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Are the Claims of Convertible Debt Holders at Risk in Bankruptcy?

BRAD B. ERENS AND TIMOTHY W. HOFFMANN

The authors examine various issues and arguments for and against the theory for reducing the amount of allowed claims in a bankruptcy arising from convertible debt instruments.

Business organizations often utilize convertible debt or other similar hybrid debt/equity instruments to raise funds. For example, real estate investment trusts sold approximately $27 billion of convertible bonds between 2005 and 2007.[1] Approximately $15 billion of these convertible bonds likely will mature in the next two years.[2] A portion of these and other companies with outstanding convertible bond debt may be unable to refinance this debt and thus forced to restructure through the filing of Chapter 11 bankruptcy cases.

The other creditors of a debtor in bankruptcy have a significant incentive to reduce the amount of claims arising from convertible debt offerings, as these types of claims often constitute a sizeable portion of the overall unsecured claim pool in a bankruptcy case. Therefore, the reduction of the amount of claims arising from convertible debt instruments may allow other creditors to increase their respective recoveries. Despite this incentive, historically, it has been accepted that the amount of a bankruptcy claim arising from a convertible debt instrument equals the amount of funds loaned under

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the instrument. In the iconic words of ESPN college football analyst Lee Corso, however, "not so fast my friends," as evidenced from an objection filed in the Chapter 11 bankruptcy cases of *SONICblue Inc.*[3]

In 2007, the trustee appointed in the *SONICblue* bankruptcy cases filed an objection seeking to reduce the value of claims arising from certain notes convertible into equity rights of the debtor. The objection sought to reduce the amount of the claims based upon the value of the conversion rights associated with the notes at the time of their issuance. Specifically, the *SONICblue* trustee argued that the face amount of the debt should be discounted by the value of the equity rights because the unamortized portion of the equity rights represented a claim for unmatured interest that is not valid under Section 502(b)(2) of the Bankruptcy Code.[4]

The trustee and noteholders in *SONICblue* resolved the claim objection as part of a comprehensive settlement between the parties in *SONICblue's* Chapter 11 plan.[5] In addition, no reported cases have definitively ruled on this issue. This article examines various issues and arguments for and against the *SONICblue* trustee's theory for reducing the amount of allowed claims in a bankruptcy arising from convertible debt instruments.

THE FUNDAMENTALS OF CONVERTIBLE NOTES AND SONICBLUE, INC.

The Basics of Convertible Debt Instruments

The most basic convertible debt instruments are convertible by their holders at any time at a fixed conversion price per share, either at the discretion of the holder or in certain cases upon demand of the issuer. Other forms of convertible debt instruments convert upon the occurrence of certain "triggers," rather than at the option of the issuer or the holder.[6] Originally, companies issued these "contingent converts" to avoid the dilution of existing shares, as historical accounting rules did not require such convertible debt instruments to count as outstanding shares for purposes of calculating diluted earnings per share.[8] The accounting rules changed in 2005 to provide that all convertible debt instruments, including those that

convert upon the occurrence of specific "triggers," constitute outstanding shares for purposes of calculating diluted earnings per share. Nevertheless, the issuance of convertible debt instruments remains a common method for companies to raise capital.[8]

Convertible debt instruments provide their holders with several advantages, including the ability to access the upside of the issuing company's stock, while maintaining a potential distribution priority over equity holders in the event of a bankruptcy filing. In exchange for these benefits, the issuing company generally will pay a below market interest rate on the convertible debt instrument. Thus, the economic question for a company issuing convertible debt is whether access to funds at a reduced interest rate adequately compensates the company's shareholders for the potential dilution of their equity interests in the company that would occur if the debt converts to equity.

From the perspective of the purchaser of a convertible debt instrument, the value of the instrument consists of two separate components: (i) the value of the loan portion of the instrument; and (ii) the value of the option to convert the loan into equity. This compares to a debt instrument with no conversion option where the issuer only provides the purchaser with a promise to repay the principal amount of the loan and pay a market interest rate.

