# Do Rights Offerings Reduce Bargaining Complexity in Chapter 11?

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One of the primary challenges faced by the courts after a firm files for bankruptcy is estimating the continuation value of the reorganized firm. Often there are large errors in these estimates, which raise significant concerns about the efficiency of the Chapter 11 process. Further, valuation disputes between competing creditor classes can prolong and increase the costs of the bankruptcy process.

In a recent paper, I document how rights offerings have evolved as a market-based response to the creditor bargaining frictions that are pervasive in bankruptcy. Rights offerings allow the bankrupt firm to raise new capital by offering a class of creditors or equity holders the right to purchase equity in the post-bankruptcy company. The money raised in the rights offerings is used to pay off the secured claimants, thereby simplifying the bargaining process.

Moreover, rights offerings allow unsecured claimants to signal their beliefs about a particular valuation of the reorganized firm.

Firms increasingly use rights offerings to finance their emergence from Chapter 11. My paper documents three developments by using novel hand-collected data on large, publicly listed firms’ Chapter 11 bankruptcy filings from 2003–2021. First, rights offerings were used in 35 percent of Chapter 11 bankruptcies (asset-size weighted), to inject roughly $46 billion into these bankrupt firms. The bankruptcies of Hertz Corporation, PG&E Corporation, and SunEdison were all financed by rights offerings. Second, larger bankruptcy cases, with more creditors and fragmented creditor classes, are likelier to use rights offerings to finance their exits from bankruptcy. Third, rights offerings are generally proposed and backstopped by hedge funds that own unsecured debt. On average, hedge funds charge backstop fees equivalent to 6 percent of the amount raised in the rights offering. Further, the rights offering participants realize 50 percent average returns on their investments within three months of the firms’ emergence from bankruptcy.

Using an instrumental variable approach that exploits exogenous stock market fluctuations, the paper documents a significant link between bankruptcy outcomes and the decision to raise financing via rights offerings. Rights offerings increase total creditor recoveries by roughly 40 percent. Using a rights offering in bankruptcy also reduces the likelihood of a firm refiling for bankruptcy. Post-bankruptcy, the new equity securities of firms financed by rights offerings significantly outperform those of other firms emerging from bankruptcy by about 30 percent. This outperformance appears to be driven by positive earnings surprises in firms using rights offerings. Taken together, these findings suggest that rights offerings lead to an overall increase in the value of the reorganized firm.

The paper studies three ways that rights offerings create value. First, they decrease bankruptcy duration by about seven months, suggesting that they help achieve consensus and resolve conflicts of interest between different creditor classes. They also improve the transparency of the valuation process, as is evident from the finding that rights offerings lower the incidence of unintended wealth transfers (or absolute priority deviations) between different claimants by 40 percent. Second, by purchasing a slice of equity in the reorganized firm through a rights offering, hedge funds specializing in distressed situations establish significant control rights in the new firm. This equity stake provides high-powered incentives for the hedge funds to improve the overall performance of the reorganized firm. On average, hedge funds purchase 43 percent of the reorganized firm's equity and appoint 40 percent of the board members in the reorganized firm. Third, financing via rights offering replaces costly asset liquidations in firms emerging as going concerns. Bankrupt firms financed by these offerings do not sell any of their assets in Section 363 sales.

Rights offerings have evolved as a market-based solution to the creditor-bargaining frictions in bankruptcy. They offer an alternative way of financing bankruptcies and are particularly valuable when traditional sources of financing like asset liquidations or super-priority financing are limited or excessively costly. It is therefore not surprising that rights offerings are on the rise in Chapter 11 bankruptcies, with their use extending to 87 percent of bankruptcies in 2019 by asset size.

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*The author's recent article, 'Do Rights Offerings Reduce Bargaining Complexity in Chapter 11?' is available here.*

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