

Bankruptcy court looks to “totality of the circumstances” regarding payment of post-petition rent

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DECEMBER 12, 2024

In *Erie Acquisition, LLC v. Guardian Elder Care at Johnstown, LLC* (*In re Guardian Elder Care at Johnstown, LLC*), No. 24-70299-JAD, 2024 WL 4799907, _ B.R. _ (Bankr. W.D. Pa. Nov. 14, 2015), the Pennsylvania bankruptcy court applied a newly stated “totality of the circumstances” test in considering whether a property constitutes “nonresidential real property” for purposes of Section 365(d)(3) of the Bankruptcy Code.

The distinction is important because Section 365(d)(3) requires the immediate payment of post-petition rent and expenses for “nonresidential real property” but not “residential real property.”

Background

The debtors were in the business of operating health care facilities for patient occupancy. Pursuant to a master lease between the debtors and their landlords, the debtors operated several “personal care homes and skilled nursing facilities” located throughout Pennsylvania. Post-petition, there were over 1,100 “resident beds” and approximately 950 patients who actually resided at the debtors’ facilities.

Post-petition procedural history

The debtors filed for Chapter 11 with the stated goal of either selling or otherwise transitioning the facilities to another buyer or operator, while simultaneously ensuring that patient care remained uninterrupted.

After the debtors sought approval to use cash collateral and obtain debtor-in-possession financing without budgeting for ongoing payment of rent, the landlords filed a motion pursuant to Section 365(d)(3) to compel the debtors to make immediate payment of the amounts allegedly owed by the debtors to the landlords under the master lease.

The debtors had argued that (i) the landlords were not entitled to seek the “immediate payment of rent” under Section 365(d)(3) because the properties did not involve “nonresidential property;” and (ii) the landlords were only entitled to a right to seek reasonable occupancy charges as an administrative expense under Section 503(b) of the Bankruptcy Code, which could be deferred until confirmation of a to-be-filed plan of reorganization.

The court denied the motion, finding that, under the totality of the circumstances, the properties were residential in nature.

Therefore, Section 365(d)(3) did not apply because it only applies to “nonresidential” — i.e., commercial — property.

Whether the skilled nursing facilities count as a ‘nonresidential real property’ for purposes of Section 365(d)(3)

Section 365(d)(3) provides that a debtor “shall timely perform all the obligations of the debtor ... arising from and after [petition date] under any unexpired lease of **nonresidential real property**, until such lease is assumed or rejected ...” (emphasis added).

The court adopted a “totality of the circumstances” test to determine whether a lease is for property that is “nonresidential” or “residential” in nature.

The term “nonresidential” is not defined in the Bankruptcy Code. Thus, the court concluded that there was a “gap in the statute.” To fill this gap, the court analyzed whether skilled nursing facilities were “nonresidential real property” by: (i) applying the dictionary meaning of nonresidential; (ii) considering the “property test” as well as the “economic test” utilized by other courts; and (iii) then analyzing the “totality of the circumstances” — ultimately landing on the totality of circumstances as the applicable test.

The dictionary meaning of nonresidential

The court observed that the term “nonresidential” is defined as “not residential” in the dictionary. The term “residential” derives from “residence,” which is defined as “used, serving, or designed as a residence” or “the place where one actually lives or has his home as distinguished from his technical domicile,” and “a temporary or permanent dwelling place, abode, or habitation to which one intends to return, as distinguished from a place of temporary sojourn or transient visit.”

Based on this definition, the court easily concluded that “[s]killed nursing facilities and personal care homes clearly fit within this plain and commonly understood meaning of what a ‘residence’ is.” That is because the debtors’ patients “reside in these facilities for periods

far longer than an inconsequential ‘temporary sojourn or transient visit.’” Moreover, the debtors’ facilities served a dual purpose of “providing necessary healthcare while simultaneously functioning as the patients’ place of dwelling and habitation.”

The ‘property test’ and the ‘economic test’

The court recognized that many other courts apply the “property” and “economic” tests in determining whether a property is “nonresidential real property.” Under the “property test,” a court “looks to the character of the property itself.”

Under the “economic test,” a court “considers the contractual intent behind the lease (that is, whether the lease is for commercial purposes or whether the lease is for non-commercial purposes.”

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The court observed that both tests “present limitations when applied to facilities that serve as both residences and business enterprises” and ignore “the human factual element germane to the leasehold.” In particular, the “economic test” focuses “too narrowly on financial purposes of a lease” and, therefore, “undervalues the fact that these facilities ... serve as places of residence for patients within the confines of the premises.” Likewise, the “property test,” “fails to account for the unique fusion of commercial purpose and personal residency that can arise in some cases.”

The court found that if it were “constrained” to select between the two tests, it would apply the “property test.” While the patients were not strictly tenants, “[f]or all intents and purposes, the patients reside at the leased premises” because “their lives are embedded within the walls of the facilities.”

The ‘totality of circumstances’ test

Due to the property test’s and economic test’s shortcomings and the absence of “mandatory authority,” the court adopted a “totality of the circumstances” test to determine whether a lease is for property that is “nonresidential” or “residential” in nature.

The court noted that courts consistently employ a totality of the circumstances test to interpret and apply terms of art within the Bankruptcy Code, which allows the court to engage in a “fact-specific analysis consistent with the text of the applicable statute.”

The court found that considering the totality of circumstances captured the “nuances of mixed-use properties, such as healthcare facilities that house residents while generating revenue, require a comprehensive assessment that captures the property’s purpose, use, and intent.”

The factors to be considered in determining the totality of circumstances include:

- The primary use of the property;
- The intended purpose as expressed in the lease agreement;
- The nature of occupancy by residents;
- Applicable regulatory requirements;
- The economic and commercial aspects of the lease;
- The relationship between the residents and the property; and
- The legislative history and statutory interpretation of Section 365.

The court applied these factors and concluded that the properties were residential. In particular:

- The properties function as homes rather than mere commercial enterprises.
- The master lease contemplated the residential purpose, describing the facilities as skilled nursing facilities or “primary care homes,” and referencing “resident” occupancy throughout.
- The legislative history supported a finding that Section 365(d)(3) was intended to cover retail spaces and similar businesses in shopping centers, but not mixed-used properties like those at issue.
- Finally, the court considered the “leverage” that a landlord would have over a debtor if the landlord could compel the immediate payment of all post-petition rent and charges for these types of mixed-used properties, finding that treating the properties as “nonresidential” would constrain the debtor’s ability to “allocate financial resources strategically and prioritize patient care, staffing, and regulatory compliance.”

Thus, the properties were “residential” for purposes of Section 365(d)(3) and the landlords were not entitled to the immediate payment of all post-petition rent and charges.

Takeaways

Guardian Elder Care is a reminder that bankruptcy courts are courts of equity and will attempt to reach outcomes that are fair and equitable based on the unique circumstances of the cases before them.

The decision is also a reminder that while bankruptcy courts are bound by the same Bankruptcy Code, they may fill gaps in the statute in different ways. Here, the court filled a gap in the statute by adopting a totality of circumstances test and rejecting the tests previously adopted by other courts on this issue. Other courts may also adopt this approach when deciding whether to compel rent payments under this section in future cases.

Bethany D. Simmons and Noah Weingarten are regular, joint contributing columnists on bankruptcy law for Reuters Legal News and Westlaw Today.

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This article was first published on Reuters Legal News and Westlaw Today on December 12, 2024.