It is important to note that the documents governing convertible note instruments generally do not place a separate value on the conversion rights.[9] As such, under the terms of the vast majority of convertible debt instruments, the debt component of the instrument equals the face amount of the instrument.

The *SONICblue Inc.* Objection

In the Chapter 11 cases of *SONICblue*, the Chapter 11 trustee attempted to reduce the amount of claims arising from an investment package issued by the debtors.[10] The investment package at issue in *SONICblue* included the purchase of the following instruments for $62.25 million: (i) a note in the principal amount of $75 million with a 7.75 percent per annum interest rate; and (ii) certain equity rights, including warrants to purchase shares of SONICblue's common stock, options to purchase stock in

United Microelectronics Corporation, a Taiwanese computer chipmaker, from SONICblue and the right to convert the $75 million note to shares of SONICblue stock.[11]

In *SONICblue,* the trustee argued that the value of the conversion and other investment rights associated with the investment package represented "original issue discount" from the $75 million face amount of the debt component of the investment package.[12] Original issue discount exists when an entity issues a bond or other debt instrument for less than its face value.[13] The *SONICblue* trustee contended that the value of the conversion and other equity rights represented "original issue discount" because the value of those rights provided the purchaser of the investment package with additional consideration beyond the mere right to repayment of the debt portion of the investment package.[14] Under this theory, any portion of the value of the conversion and other equity rights associated with the investment package that were not amortized prior to the bankruptcy filing (*i.e.* the "original issue discount") would represent "unmatured interest" disallowed under Section 502(b)(2) of the Bankruptcy Code.

Section 502(b)(2) provides that allowed claims in a bankruptcy case do not include unmatured interest — *i.e.* interest accruing after the petition date[15] — and bankruptcy courts have utilized Section 502(b)(2) to reduce the allowed amount of claims based on debt instruments issued at a discount on the theory that the discount constitutes unmatured interest.[16] Following this line of reasoning, a bankruptcy claim based upon an unsecured convertible debt instrument that contains original issue discount will not be allowed at the face amount of the debt instrument.[17] Instead, the value of the claim will equal the face amount of the instrument, minus the value of the conversion rights at the time of issuance (*i.e.* the "original issue discount"), plus the amount of the amortized portion of the original issue discount as of the filing date of the bankruptcy case.[18]

The main tenet and underlying principle of the *SONICblue* trustee's argument was that the various equity rights (including the conversion rights) associated with the investment package had values separate from and in addition to the value of the note.[19] Using the Black-Scholes model, a valuation model commonly used to value "call option" derivatives, the trustee asserted that the equity components had an aggregate value

of roughly $41 million at their time of issuance, including $7.7 million allocable to the conversion rights.[20] Based upon the Black-Scholes valuation, the trustee argued that, in order to reflect the economic reality of the investment package, $41 million of the noteholders' claim arising from the amounts owed on the notes actually represented "original issue discount" on the debt portion of the investment package, and thus, the actual amount loaned to the debtor was only $21 million.[21] As a result, the *SONICblue* trustee concluded that the unamortized portion of the $41 million (*i.e.*, the "original issue discount") represented unmatured interest that the bankruptcy court should disallow as a claim.[22]

THE LEGAL ISSUES SURROUNDING CONVERTIBLE DEBT CLAIMS

Legal Precedent For and Against the Separate Valuation of Conversion Rights and Characterization as Original Issue Discount

No definitive legal precedent exists regarding whether conversion rights embedded within a convertible debt instrument may be separately valued and classified as original issue discount on the face amount of the debt component of the instrument. Section 101(16) of the Bankruptcy Code, however, provides one potential argument that the separate valuation of conversion rights is inappropriate for purposes of reducing a claim based on a convertible debt instrument. Section 101(16) defines the term "equity security" as follows:

> (16) The term "equity security" means —
>
> (A) share in a corporation, whether or not transferable or denominated "stock", or similar security;
>
> (B) interest of a limited partner in a limited partnership; or
>
> (C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph.[23]

Thus, the Bankruptcy Code expressly excludes a "right to convert" from its definition of "equity security."[24]

Furthermore, a review of legislative history from the Bankruptcy Reform Act of 1978 — the source of the language found in Section 101(16) — specifically reveals that Congress did not intend the definition of "equity security" to include "a security, such as a convertible debenture, that is convertible into an equity security, but has not been converted."[25] Therefore, based upon the definition of "equity security" ultimately included in the Bankruptcy Code, one could infer that Congress intended that bankruptcy courts view a convertible debt instrument as purely debt until the requisite election or trigger occurs, and the debt actually converts to equity.

