By R. Stephen McNeill and D. Ryan Slaugh

Are Two Caps Better than One?

An Analysis of the Interplay Between §§ 502(b)(6) and 503(b)(7)

R. Stephen McNeill
Potter Anderson & Corroon, LLP
Wilmington, Del.

D. Ryan Slaugh
Potter Anderson & Corroon, LLP
Wilmington, Del.

Stephen McNeill and Ryan Slaugh are associates in Potter Anderson & Corroon, LLP's Litigation Group in Wilmington, Del.

The bankruptcy case of *In re Energy Future Holdings Corp.* has generated a number of substantial disputes. While much of the controversy has involved make-whole, asbestos and confirmation issues, a less-publicized dispute involves the interplay between the lease caps found in §§ 502(b)(6)[1] and 503(b)(7)[2] of the Bankruptcy Code. Given the absence of case law on this topic, the U.S. Bankruptcy Court for the District of Delaware is faced with a unique opportunity to create foundational precedent on a multi-million-dollar issue.

Factual Background

The debtor, Luminant Generation Co. LLC, entered into a water rights lease with the City of Dallas on Feb. 23, 2011, which afforded Luminant the right to use up to 12,000 acre-feet of water per year from Jan. 1, 2011, to Dec. 31, 2050.[3] Luminant assumed the lease on Oct. 27, 2014, in advance of the § 365(d)(4) deadline.[4] On Oct. 14, 2015, the court entered an order authorizing Luminant to reject the lease *nunc pro tunc* to Sept. 22, 2015.[5]

Following the rejection, Dallas filed a rejection damages claim for $16,223,382.78, consisting of a $6,445,897.62 administrative claim under § 503(b)(7) and a $9,777,485.16 general unsecured claim under § 502(b)(6).[6] On Aug. 26, 2016, Luminant objected to Dallas's claim, seeking to reduce it to $5,910,226.06, consisting of a $4,053,043.84 administrative claim and a $1,857,182.22 general unsecured claim.[7] While Luminant also sought to estimate the claim and reduce it to present value,[8] this article focuses solely on the interplay between the statutory caps set forth in §§ 502(b)(6) and 503(b)(7).

General Application of the Landlord Claim Caps

Before discussing §§ 502(b)(6) and 503(b)(7) in depth, a quick review of their general application is warranted. Section 502(b)(6) provides, in relevant part, that a landlord's claim under a lease will be capped at

> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of — (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.[9]

Although the language of this section is somewhat difficult to parse, the application of the cap is quite simple, at least for courts that follow the "time-based" approach. In those jurisdictions, the cap is equal to one year's rent if the remaining term is less than 80 months (six years and four months), the rent for 15 percent of the remaining term if that term is between 80 and 240 months (20 years), and three years of rent if the remaining term is more than 20 years.[10]

In contrast, jurisdictions that follow the "rent-based" approach require the landlord to calculate 15 percent of the remaining rent, take the lesser of that number and three years of rent, then take the greater of that number and one year's rent.[11] The cap only differs under the two approaches where the rent price is not constant throughout the term of the lease.[12]

As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress enacted § 503(b)(7) to provide a separate cap on a landlord's administrative claim if a lease is rejected following an earlier assumption by the debtor. In relevant part, § 503(b)(7) sets a cap on the landlord's post-rejection administrative claim at

> equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of [two] years following the later of the rejection date or the date of actual turnover of the premises....[13]

Prior to the enactment of § 503(b)(7), courts offered competing interpretations of how § 502(b)(6) applies to cases involving real property

1 11 U.S.C. § 502(b)(6).
2 11 U.S.C. § 503(b)(7).
3 *In re Energy Future Holdings Corp.*, Case No. 14-10979, Objection of Energy Future Holdings Corp., *et al.*, to Proof of Claim 13319 Filed by the City of Dallas, ¶ 9 [D.I. 9409] (Bankr. D. Del. Aug. 26, 2016).
4 *Id.* at ¶ 14.
5 *Id.* at ¶ 15.
6 *Id.* at ¶ 16.
7 *Id.* at ¶ 17.
8 *Id.* at ¶ 21.
9 11 U.S.C. § 502(b)(6).
10 4 *Collier on Bankruptcy* ¶ 502.03[7][c], at 502-45 (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).
11 *Id.* at 502-44.
12 *Id.* at 502-45.
13 11 U.S.C. § 503(b)(7).

leases that had been assumed and subsequently rejected.[14] Espousing the majority view in *Klein*, the Second Circuit explained that two divergent policy concerns were at issue: "promoting parity among creditors" and "granting priority to the claims of creditors who continue to do business with an insolvent debtor."[15] Ultimately, the Second Circuit determined that the language of the statute favored the latter.[16]

Congress implemented § 503(b)(7) in an attempt to strike a balance between the policy concerns addressed in *Klein*. Accordingly, Congress capped the administrative claim available to the landlord at a maximum of two years of rent under § 503(b)(7) while also permitting the landlord to file an unsecured claim for the remaining rent, subject to the § 502(b)(6) cap.

