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No Place Like Home: Treatment of SNF Leases Under § 365

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There are approximately 15,000 skilled nursing facilities (SNFs) in the U.S., which is a highly fragmented industry that has struggled with low reimbursement rates and high expense growth. Further exacerbating this challenging financial dynamic is the rise of the operating entity/property-owning entity (OpCo-PropCo) structure, in which the owner of the real property is a separate entity than the entity operating the SNF, and the proliferation of for-profit ownership in this important subsector of the health care ecosystem. Long-term leases, with fixed annual rate increases (generally ranging from 2-4 percent), contribute to the financial distress as in many states reimbursement rates, particularly for Medicaid, have failed to keep pace with the Consumer Price Index year over year.

The OpCo-PropCo structure has the added benefit of reducing the attractiveness of the skilled-nursing space to the plaintiff bar due to the fact that the primary asset in an SNF — its real estate — has been stripped away and is thus shielded from litigation attack in the context of wrongful-death suits. For many nursing homes, the lease between the PropCo landlord and OpCo tenant is the primary financial arrangement around which much of the decision-making revolves. Given the commercial nature of the operating entity, the protections afforded to residential leaseholds under the Bankruptcy Code would appear to be unavailable to the SNF OpCos. This article explores a contrary position that has recently emerged.

Relevant Code Provisions

In chapter 11 cases involving SNFs, addressing the facility leases is often a central component of the reorganization effort. The characterization of a lease as residential real property rather than nonresidential real property can have significant consequences, including determining the date by which a debtor must make the ultimate decision to retain or reject a lease that, in turn, establishes whether and when pre-petition defaults under the lease must be cured.

The rights and obligations of a chapter 11 debtor with respect to its real property leases are set forth in § 365 of the Bankruptcy Code. Section 365(d)(4) provides that a debtor/lessee has 120 days in which to assume an "unexpired lease of nonresidential lease of real property," after which it will be deemed rejected. The debtor may unilaterally seek to extend the initial period for an additional 90 days, but thereafter, no additional extension can be granted absent the lessor's consent. In complex cases requiring more than seven months to confirm a plan and without its lessor's agreement, a debtor might be required to prematurely assume a lease and risk significant administrative-expense exposure in order to avoid the deemed rejection of a lease that might be central to its reorganization efforts.

In addition, § 365(d)(3) requires that a debtor timely perform post-petition lease obligations, including continued payment of rent under an unexpired lease of nonresidential real property pending assumption or rejection. Thus, § 365(d)(3) and (4) might afford a lessor of nonresidential real property significant leverage in a debtor's chapter 11 case.

In contrast, in the case of a lease of *residential* real property, § 365(d)(2) provides that a debtor has until plan confirmation to assume or reject such lease unless the court orders otherwise. Moreover, the affirmative requirements to timely perform post-petition obligations set forth in § 365(d)(3) are not

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applicable to a lease of residential real property and provide meaningful cash-flow relief during the pendency of the case.

The *PNW Healthcare* Decision

In a May 2020 decision by the U.S. Bankruptcy Court for the Western District of Washington, Hon. **Mary Jo Heston** issued a memorandum decision holding that the leases of real property upon which the debtors operated SNFs constituted leases of residential real property to which § 365(d)(2) was applicable and §§ 365(d)(3) and (4) were inapplicable.[2]

The *PNW Healthcare* debtors operated a community of 15 residential SNFs and one assisted-living facility in three states. The debtors were sublessees and not prime tenants of the real property upon which the facilities operated. The bankruptcy court traced the evolution of § 365, including the 1984 legislative amendments to § 365(d) that led to the residential/nonresidential distinction, then applied principles of statutory construction to the phrase "lease of nonresidential real property" used in § 365(d).

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Judge Heston concluded that under such principles of statutory construction, and because the term "nonresidential" modifies "real property" and not a "lease," the character of the property at issue — not the character of the lease — dictates applicability of § 365(d)(3) and (4). Noting that the sublessors had understood and intended that the debtors would operate the leased properties as SNFs, that the underlying lease documents recognized the facilities' intended residential use and that most of the residents had lived at the facilities for more than two years, the bankruptcy court found that the character of the real property was residential.[3]

In focusing on the character of the real property rather than the character of the lease, the bankruptcy court adopted what has been referred to as the "property test," as opposed to focusing on the nature of the lease, an analysis that has been referred to as the "nature of the lease" or "income test." The property test construes the phrase "lease of nonresidential real property" narrowly, with the focus of the inquiry on whether the property is used for residential purposes.[4] On the other hand, the nature of the lease/income test focuses on the nature of the lease between the lessor and debtor/lessee.[5] Under the nature of the lease/income test, courts have interpreted "lease of nonresidential real property" to include leases that contemplate a commercial use of the property from the debtor's perspective, regardless of whether individuals reside thereon.[6]