Further support for the notion that a convertible debt instrument constitutes only debt prior to conversion may be found in the *Calpine Corporation* Chapter 11 cases.[26] In *Calpine*, a group of convertible noteholders holding three different series of convertible notes asserted a claim against the debtors for damages arising from the termination of certain conversion rights as a result of the early repayment of the notes under the *Calpine* plan of reorganization. Absent the early repayment, such conversion rights would have remained available for exercise, in the event that certain contingent triggers were satisfied, for an additional seven, eight and 16 years, respectively.[27]

The *Calpine* noteholders unsuccessfully argued that the early repayment of the notes deprived them of distinct and valuable conversion rights, and that the loss of the "time value" of those options, as established under the Black-Scholes method, gave rise to a valid claim against the *Calpine* bankruptcy estate.[28] The bankruptcy court rejected this argument, reasoning that "a convertible debenture is an indivisible unit" and that an issuer is obligated only either to redeem the note or convert it to stock; "[an issuer of convertible debt] can never be required to do both."[29] Thus, the court held that the convertible noteholders were not entitled to receive payment of their debt *and* damages on the account of the loss of their conversion right.[30] The bankruptcy court's decision in *Calpine* favors the indivisibility of conversion rights, and one may utilize the decision to argue against the separate valuation of conversion rights. Regardless of one's

interpretation of the case, its precedential value is limited, as the case was ultimately decided on other grounds on appeal, and the district and bankruptcy courts' decisions remain unpublished.

In contrast to the above, courts addressing the separate valuation of conversion rights in other contexts have recognized that conversion rights possess an independent value.[31] For example, in the bankruptcy case of *Bridge Information Systems, Inc.*, the court held that the unsecured debt and conversion components of a convertible note were discrete and should be valued separately.[32] The *Bridge* court examined this issue in evaluating a lender's assertion of the new value defense to a preference action under Section 547 of the Bankruptcy Code brought by the administrator of the *Bridge* debtor's confirmed plan.[33] One of the requirements of the new value defense to a preference action is that the transferee must prove that it gave the debtor "money or money's worth in goods, services, or new credit" in exchange for the alleged preference payments and that the debtor did not make an additional transfer to the transferee on account of the new value.[34]

In *Bridge*, Welsh Carson, a lender to and equity holder in the debtor, received approximately $20 million in alleged preference payments from the debtor as part of the debtor's repayment of a loan agreement with various creditors.[35] After receiving the alleged preference payments, Welsh Carson transferred $30 million to the debtor in exchange for promissory notes that carried an interest rate of 12% per annum and matured on December 31, 2005.[36] Two months later, Welsh Carson exchanged the promissory notes for convertible notes that could be converted into the debtor's common shares, carried an interest rate of 8% per annum and matured on December 31, 2005.[37] The plan administrator admitted that the $30 million loan was new value for purposes of the new value defense, but argued that the conversion rights granted to Welsh Carson in connection with the convertible notes held an independent value that prevented Welsh Carson from utilizing the entire $30 million face amount of the convertible debt instrument for its new value defense.[38]

The *Bridge* court examined the conversion rights embedded in the convertible notes and found that the conversion rights were discrete and had a value separate from the promissory note.[39] The court reasoned that,

because the convertible notes gave Welsh Carson the right to exchange the debt for common stock at a specified rate, the conversion rights were "functionally equivalent" to a call option on the debtor's common stock.[40] The grant of the conversion rights thus constituted a transfer of value because the transfer both: (i) deprived the debtor of something of value because the sale of common stock is a means by which a corporation may raise capital; and (ii) gave the transferee something of value, because the right to buy the common stock at a specified price is a right that may be sold to others.[41]

