock-Up

- J.L. French
  - In opposing a proposed rights offering backstopped by the existing second lienholders, the official committee of unsecured creditors argued that a restructuring support agreement served as an improper lock-up for the sole benefit of secured creditors.
  - Indeed, the committee argued that the rights offering (which was insulated from competition by a combination of excessive fees and aggressive timing) was the functional equivalent of a disguised foreclosure sale.

The *Washington Mutual* Decision

- The recent decision of the U.S. Bankruptcy Court for the District of Delaware in the *Washington Mutual* case is important in that it is one of the few decisions in which confirmation of a chapter 11 plan was denied, in part, based upon objections to a proposed rights offering.
- *See* Case No. 08-12229, Dkt. No. 6528 (Bankr. D. Del. Jan. 7, 2011)

The *Washington Mutual* Decision

- In the Sixth Amended Joint Plan filed by Washington Mutual and its affiliated debtors, Washington Mutual proposed a rights offering, pursuant to which certain holders of “Allowed PIERS Claims related to PIERS Preferred Securities” would receive the right to purchase up to 100,000,000 shares of common stock (in addition to the stock they would receive as a distribution on account of their claims) of the reorganized debtor.
- The Plan further provided that only holders of PIERS Claims (relating to the PIERS Preferred Securities) in an amount equal to or greater than $15,313,483.99 were eligible to participate in the rights offering.
- PIERS Claims were classified as Class 16 Claims under the Sixth Amended Joint Plan.

The *Washington Mutual* Decision

- Several creditors filed objections to the Sixth Amended Plan and its proposed rights offering:
  - Tricadia Capital Management: Tricadia, a holder of certain guarantee claims classified as Class 15 Claims under the Plan, objected to the holders of allowed Class 16 PIERS Claims having the exclusive opportunity to participate in the rights offering, given that Class 15, a senior class, would not receive payment in full under the plan.

The *Washington Mutual* Decision

- The Tricadia objection (cont.)
  - Tricadia argues, under the U.S. Supreme Court's opinion in Bank of America v. 203 N. LaSalle P'Ship, that allowing the holders of PIERS claims to exclusively participate in the rights offering violates the absolute priority rule.
  - Moreover, Tricadia objected to the lack of a market valuation for the common stock offered in the rights offering, and submits that for several reasons, the stock is undervalued.

The *Washington Mutual* Decision

- <u>Nate Thoma</u>
  - Nate Thoma, an individual creditor, also objected to the proposed rights offering, but for different – and perhaps more compelling – reasons than did Tricadia.
  - Mr. Thoma is a holder of a PIERS Claim that was not large enough to qualify him to participate in the rights offering, and therefore, argued that he was being discriminated against compared to other members of his class, in violation of section 1123(a)(4) of the Bankruptcy Code.

The *Washington Mutual* Decision

- Delaware Bankruptcy Judge Walrath found Mr. Thoma's argument persuasive, and denied confirmation of the Plan (in part) based thereupon.
- Judge Walrath held:
  - First, the plan supporters' argument that the offering was made only to larger claimants to avoid the administrative burden of issuing stock to smaller holders was unavailing, as there is nothing in section 1123(a)(4) that permits discrimination for administrative convenience.

The *Washington Mutual* Decision

- Second, Judge Walrath rejected the plan supporters' argument that there is no discriminatory treatment because the rights offering is of no value.
  - Even if the PIERS Claimants were obtaining their stock at par (a fact that was not established as of the Plan confirmation hearing), the Court held that the right to buy stock in a company has inherent value – the "upside" that results if the company is successful.
  - Additionally, the Court found that the reorganized debtors have value in excess of the enterprise value cited by the debtors' expert.

The *Washington Mutual* Decision

- The Court noted that the expert failed to take into account the value that may be generated were the reorganized debtors to start or acquire another business.
- Finally, the Court found that if the reorganized debtors are a public company – depending on the number of creditors accepting stock in lieu of cash and participating in the rights offering – the value of being a public company (i.e., the ability to raise capital and acquire or be acquired by other businesses must be taken into account.
- Accordingly, because the rights offering has value, the Court held that the Plan must be modified to allow all PIERS Claimants the opportunity to participate in the rights offering.

Please feel free to contact me with any questions . . .

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