2 *In re PNW Healthcare Holdings LLC, et al.*, Case No. 19-43754 (W.D. Wash. May 20, 2020) [Docket No. 526].
3 *Id.*
4 *See, e.g., In re Indep. Vill. Inc.*, 52 B.R. 715, 722 (Bankr. E.D. Mich. 1985).
5 *See, e.g., In re Sonora Convalescent Hosp. Inc.*, 69 B.R. 134 (Bankr. E.D. Cal. 1986).
6 *Id.* at 136.

Legislative History

The U.S. Supreme Court instructs that "[t]he plain meaning of legislation should be conclusive, except in 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'"[7] This has led courts to review the legislative history surrounding the addition of the residential and nonresidential qualifiers.[8]

Prior to 1984, § 365 contained no distinction between unexpired leases of residential property and unexpired leases of nonresidential real property, and the deadlines for lease assumption were based solely on the applicable bankruptcy chapter and the fundamental purposes of that chapter. In 1984, among other changes, Congress amended § 365(d)(2)-(4) of the Bankruptcy Code (the "1984 Amendments") to insert the adjective "residential" before "real property" in § 365(d)(2) and "nonresidential" before "real property" in § 365(d)(3) and (4).[9] As a result of the 1984 Amendments, the provisions of § 365(d)(3) and (4) now apply to "unexpired lease[s] of nonresidential real property."

The 1984 Amendments to § 365(d)(4) added a 60-day deadline for a debtor to assume unexpired leases of nonresidential real property, although, until 2005, the bankruptcy court had discretion to extend the 60-day deadline.[10] The addition of this deadline created a deadline specific to debtors/lessees of nonresidential real property.[11] The 1984 Amendments purported to address issues faced by retail shopping center landlords and surrounding tenants when one tenant files for bankruptcy and its space remains vacant for an unlimited pre-rejection period.[12] The focus of the 1984 Amendments on issues relating to shopping center tenant bankruptcies resulted in the amendments being referred to as the "Shopping Center Amendments."[13]

Case Law

The majority of bankruptcy courts considering the interpretation of "lease of nonresidential real property" under § 364(d) have concluded that the nature of the property (*i.e.*, the property test), and not the nature of the lease, is determinative.[14] This is also true outside of the context of SNFs. In *In re Care Givers*, the court found that the

7 *United States v. Ron Pair Enters. Inc.*, 489 U.S. 235, 242, 109 S. Ct. 1026, 1031 (1989) (quoting *Griffin v. Oceanic Contractors Inc.*, 458 U.S. 564, 571, 102 S. Ct. 3245 (1982)).
8 *See, e.g., In re Care Givers Inc.*, 113 B.R. 263 (Bankr. N.D. Tex. 1989); *In re Indep. Vill. Inc.*, 52 B.R. 715 (Bankr. E.D. Mich. 1985).
9 Pub. L. No. 98-353, § 363, 98 Stat. 333 (1984).
10 *Id.*
11 *Id.*
12 *In re Care Givers*, 113 B.R. at 266-67 (citing 130 Cong. Rec. S. 8890-95 (daily ed. June 29, 1984), *reprinted in* 1984 U.S. Code Cong. & Ad. News 576, 599 (statement of Sen. Orrin Hatch)).
13 *See Boyle Ave. Props. v. New Meatco Provisions LLC (In re New Meatco Provisions LLC)*, 2014 WL 2446314, at *9 (B.A.P. 9th Cir. May 30, 2014) (noting that 1984 Amendments to § 365(d) are "commonly known as the 'Shopping Center Amendments'"); *In re Morregia & Sons Inc.*, 852 F.2d 1179, 1185 (9th Cir. 1988).

debtor's leases of six nursing homes constituted leases of residential real property. Adhering to the principle that where the statute's language is plain, the court's sole task is to enforce it according to its terms, the court reasoned that an interpretation that focuses on the nature of the lease, rather than the use of the property, cannot be grammatically reconciled with the statute's language.[15] In reviewing the legislative history of the Shopping Center Amendments, the court found that there was nothing that contradicts the plain language of the statute in which "nonresidential" modifies "property."[16]