The court further cited to the separate valuation of convertible debt instruments embodied in the Internal Revenue Code and the statements of the Financial Accounting Standards Board.[42] The Internal Revenue Code requires the issuer of a convertible debt instrument to treat the value of call options contained in a financial instrument as an ordinary business expense. The issuer may then deduct the expense from the issuer's gross income.[43] Similarly, the Financial Accounting Standards Board requires parties to a convertible debt transaction to "separate the value of the [conversion rights] from the value of the unsecured debt for accounting purposes."[44] Thus, the conversion rights associated with a convertible debt instrument must be accounted for as a derivative financial instrument, and the debt component of a convertible debt instrument must be accounted for as ordinary unsecured debt.[45]

Based upon these authorities, the court found that the unsecured debt and conversion rights components in the convertible notes should be valued separately and that the debtor transferred value to Welsh Carson on account of the alleged preference payments to the extent of the value of the conversion rights associated with the convertible notes.[46] Importantly, the court further noted that the fact that the conversion rights lacked value at the time of the hearing was irrelevant, and the proper time for valuation was the time of the transfer of the conversion rights.[47]

Another case that supports the argument that a separate value should be placed on conversion rights is the Ninth Circuit's decision in *Custom Chrome, Inc. v. IRS*.[48] In *Custom Chrome*, a borrower attempted to deduct on its tax return the cost of warrants the borrower granted to a bank that provided financing to allow the borrower to complete a leveraged buy-

out.[49] The *Custom Chrome* borrower issued the warrants as additional compensation (beyond the interest rate attached to the loan) to compensate the bank for the perceived high level of risk associated with providing the loan.[50] Several years after receiving the warrants, the bank exercised the warrants and realized gains in excess of $3 million.[51] The *Custom Chrome* borrower attempted to claim the entire $3 million that the bank received — *i.e.*, the value of the warrants at the time that the bank exercised the warrants — as a deduction on the borrower's tax return.[52] The court ultimately held that the cost of the warrants was deductible, but that the appropriate deduction was the value of the warrants at the time of issuance, and not the ultimate exercise value of the warrants.[53]

While addressing the ability of the *Custom Chrome* borrower to deduct the value of the warrants, the Ninth Circuit made two determinations that may apply to convertible debt instruments in the context of a bankruptcy case. First, the Ninth Circuit determined that the warrants granted to the *Custom Chrome* borrower had an independent value, and the proper time to measure that value was at the time of issuance, rather than the time of exercise.[54] In reaching this conclusion, the Ninth Circuit employed a similar rationale to that employed in *Bridge*.[55]

Second, the Ninth Circuit determined that the value of the warrants represented original issue discount to the face amount of the loan, which discount the issuer of the warrants could deduct ratably over the life of the loan.[56] In deciding that the value of the warrants constituted original issue discount, the Ninth Circuit noted that the value of the equity rights associated with the loan compensated the bank for risk associated with the loan, "raising the effective interest rate of the loan and resulting in [original issue discount]."[57]

In addition to the *Custom Chrome* decision, a district court decision in an appeal from the bankruptcy cases of *ICH Corp.* provides further potential support for the theory that a court may find that the value of conversion rights granted under a convertible debt instrument constitutes original issue discount.[58] In *ICH Corp.*, the debtor became liable for the payment of a $30 million convertible debenture as a result of a merger with the original issuer.[59] The original issuer issued the convertible debenture and provided an additional $15 million cash payment to purchase a controlling

equity interest in another company called HCA, Inc.[60] The stock purchase agreement indicated the stock had a value of $45 million.[61]

The trustee appointed in the *ICH Corp.* case filed an objection to the debenture-holder's proof of claim, arguing that the value of the stock was less than $45 million at the time of the transaction, and therefore, the debenture contained original issue discount, because the actual proceeds of the loan could only equal the value of the stock minus the $15 million cash payment.[62] The bankruptcy court determined that, as a matter of law, the debenture did not contain original issue discount, because the stock purchase agreement designated the value of the stock as $45 million.[63] The district court reversed the bankruptcy court decision, determining that the stock purchase agreement was not conclusive evidence of the value of the stock, and noted that the bankruptcy court should have considered other extrinsic evidence to determine the value of the stock at the time of the transaction.[64] The *ICH Corp.* decision thus supports the notion that courts may independently evaluate whether original issue discount exists based upon the economics associated with a particular transaction, despite language in a governing document that would indicate otherwise.

