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Calpine District Court Decision Disallows Bondholder Claims for Lost Conversion Rights

In a recent appeal¹ arising from a claims objection proceeding in the *Calpine* chapter 11 case, the United States District Court for the Southern District of New York affirmed the Bankruptcy Court's decision disallowing certain bondholders' claims for compensation for the alleged loss of their right to convert their notes into common stock of Calpine Corporation ("Calpine").

The controversy in *Calpine* involved four series of unsecured convertible notes (the "Convertible Notes") issued by Calpine between 2000 and 2005. After timely filing proofs of claim for the unpaid principal, interest, trustee fees and "any and all other amounts due or to become due" under the Convertible Notes indentures (the "Indentures"), and attaching the relevant Indentures to such claims, the indenture trustees sought to supplement the proofs of claim well after the filing deadline to include claims for the conversion rights and alleged damages for breach of the Indentures including the conversion rights (the "Conversion Right Claims"). Calpine filed a limited objection seeking to disallow the Conversion Right Claims as untimely and otherwise not compensable under the terms of the Indentures. Calpine also argued that, to the extent allowed, the Conversion Right Claims should be subordinated under section 510(b) of the Bankruptcy Code.² The Bankruptcy Court agreed with Calpine on all counts and sustained its objection; certain holders of the Convertible Notes and their respective indenture trustees appealed.

On appeal the District Court first considered the appellants' argument that the broad, "catch-all" language contained in the original proofs of claim, and the fact that the Indentures were attached to such claims, encompassed the Conversion Right Claims, or, in the alternative, that the subsequent proofs of claim amended the earlier claims and should "relate back" to the filing of the earlier claims. The District Court ruled that the Conversion Right Claims were "novel" and that the "catch-all" provision in the earlier proofs of claim would not have given Calpine reasonable notice that the noteholders were asserting claims for the alleged breach of their

¹ *Aristeia Capital, L.L.C., et al., v. Calpine Corp., et al., (In re Calpine Corp., et al.)*, 2007 WL 4326738 (S.D.N.Y. December 4, 2007).

² Section 510(b) of the Bankruptcy Code provides, in relevant part, that

[f]or the purpose of distribution under this title, a claim . . . for damages arising from the purchase or sale of [a security of the debtor] . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

11 U.S.C. § 510(b).

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conversion rights. According to the District Court “[t]he fact that the [Conversion Right Claims] arise out of the same Indentures [was] not sufficient to establish relation back” Importantly, the Court ruled that “[w]hile a Proof of Claim does not necessarily require absolute precision, it still must provide sufficient notice to the parties.” The District Court next analyzed whether equitable principles warrant consideration of the Conversion Right Claims. Specifically, the District Court considered the prejudice to the debtor and other parties in interest if the Conversion Right Claims were allowed. The District Court concluded that, given the size of the Conversion Right Claims – estimates ranged from approximately \$258 million to \$500 million – and the more than six-month delay in filing them, the debtors would be unduly prejudiced by their allowance.

Next, turning to the merits, the District Court found that, even if the Conversion Right Claims were timely filed, the noteholders’ conversion rights expired on their own prior to Calpine’s bankruptcy filing. Pursuant to the express terms of the Indentures, Calpine’s bankruptcy filing resulted in the automatic acceleration of all of the obligations due and payable under the Indentures. Under the terms of the notes that were attached as exhibits to the Indentures, the conversion rights were to expire at the close of business on the business day immediately preceding the date of “Maturity.” According to the District Court, the notes “matured” on the petition date as a result of the automatic acceleration caused by Calpine’s bankruptcy filing.³ Because none of the conditions precedent to the exercise of the conversion rights had occurred as of that date, it follows that the conversion rights expired the day before Calpine’s bankruptcy filing. Therefore, the District Court ruled that the noteholders no longer held the conversion rights as of the petition date and, in consequence, could not assert a cognizable claim for breach of such rights.

The District Court pointed out that its ruling was consistent with the Bankruptcy Court’s earlier opinion in *In re Calpine Corp., et al.*, 365 B.R. 392 (Bankr. S.D.N.Y. 2007) (the “*CalGen* Decision”). In *CalGen* (which was the subject of an earlier client memorandum), the debtors sought through a refinancing to repay certain of their secured notes notwithstanding that a “no-call” provision in the indenture arguably barred repayment. In its *CalGen* Decision, the Bankruptcy Court held that, while the notes could be repaid, the noteholders were entitled to an unsecured claim for damages because the noteholders’ “expectation of an uninterrupted payment stream ha[d] been dashed.”⁴ Unlike in *CalGen*, however, there was no breach of the Indentures and the noteholders suffered no “dashed expectations;” to the contrary, the noteholders’ expectations – *i.e.* that the conversion rights would expire one day prior to maturity – were fully met.

Finally, the District Court ruled that, even if allowable, the Conversion Right Claims would be subordinated to the level of equity under section 510(b) of the Bankruptcy Code. That is because the damages claimed by the noteholders arose from the alleged elimination of their right to convert their notes into common stock. “The claim or interest represented by the conversion right is the common stock of Calpine, not the underlying debt instrument, and therefore the Conversion Right Claims, to the extent allowable, are subordinated to the level of common stock”

³ The term “Maturity” was not defined under the Indentures. The District Court nonetheless adopted what it termed the “general understanding” of the meaning of “maturity,” which is consistent with Judge Beatty’s recent ruling in *In re Solutia, Inc.* that “[a]cceleration moves the maturity date from the original maturity date to the acceleration date and that date becomes the new maturity date.” 2007 WL 3376900 (Bankr. S.D.N.Y. November 9, 2007).

⁴ *In re Calpine Corp.*, 365 B.R. at 399.

This most recent decision arising out of contested claims proceedings in the *Calpine* chapter 11 case should serve as a reminder to practitioners that (i) the effect of contractual provisions providing for acceleration of obligations upon the filing of a bankruptcy case by the borrower will be strictly construed and (ii) less-than-obvious claims need to be spelled out with specificity in a timely filed proof of claim.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be addressed to:

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