Notwithstanding that the majority of cases have utilized the property test, other courts have relied on the income/nature-of-the-lease test. In *In re Passage Midland Meadows Operations LLC*,[17] the court reasoned that the purpose for which the debtor/lessee intends to use the property is relevant, relying on language found in §§ 362(b)(10), 365(c)(3) and (d)(4)(A), and 541(b)(2) of the Bankruptcy Code, which specifies that the lease at issue is the lease where the debtor is the lessee. This statutory language indicates that the debtor's intended use as a lessee under the lease is also relevant.[18]

Bankruptcy Implications

Seeking a determination that a lease constitutes one of residential real property could provide a chapter 11 debtor with numerous practical and tactical advantages. Perhaps the most important benefit is the additional time afforded to the debtor to make the critical determination of lease assumption, which carries with it the obligation to cure potentially significant monetary defaults in short order. A debtor seeking such a determination should ensure that the deadline to assume or reject does not expire pending such a determination. In the event that the bankruptcy court determines that the property is nonresidential, the expiration of the deadline will result in a deemed rejection.[19]

The significance of the financial implications depends on the specifics of any given case. Finding that a lease is of residential property eliminates the statutory requirement of § 365(d)(3) that the debtor pay rent pursuant to the lease terms.[20] Should a chapter 11 debtor decide to argue that its lease is residential, it could withhold rent payments until the bankruptcy court determines whether the lease is residential or commercial. Nonpayment of interim rent may materially impact the debtor's available cash flow for operations depending on the magnitude of the rent expense, length of time that rent is withheld and whether the court requires adequate protection in the form of an escrow account.

Temporary suspension of rent payments might also have adverse effects on the lessor and/or sublessor. A debtor's deferred rent payments could cause cash-flow pressure for a lessor or sublessor that has mortgaged the property and meet its own mortgage obligations. Particular caution must be taken with regard to mortgage loans held by the U.S. Department of Housing and Urban Development due to the potentially severe repercussions for both borrowers and operators in a default. In addition, if the rent deferral is nonconsensual and extends for several months, a lessor could be required to record a bad debt reserve, convert to cash basis and/or evaluate whether asset impairment is required based on factors such as organizational structure, reporting requirements by the U.S. Securities and Exchange Commission, and internal accounting policies. Financial implications may differ on a tax-versus-book basis depending on individual circumstances.

In *PNW Healthcare*, the lease-obligation expense for the real property in question represented, on average, 8 percent of total operating disbursements and was one of the largest operating expenses after employee payroll and benefits.[21] Had the debtors not expeditiously reached a consensual reorganization plan, the lessors and sublessors could have been faced with millions of dollars in deferred rental income and potentially severe financial distress of their own. The debtors' plan, providing for full recovery to general unsecured creditors and assumption of the real property lease obligations, was ultimately confirmed. abi

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14 Cases in the long-term care facility context adopting and/or utilizing the property test include *In re Memory Lane of Bremen LLC*, 535 B.R. 901, 905 (Bankr. N.D. Ga. 2015); *In re Texas Health Enters. Inc.*, 255 B.R. 181 (Bankr. E.D. Tex. 2000); *In re Care Givers*, 113 B.R. 263 (Bankr. N.D. Tex. 1989); *In re Indep. Vill. Inc.*, 52 B.R. 715 (Bankr. E.D. Mich. 1985). Cases outside of the skilled-nursing context include *In re Michael H. Clement Corp.*, 446 B.R. 394, 404-06 (Bankr. N.D. Cal. 2011); *In re Bonita Glenn*, 152 B.R. 751, 753-54 (Bankr. S.D. Cal. 1993); *In re Lippman*, 122 B.R. 206 (Bankr. S.D.N.Y 1990); *In re Terrace Apartments*, 107 B.R. 382 (Bankr. N.D. Ga. 1989).

15 113 B.R. at 266.

16 *Id.*

17 578 B.R. 367 (Bankr. S.D. W.Va. 2017).

18 *Id.* at 379-80.

19 11 U.S.C. § 365(d)(4).

20 Nonetheless, upon cessation of such payments, a debtor should be prepared for a motion by the lessor seeking immediate payment of their administrative rent pursuant to § 503(b)(1) of the Bankruptcy Code and/or adequate protection in the form of the monthly payments pursuant to § 363(e) of the Bankruptcy Code. A debtor should also bear in mind that upon plan confirmation, with the exception of a chapter 11 filed as a subchapter V bankruptcy, § 1129(a)(9) of the Bankruptcy Code requires that any administrative expense claim incurred with respect to nonpayment of rent be paid in full.

21 *See In re PNW Healthcare* at Docket No. 18.