In short, legal precedent is minimal with respect to valuing claims arising from convertible debt instruments in the bankruptcy context. It is plausible that a bankruptcy court could apply the reasoning set forth in *Bridge*, *Custom Chrome* and *ICH Corp.* and determine that the value of conversion rights at the time of their issuance constitutes original issue discount on the face amount of a convertible debt instrument. The proponent of such a position would argue that, from a purely economic perspective, the characterization of the value of the conversion rights as original issue discount accurately reflects the true economics of a convertible debt instrument, as the purchaser of a convertible debt instrument receives both the right to repayment of the debt portion of the instrument and the value associated with the conversion rights. The issuer of a convertible debt instrument generally is entitled to pay a below market interest rate on the debt. The benefit of that reduced interest rate accrues over the life of the debt instrument and that benefit corresponds to the value of the equity conversion rights granted to the holder of the instrument. Accordingly, classifying the value of the conversion rights as original issue discount

and amortizing the value of the conversion rights over the life of the convertible debt instrument mirrors the benefit the issuer of a convertible debt instrument receives from the reduced interest rate over the life of the debt instrument.

What is the Appropriate Method to Value Conversion Rights?

If a bankruptcy court were to decide that conversion rights associated with a convertible debt instrument should be valued separately from the promise to repay the debt, it is open to question what method the court would utilize to determine that value.[65] The valuation method is important, because the value of the conversion rights directly corresponds to the amount of original issue discount on the face amount of a convertible debt instrument. Accordingly, the larger the amount of original issue discount attached to a convertible debt instrument, the larger the potential reduction in the allowed amount of a bankruptcy claim arising from the convertible debt instrument.

As discussed above, the *SONICblue* trustee used the Black-Scholes method to place a value on the conversion rights.[66] This method is commonly used by financial experts and considers six separate variables in valuing a "call option," a derivative comparable to an equity conversion right, including:

- the time to expiration of the option;
- the expected future volatility of the underlying security;
- the price of the underlying security;
- the exercise price of the option;
- the "risk free" rate of return (which is generally considered to be the return on a U.S. Treasury Bill); and
- the dividend yield of the underlying security.[67]

Although the Black-Scholes model is recognized as the most common method used to value "call option" derivatives, alternative methods, such as the "binomial option pricing model" (upon which the Black-Scholes

model is based) and more sophisticated versions of the Black-Scholes model that take into account an issuer's call rights and the dilutive consequences of conversion may also be used.[68]

One other potential method is to base the value of the conversion rights on the value of the reduced interest rate on the debt portion of the convertible debt instrument. Where the issuer and the purchaser of a convertible debt instrument have engaged in an arm's-length transaction, this method may most accurately reflect the economic realities of a convertible debt instrument because, in exchange for the equity conversion rights associated with a convertible debt instrument, the purchaser of the instrument agreed to a below market interest rate. Thus, the value of the reduced interest rate to the issuer of a convertible debt instrument arguably should equal the value of the conversion rights received by the purchaser of a convertible debt instrument.

In *Monarch Cement Company v. U.S.*, the Tenth Circuit valued certain warrant rights issued in conjunction with a debt instrument in the manner described above.[69] In approving the valuation method, the Tenth Circuit noted that Section 1.1232-3(b)(2)(ii) of the Treasury Regulations directs that the value of warrants should "be determined by reference to the probable interest rate at which the note could have been issued without the warrants."[70] In addition, the Ninth Circuit and the *Bridge* bankruptcy court have specifically noted that the valuation method utilized in *Monarch* represented a reasonable approach.[71] Both courts also observed, however, that other potential valuation methods may be appropriate as well. Thus, the propriety of the Black-Scholes method and other valuation methods in this context remains an open issue.[72]

CONCLUSION

As there exists no definitive law in the context of bankruptcy, it is unclear whether a bankruptcy court would adopt the theory that the value of conversion rights attached to a convertible debt instrument represents original issue discount on the instrument. The existence of cases such as *Bridge*, *Custom Chrome* and *ICH Corp.*, however, make the adoption of such a theory plausible. As such, the theory poses a risk to the holders of convertible

debt instruments that their claims may be reduced in bankruptcy.