Possible Reconciliation of the Two Caps

Although § 503(b)(7) was enacted to cap landlords' administrative claims, its final phrase provides that "the claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6)."[17] This invocation of § 502(b)(6) requires reconciliation of the two statutory caps to ensure a uniform application of the Bankruptcy Code. For example, § 502(b)(6) provides for a calculation running from no later than the petition date, but § 503(b)(7) starts its calculation no later than the rejection date.[18] Given this inconsistency, the only way to reconcile the two statutes in order to give them both meaning is to start the calculation of the "claim for remaining sums due ... under section 502(b)(6)" from the date of the rejection — not the petition date.

The analysis does not end there, however; the potential overlap between the two caps must also be addressed. One way to address the overlap is to follow the approach advocated by Luminant. Essentially, Luminant argued that the § 502(b)(6) amount should be calculated first, and then the first two years of that amount should be given administrative priority under § 503(b)(7) (the "Luminant approach").[19] To support its position, Luminant argued that, because the last clause of § 503(b)(7) is clearly ambiguous, the court should find in its favor based on policy considerations.[20] In particular, Luminant contended that the history of § 502(b)(6), the public policy of the Bankruptcy Code and the fact that a creditor cannot collect twice on its claim all support its interpretation.[21]

On the other side, Dallas argued that the text of § 503(b)(7) is unambiguous and requires the application of the § 502(b)(6) cap commencing two years following the rejection date (the "Dallas approach").[22] Dallas agreed with Luminant that the two-year period immediately following the rejection date was entitled to administrative priority. Given the remaining term of the water rights lease, the Dallas approach would require the payment of five full years of rent, with the first two years entitled to priority.[23]

The parties' positions both find support in *Collier's*, which acknowledges that no case has addressed the issue.[24] However, a third potential calculation is available based on the rules of statutory interpretation. This approach would still leave the landlord with an administrative claim equal to the first two years of rent following the rejection date under § 503(b)(7), but it would also start the § 502(b)(6) calculation at the rejection date (the "third approach"). Unlike the Luminant approach, the third approach would provide the landlord with a general unsecured claim for the full § 502(b)(6) amount, rather than a claim that has been reduced by the administrative portion.

The third approach may appear to be at odds with bankruptcy policy by providing a landlord with two separate claims for the same time period. However, because § 502(b)(6) only provides a cap on a claim and not the claim itself, the relevant calculation period could be interpreted to include the entire remainder of the lease, regardless of the administrative claim allowed under § 503(b)(7).

A similar situation arises in the context of unpaid post-petition rent. As explained in *Collier's*, because § 502(b)(6)(A) only provides for the calculation of a limit and not a claim, "any post-petition rent received ... is calculated by reference to the post-petition period just as a benchmark, not as a requirement that the debtor pay again for the same period."[25]

Comparing the Reconciliation Approaches

While all three approaches have some basis in the Bankruptcy Code or bankruptcy policy, they each potentially cap the landlord's unsecured claim at a different amount. Not surprisingly, the Luminant approach generates the smallest possible claim amount in all circumstances, which ultimately benefits the debtor's other creditors. Nevertheless, this approach is based primarily on bankruptcy policy, not a textual analysis of § 503(b)(7). Even if a court finds that § 503(b)(7) is ambiguous, the leap from using § 502(b)(6) to calculate the "remaining sums due" to an analysis that starts with the § 502(b)(6) cap and then subtracts two years of administrative priority might be too great for a bankruptcy court to adopt.[26]

The Dallas and third approaches are closely related and more consistent with the statutory language because they start with § 503(b)(7). However, they also reach different cap figures depending on the remaining term under the lease as of the rejection date and whether the rent is constant throughout the life of the lease. For example, where the remaining term of the lease is less than 20 years, the Dallas approach will generate a lower claim amount because two additional

14 *Compare In re Johnston Inc.*, 164 B.R. 551 (Bankr. E.D. Tex. 1994) (determining that because lessee had vacated premises, future rents were not necessary to preserve estate and therefore should not be given administrative priority), *with In re Klein Sleep Prods. Inc.*, 78 F.3d 18, 28 (2d Cir. 1996) (finding that proper construction of Bankruptcy Act required future rent of assumed lease to be treated as administrative expense, and therefore not to be limited by § 502(b)(6) cap).

15 *Klein*, 78 F.3d at 20.

16 *Id.* at 28.

