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Delaying Rent Payment by Assisted Living and Skilled Nursing Facilities in Chapter 11

WRITTEN BY

Francis J. Lawall | Nikki L. Donofrio

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The lifeblood of any debtor operating in Chapter 11 is access to cash to maintain ongoing operations. This is particularly important in cases involving assisted living and skilled nursing facilities given the health, safety, and welfare concerns with respect to their residents. One of the most significant calls on cash involves post-petition rent obligations due on leased facilities. Under Section 365(d)(3) of the Bankruptcy Code, post-petition obligations with respect to leased “nonresidential real property” must be timely paid. While the code draws a distinction between residential and nonresidential real property, there is no explicit definition of “nonresidential,” thus creating difficult issues in certain health care cases.

In a recent decision, the U.S. Bankruptcy Court for the Western District of Pennsylvania tackled this problem in a Chapter 11 involving Guardian Elder Care at Johnstown, LLC, d/b/a Richland Healthcare and Rehabilitation Center. See *In re Guardian Elder Care at Johnstown,* No. 24-70299-JAD, 2024 WL 4799907 (Bankr. W.D. Pa. Nov. 15, 2024). At issue was whether a master lease to operate an occupied healthcare facility should be classified as “residential” or “nonresidential” real property under Section 365(d)(3). If the court determined that this was a lease for nonresidential real property, timely payment of post-petition rent would be required.

Guardian Care and its affiliates entered into a master lease agreement with a real estate investment trust involving several properties operated as personal care and nursing home facilities with approximately 1143 licensed beds and 950 residents. In July 2024, the debtors moved to either sell or otherwise transition their facilities to another buyer or operator without interrupting patient care. The debtors also sought authorization to use cash collateral and obtain debtor-in-possession financing to carry out the planned transactions. Although the landlords supported this plan and entered into new leases with the proposed buyers, they were concerned the DIP financing did not provide for the immediate payment of post-petition rent or other accrued charges under the master lease. The landlords argued that under Section 365(d)(3) those obligations should have been provided for in the DIP budget because their facilities were “nonresidential.”

During the DIP financing hearing, the court rejected the landlords’ objections as they had not filed a separate motion seeking immediate rent payment. The court approved the financing and suggested that the Section 365(d)(3) issue be addressed separately through a formal contested matter, which the landlords later did through a subsequent motion to compel.

Discussion

The *Guardian Care* court recognized that if a lease is deemed “nonresidential,” a trustee or debtor-in-possession must timely perform post-petition obligations under Section 365(d)(3). This also means that if the lease is found to be “residential,” although the rent will be an administrative claim, there is some flexibility as to the timing of payment which remains within the discretion of the bankruptcy court. See *In re Colortex Industries,* 19 F.3d 1371, 1384 (11th Cir.1994). In deciding such timing, a bankruptcy court has the goal of an orderly and equal distribution among creditors in order to prevent a race to the debtor’s assets. Distributions prior to plan confirmation are usually disallowed when the estate may not be able to pay the administrative expenses in full. See *In re Standard Furniture*, 3 B.R. 527, 532 (Bankr. S.D. Cal.1980).

To determine the type of property in question, the *Guardian Care* court looked first to the Bankruptcy Code, which does not provide a definition of “nonresidential” and then to Webster’s Third International Dictionary. In Websters, “nonresidential” is defined as “not residential” where “residence” is defined as “the place where one actually lives or has his home as distinguished from his technical domicile.”

Although one might expect that a straightforward reading of Section 365(d)(3) should resolve the issue, Congress left a gap in the code due to the missing defined term. In addressing this gap some courts have analyzed the question through either a “property test” or an “economic test.” See *In re PNW Healthcare Holdings,* 617 B.R. 354 (Bankr. W.D. Wash. 2020); *In re Passage Midland Meadows Operations*, 578 B.R. 367 (Bankr. S.D. W. Va. 2017). The *Guardian Care* court noted that “the property test looks to the character of the property itself while the economic test looks to the contractual intent behind the lease, in other words, asking if the lease is for commercial purposes or noncommercial purposes.” While the court acknowledged that the property test was more persuasive as it highlights substance over form, it went on to find that a “totality of the circumstances” test would actually be much more fitting, as it relies on no one decisive factor. This test allows the court to consider the specific nature of the leased property as well as its purpose, use and intent. In this case, the court found that the debtors’ properties, due to their long-term occupancy, qualified as residential.

Coupled with the totality of the circumstances test, is the legislative history, which also supports a determination that the debtors’ properties were residential. In 1984, Congress passed amendments to the Bankruptcy Code which created the distinction between residential real property leases and nonresidential real property leases. H.R. Conf. Rep. 98-882 (1984), as reprinted in 1984 U.S.C.C.A.N. 576, 598-99 (titling the section “Shopping Center Bankruptcy Amendments). Congress created this divide to “remedy serious problems caused to shopping centers and their solvent tenants by the administration of the Bankruptcy Code.” The legislative history makes it clear that Congress sought to avoid the imposition of financial burdens against landlords, however, these protections were limited to landlords in shopping malls and centers. If Congress had intended these protections to include mixed-use properties like the debtors’ facilities, they would have stated that or even defined the term “nonresidential” more broadly. The *Guardian Care* court therefore found that to broadly interpret “nonresidential” to include these facilities runs counter to the Supreme Court’s precedential approach to statutory construction. See *Harrington v. Purdue Pharma*, 603 U.S. –, 144 S. Ct. 2071, 219 L.Ed.2d 721 (2024).

The *Guardian Care* court further noted that public policy supports interpreting the master lease as residential, especially in a bankruptcy context. These care facilities serve a variety of individuals, with many being extremely at-risk. Disrupting care would be detrimental to both society and public health. These residents are dependent on these facilities to maintain a stable home while also being treated with personalized care. The master lease supports this reading as well as it highlights the property's identity as a place of residence throughout the agreement.

Characterizing these properties as residential also contributes to the debtors' ability to restructure effectively. If the lease was classified as "nonresidential," it would impose substantial cash flow pressures onto the debtors, which could impede their reorganization efforts as well as the operations of the facilities themselves, which would negatively impact resident care. When there are no immediate post-petition payment obligations on a debtor subject to a residential real property lease, there is more flexibility to maximize the value for all creditors and run the facilities.

It should be noted that even with a residential classification, the Bankruptcy Code still provides the landlords with protections. For example, Section 503(b) grants administrative expense priority for reasonable post-petition occupancy charges. The landlords can also seek stay relief pursuant to Section 362(d) if they suffer economic hardship because the debtor continues to use the facilities without making rental payments .

The *Guardian Care* decision joins several other courts around the country in attempting to clarify the question of what constitutes residential real property under Section 365(d)(3). By adhering to the goals of the Bankruptcy Code and following Supreme Courts statutory construction tenants, this court has created a commonsense approach supported by legislative history and public policy concerns.

Since the end of the pandemic, federal funds to support assisted living and skilled nursing facilities have been significantly reduced causing increased cash flow problems for many operators. As a result, when bankruptcy becomes the only option, the immediate payment of rent will be an important issue in these cases throughout the country.

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