It is important to note, however, that the theory would not apply in all bankruptcy cases involving claims arising from convertible debt instruments. To the extent a company filed for bankruptcy due to an inability to refinance a convertible debt issuance that had matured, the holders of such convertible debt would possess a bankruptcy claim for the full amount of the debt portion of the instrument. This result would occur, because, at the time a convertible debt instrument matures, any original issue discount would be fully amortized. As a result, the above theory only poses a risk to the holders of convertible debt instruments in certain cases.

NOTES

[1] *See* A.D. Pruitt, *For Some REITs, Payout Date Looms*, The Wall St. J., May 26, 2010, at C8.

[2] *See id.*

[3] Objection of the Chapter 11 Trustee to the Claims of Portside Growth and Opportunity Fund, Ltd., Smithfield Fiduciary LLC and Citadel Equity Fund, Ltd., *SONICblue Inc.*, Case No. 03-51775 (MM) (Bankr. N.D. Cal. Nov. 14, 2007) [Docket No. 2559] (hereinafter "Objection").

[4] *See* 11 U.S.C. § 502(b)(2) (disallowing any claim for "unmatured interest"); 11 U.S.C. §§ 101-1532 (2010) (the "Bankruptcy Code").

[5] *See* First Amended Disclosure Statement Describing the First Amended Joint Chapter 11 Plan of Liquidation Proposed by Dennis J. Connolly, Chapter 11 Trustee and the Reconstituted Creditors' Committee (as Modified as of August 22, 2008) at § I.B.B, *SONICblue Inc.*, Case No. 03-51775 (MM) (Bankr. N.D. Cal. Sept. 4, 2008) [Docket No. 3277].

[6] *See* Carol A. Marquardt, et al., *Economic Consequences of Regulation of Financial Reporting: The Case of Contingent Convertible Securities*, 12 Review of Accounting Studies 487, 488 (2007).

[7] *Id.*

[8] *Id.*; *see* Pruitt, *supra* note 1.

[9] *See*, *e.g.*, *In re Calpine Corp.*, 2007 U.S. Dist. LEXIS 86514, at *38 (S.D.N.Y. Dec. 4, 2007) (noting that convertible noteholders offered a lower interest rate and less restrictive covenants on the convertible notes at issue in exchange for conversion rights, but not assigning a separate value to the

conversion rights).

[10] Objection at 2-3.

[11] Objection at 3-4.

[12] The "original issue discount" arising from the value of the investment rights associated with the investment package was in addition to the "original issue discount" that existed because the face amount of the $75 million note was greater than the $62.25 million purchase price of the investment package. *See* Objection at 2-4.

[13] *See LTV Corp. v. Valley Fidelity Bank & Trust (In re Chateaugy Corp.)*, 961 F.2d 378, 380 (2d Cir. 1992) ("[O]riginal issue discount results when a bond is issued for less than its face value. The discount, which compensates for a stated interest rate that the market deems too low, equals the difference between a bond's face amount (stated principal amount) and the proceeds, prior to issuance expenses, received by the issuer.").

[14] Objection at 15-16.

[15] *Id.*; Section 502(b)(2) of the Bankruptcy Code states:

> (b) [T]he court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that …
>
> (2) such claim is for unmatured interest[.]
>
> 11 U.S.C. § 502(b)(2).

[16] *See, e.g.*, *Chateaugay*, 961 F.2d at 383; *In re Allegheny International, Inc.*, 100 B.R. 247, 250 (Bankr. W.D. Pa. 1989).