17 11 U.S.C. § 503(b)(7).

18 *Compare* 11 U.S.C. § 502(b)(6) *with* 11 U.S.C. § 503(b)(7).

19 *In re Energy Future Holdings Corp.*, Case No. 14-10979, Objection of Energy Future Holdings Corp., *et al.*, to Proof of Claim 13319 Filed by the City of Dallas, ¶ 32 [D.I. 9409] (Bankr. D. Del. Aug. 26, 2016).

20 *Id.* at ¶ 34.

21 *Id.* at ¶ 36.

22 *In re Energy Future Holdings Corp.*, Case No. 14-10979, Response of the City of Dallas in Opposition to the Objection of Energy Future Holdings Corp., *et al.*, to Proof of Claim 13319, ¶ 49 [D.I. 9779] (Bankr. D. Del. Oct. 7, 2016).

23 *Id.* at ¶ 55.

24 4 *Collier on Bankruptcy* ¶ 503.14[2] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).

25 *Id.*, ¶ 502.03[7][c] at 502-45.

26 The Luminant approach would obviate § 502(b)(6) in situations where the remaining term is less than 13 years and four months and the rent is constant. In such a situation, the § 303(b)(7) administrative claim will exceed the § 502(b)(6) cap.

continued on page 56

from page 27

years of rent will be excluded from the 15 percent calculation. Conversely, if the remaining term of the lease is longer than 22 years and the rent price is constant, the claims will be the same because § 502(b)(6) would limit them to a maximum of three years' rent. Table 1 reflects the claim cap calculations for all three approaches under a hypothetical lease with $2,000 in monthly rent and 15 years remaining as of the rejection date.[27]

On the other hand, where the rent price increases over time, the Dallas approach should generate a larger claim where the remaining term exceeds 22 years because the three-year calculation period begins two years later (when rent is higher). When the remaining term is less than 20 years, however, the Dallas approach should still provide a lower claim amount, albeit one that is closer to the third approach.[28] Table 2 reflects the various claim cap calculations under this hypothetical, where the rent increases by 1 percent annually.

Due to the potential two-year swing, the differences between the Dallas and third approaches are most noticeable when the remaining term is between 20 and 22 years. Specifically, while the third approach will cap the claim at the same amount for any term beyond 20 years, the Dallas approach will not reach its maximum cap until a term of 22 years. Where the rent has increased over time, the Dallas approach generates a cap that eventually exceeds, the cap generated by the third approach. Table 3 shows a comparison of these two approaches where the initial rent is $2,000 per month and increased by 1 percent annually.

Conclusion

Regardless of the outcome of the dispute between Luminant and the City of Dallas, the final analysis of the relationship between §§ 502(b)(6) and 503(b)(7) is far from finished. The policy-based Luminant approach is most beneficial to the estate, while the Dallas approach is most beneficial to a landlord when the lease has more than 22 years remaining. The third approach is likely most favorable to the landlord in all other situations. While they await further guidance from the courts or Congress, landlords would be wise to crunch the numbers under all of these approaches to determine their most favorable option in the event of a distressed lessee. abi

27 As previously noted, the capped claim is identical under both the time- and rent-based approaches.

28 This is true because although the Dallas approach would still not include the first two years of rent into the § 502(b)(6) calculation, it still includes the later higher-rent periods, generating a higher claim than in a fixed-rent scenario.

Table 1: Claim Cap Calculations under a Hypothetical Lease

	Administrative Claim	Unsecured Claim	Total
Luminant Approach	$48,000	$6,000	$54,000
Dallas Approach	$48,000	$46,800	$94,800
Third Approach	$48,000	$54,000	$102,000

Table 3: A Comparison of the Dallas and Third Approaches

Remaining Term	Dallas Approach	Third Approach	Difference
20 Years (Time)	$72,722.40	$67,940.50	$4,781.90
20 Years (Rent)	$72,722.40	$72,032.41	$689.99
21 Years (Time)	$72,722.40	$72,102.91	$619.49
21 Years (Rent)	$72,722.40	$74,184.12	-$1,461.72
22 Years (Time)	$72,722.40	$74,184.12	-$1,461.72
22 Years (Rent)	$72,722.40	$74,184.12	-$1,461.72

Table 2: Various Claim Cap Calculations

	Administrative Claim	Unsecured Claim (Time-Based)	Unsecured Claim (Rent-Based)	Total (Time-Based)	Total (Rent-Based)
Luminant Approach	$48,240.00	$6,120.60	$9,708.82	$54,360.60	$57.948.82
Dallas Approach	$48,240.00	$49,209.62	$50,712.82	$97,449.62	$98,952.82
Third Approach	$48,240.00	$54,360.60	$57,948.82	$102,600.60	$106,188.82