KIRKLAND & ELLIS LLP

ALERT

August 2007

Bankruptcy Judge Rejects Claims Based on Loss of Note Conversion Rights

On August 8, 2007, in the Calpine bankruptcy case, U.S. Bankruptcy Judge Burton R. Lifland denied novel breach of contract claims asserted by holders of Calpine's convertible notes. Allowance of these claims could have resulted in hundreds of millions of dollars in additional liabilities for the Calpine bankruptcy estate. By denying these claims, Judge Lifland rejected a theory that would create a new species of claims for holders of convertible debt interests. The ruling also removes a major distraction from Calpine's focus on its goal of confirming a plan of reorganization and emerging from chapter 11 by January 31, 2008.

Factual Background

Between 2000 and 2005, Calpine issued four series of unsecured convertible notes that allowed holders to elect, under certain circumstances, whether to receive a cash repayment of principal and interest or to convert the notes into a combination of cash and Calpine common stock. The notes were attractive to holders because they combined the security of debt instruments with an ability to access any upside associated with an increase in Calpine's stock price.

The indentures governing the notes provided that any right to convert the notes would terminate at maturity and that the notes would mature, among other times, upon an acceleration resulting from a bankruptcy filing. Thus, all conversion rights associated with the notes were terminated when the convertible notes were automatically accelerated upon Calpine's December 20, 2005 bankruptcy filing.

Recognizing these conversion rights had terminated, the indenture trustees for all of the convertible notes filed claims against Calpine before the August 1, 2006 claims bar date seeking repayment of principal and interest and failing to make any mention of "conversion rights." The claims did, however, include catchall claims for "other unliquidated amounts." In January 2007, the Debtors stipulated with the indenture trustee for three series of the notes to allow their claims for principal and interest and to reserve disputes about appropriate postpetition interest rates until the end of the case. Nonetheless, in March and April of 2007, shortly after the Court awarded certain of CalGen's secured lenders unsecured breach of contract claims for "dashed expectations" in connection with early repayment of their notes, the indenture trustees for the Calpine convertible notes filed "supplemental" claims seeking damages for breach of their "conversion rights." Although the noteholders did not assert a dollar amount of damages, they indicated they intended to seek hundreds of millions of dollars in damages.

Calpine objected to these "conversion rights" claims on the basis that they were untimely and meritless and argued that, even if the claims were allowed, they should be treated as equity rather than debt because they implicated the noteholders' right to acquire equity with the principal of their notes.

August 8, 2007 Bankruptcy Court Decision

At a hearing on August 8, 2007, Judge Lifland issued an oral decision in favor of Calpine and against the convertible noteholders in all respects. The Court ruled that there was no justification for the delay in filing the claims and that, in any event, the convertible noteholders were not entitled to damages for breach of their "conversion rights" in addition to an allowed claim of principal and interest. The Court's reasoning was based on the inherent nature of convertible debentures, which allow holders the alternative right to receive principal and interest or to convert their debt into stock, but never both. The Court also found, based on the plain language of the indentures, that the noteholders' right to convert their notes to stock had terminated upon Calpine's bankruptcy filing. Because the Court denied the "conversion right" claims in their entirety, it did not need to rule on whether they should be subordinated to the level of equity, but did note that the "conversion rights" claims would have been treated as stock if allowed.

Because securities issued by chapter 11 debtors often contain features analogous to the conversion rights at issue in the Calpine case, we expect bondholders to continue to test the waters on such theories. However, Judge Lifland's decision may indicate skepticism in some quarters as to the viability of such claims in chapter 11 bankruptcy cases.

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact:

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