[17] *Id.*

[18] *Id.* The legislative history to Section 502 of the Bankruptcy Code provides the following example to illustrate the calculation of original issue discount: "[A] claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the cash actually advanced. If the original discount was ten percent so that the cash advanced was only $900, then notwithstanding the face amount of the note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case." H.R. Rep. No. 959, 95th Cong., 1st Sess. 352-53 (1977), *reprinted in* Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). *See*, *infra*, note 22 for a discussion of the different methods used to amortize original issue discount.

[19] *See* Objection at 7-8.
[20] *Id.*
[21] *Id.*
[22] *Id.* The trustee further argued that the "constant interest" amortization method should be used to calculate the unamortized portion of the original issue discount, as opposed to the "straight line" method. *Id.* at 16-18. If a note contains unmatured interest in the form of an original issue discount, the question arises as to how this unmatured interest amortizes over the life of the loan. The courts have split over how to "pro-rate" the discount so as to determine how much of the unmatured interest has accrued prior to the bankruptcy filing (and thus should be allowed as matured interest). *See* 6 *Collier Bankruptcy Practice Guide* ¶ 94.03[3][b][i] (2009). Under the straight line method, original issue discount is amortized by a constant amount, rather than a constant rate, over time; e.g. for a ten-year note, one-tenth of the original issue discount is deemed to amortize annually. *Allegheny*, 100 B.R. at 254-55. Under the constant interest amortization method, the court assumes that the interest is compounded over time and that the amount of interest that accrues each day increases over time (e.g. for a ten-year note, an annual compound interest rate is assumed that would produce the face amount of the note if applied to the purchase price paid for the note). *Chateaugay*, 961 F.2d at 383.
[23] 11 U.S.C. § 101(16).
[24] *Id.*
[25] S. Rep. No. 989, 95th Cong. (2d Sess. 1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5810; H.R. Rep. No. 95-595, 95th Cong. (lst Sess. 1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6268; *see In re America West Airlines, Inc.*, 179 B.R. 893 (Bankr. D. Ariz. 1995) ("The legislative history reveals that only a right to convert is not included in the definition of 'equity security' ... [a] right to purchase however, is within the definition provided in the Bankruptcy Code.").
[26] *Calpine*, 2007 U.S. Dist. LEXIS 86514 (S.D.N.Y. Dec. 4, 2007).
[27] *Id.* at *3.
[28] *Id.*; *In re Calpine Corp.,* Case No. 05-60200 (BRL), Hr'g. Tr., Aug, 8, 2007 (hereinafter *Calpine Transcript*) at 78-79, 95-96.
[29] Calpine Transcript at 100:3-25 (*citing Chock Full O' Nuts v. U.S.*, 453 F.2d 300 (2d Cir. 1971) ("convertible debentures provide for two mutually [exclusive] modes of satisfaction.")).
[30] *Id.*; *see also Husky Oil Co. v. Comm'r of Internal Revenue,* 83 T.C. 717, 735

(T.C. 1984) ("The holder of a convertible debenture has alternative contractual rights — he may demand payment of the debenture, or he may demand shares of stock in accordance with the conversion privilege. When performance of one of the issuer's obligations to a holder of a convertible debenture is demanded and completed, the alternative obligation is discharged."); *National Can Corp. v. U.S.,* 520 F. Supp. 567, 574 (N.D. Ill. 1981) ("The convertible debenture is an indivisible unit; the issuer has but one obligation to meet, either redemption or conversion. It can never be required to do both."); *but see Bridge Information Systems, Inc.*, 311 B.R. 781, 792 (Bankr. E.D. Miss. 2004) (finding, in context of hearing on whether "new value" was provided to debtor by convertible note, that convertible notes were "hybrid financial instruments" containing both an unsecured debt and an option component that should be valued separately).

[31] *See Custom Chrome, Inc. v. Comm'r of Internal Revenue*, 217 F.3d 1117, 1128 (9th Cir. 2000); *Bridge*, 311 B.R. at 793; *ICH Corp.*, 230 B.R. 88, 96 (N.D. Tex. 1999).

[32] *Bridge*, 311 B.R. at 792.

[33] The plan administrator was granted the exclusive right to pursue preference actions on behalf of the debtor. *Id.*

[34] 11 U.S.C. § 547(a)(2); *Bridge*, 311 B.R. at 787.

[35] *Bridge*, 311 B.R. at 785-87.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* at 792.

[40] *Id.* at 788.

[41] *Id.* at 790.

[42] *Id.* at 792.

[43] *Id.* (*citing* 26 U.S.C. §§ 163(e)(1), 1273(c)(2)); *Custom Chrome*, 217 F.3d at 1121-22.

[44] *Id.*

[45] *Id.*

[46] *Id.* at 791.

[47] *Id.*

[48] 217 F.3d at 1128.

[49] *Id.* at 1120.

[50] *Id.*

[51] *Id.*
[52] *Id.* at 1123.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* at 1121-22 (citing to Section 1273 of the Internal Revenue Code, the court held that the issue price for the warrants should be based on the issue price of the note); *see* 26 U.S.C. § 1273(c) (providing in relevant part that whenever "any debt instrument and an option...[are] issued together as an investment unit...the issue price for such unit shall be determined...as if it were a debt instrument."). Compare this treatment to the Second Circuit's review of a similar tax court case in *Chock Full O' Nuts*, 453 F.2d at 306. In that case, a taxpayer/borrower sought an income tax deduction for the conversion feature of certain convertible debentures on the theory that the conversion rights constituted prepaid interest subject to original issue discount. *Id.* at 301. The Second Circuit held that the initial offering price of certain convertible debentures allocable to the conversion feature did not constitute original issue discount, and thus the taxpayer/borrower was not entitled to a tax deduction with respect to the same. *Id.* at 304. The court primarily based its decision on the rationale that convertible bonds constituted a single indivisible unit and thus, the price of the conversion option should not be separately considered for purposes of calculating original issue discount. *Id.* In rejecting the taxpayer's argument, the court noted: "… if we were to exclude the value of the conversion feature in determining the issue price, we could by the same logic deduct that figure when arriving at the redemption price, in recognition of the fact that the bond contains two distinct and separate components. We do not believe that the statutory language contemplates such a division." *Id.*
[57] *Custom Chrome*, 217 F.3d at 1121-22.
[58] *ICH Corp.*, 230 B.R. at 96.
[59] *Id.* at 90.
[60] *Id.*
[61] *Id.*
[62] *Id.* at 91.
[63] *Id.*
[64] *Id.* at 94-95 (finding that extrinsic evidence might support the conclusion that the value of the stock was less than the $45 million stated because (i) prepayment provisions in the debenture allowed the issuer to prepay the

note at an amount below face value and (ii) the lender accepted a letter of credit as security that only secured an amount below the face value).

[65] *See Bridge*, 311 B.R. at 792-93.

[66] Objection at 7.

[67] *Id.* (*citing Litman v. US.*, 78 Fed. Cl. 90, 121 (Fed. Cl. 2007) (setting forth the variables considered by the Black-Scholes valuation model)); *see also* Stephen I. Glover, *Solving Dilution Problems,* 51 Bus. Law. 1241, 1252-55 (1996) (same).

[68] Glover, *supra* note 67, at 1252-55. The binomial option price model assumes that over a period *t*, the price of the stock that underlies an option will move to one of two prices with a probability of *p* and *l-p*, respectively. It determines the value of an option to buy the stock at the end of period *t* with a specified exercise price by using a "replicating portfolio" approach. Specifically, the model determines the amount of common stock that an individual would have to purchase and the size of the borrowing at the risk-free interest rate that an individual would have to make at the beginning of the time period *t* to produce the same cash flow as the option at the end of the period *t*. By then valuing this portfolio of stock and borrowings, the model can determine the value of the option at the beginning of the period. *Id.* at 1252.

[69] *Monarch Cement Co. v. United States*, 634 F.2d 484, 485 (10th Cir. 1980).

[70] *Id.*

[71] *Id.* at 486; *Bridge*, 311 B.R. at 793.

[72] *Id.*