American Bankruptcy Institute

How Do Courts Analyze Whether Senior Living, Other Health Care Facilities Qualify as Residential vs. Nonresidential Real Estate for Purposes of § 365(d), and Is There a Trend?

Section 365(d) of the Bankruptcy Code draws a clear distinction between residential and nonresidential leases, and those distinctions can impact a debtor's rights. For example, § 365(d)(3) requires timely performance of post-petition obligations arising from "any unexpired lease of nonresidential real property," and under § 365(d)(4), "an unexpired lease of nonresidential real property under which the debtor is the lessee" is deemed rejected if it is not assumed or rejected by the earlier of 120 days from the filing date or the date a plan is confirmed (subject to provisions permitting limited extensions). Residential leases are not subject to these requirements.

However, § 365(d) does not define the terms "residential" and "nonresidential." As a result, courts have relied on two substantially different approaches to determine whether a lease is residential or nonresidential for the purpose of § 365(d). In this article, we will discuss the two approaches — the "property test" and the "lease test" — and how courts have classified senior living and other health care facilities under each one. Further, we will discuss an alternative approach recently suggested by the U.S. Bankruptcy Court for the Western District of Pennsylvania — the totality-of-the-circumstances analysis — which appears more suitable for dual-purpose facilities like senior living and health care facilities.

Property Test

The property test is the approach adopted by the majority of courts. It focuses on the nature of the leased property and whether people, not necessarily the debtor, reside on such property in determining whether a lease is residential or nonresidential real estate for the purpose of § 365(d).[1] Courts applying the property test find it most consistent with the language of § 365(d), its usage in the broader context of § 365, and the legislative history of the 1984 and 2005 amendments of the Bankruptcy Code.[2] The court in *PNW Healthcare* emphasized that in § 365, the terms "nonresidential" or "residential" are used as adjectives to modify "real property," not "lease."[3]

The U.S. Bankruptcy Court for the Eastern District of Michigan in *In re Independence Village Inc*. concluded that a life-care facility for the elderly with more than 100 individuals residing in it was residential, even though it was not used as a residential property by the debtor or the trustee.[4] Following that decision, the U.S. Bankruptcy Court for the Eastern District of Texas in *In re Care Givers Inc*. found that § 365(d)(4) applies only to property that is wholly nonresidential.[5] The court in *Care Givers* concluded that nursing homes, which have both residential and nonresidential aspects, cannot be identified as nonresidential within the meaning of § 365(d)(4).[6] Under similar reasoning, courts in the Northern District of Georgia and the Eastern District of Texas found a long-term-care facility and nursing home to be residential for purposes § 365(d).[7]

Under the property test, because senior living and other health care facilities have residents residing in them, they often qualify as residential real estate — and thus avoid the requirements of nonresidential leases under § 365(d) — regardless of the parties' intent under the lease or whether the purpose of the facility is primarily commercial.

Lease Test

The lease test is a minority approach that focuses on the nature of the lease — whether the intent of the lease is to provide income for the commercial lessee.[8] This approach is also referred to as the economic test and the income test.[9]

The U.S. Bankruptcy Court for the Southern District of West Virginia emphasized that the precise purpose the lessee has for the property must be incorporated in the analysis of § 365(d) in order to give effect to the entirety of the debtor-focused statutory provision.[10] The court was concerned that the property test will inevitably lead to unnecessary complexities and unintended results.[11] For example, patients who may have no intention of becoming residents of the facilities would be treated by the property test as having such tenancy or interest.[12]

Rather than solely focusing on the fact that residents lived in the health care facilities at issue, the court considered the use intended by the debtor, which was as an investment for income-production as opposed to "setting up house."[13] Based on the debtor's clear commercial intent, the court concluded that the health care facilities were nonresidential for the purpose of

§ 365(d).[14] Based on similar reasoning, the U.S. Bankruptcy Court for the Eastern District of California determined that a hospital was a nonresidential property for purposes § 365(d)(4) — despite the fact that patients actually resided on the property — because of the contemplated commercial use of the property was clearly stated in the lease.[15]

Under the lease test, if the parties' commercial intent is clearly stated in the lease, senior living and other health care facilities may be more likely to be identified as nonresidential real estate for purposes of § 365(d).

Totality-of-the-Circumstances Analysis

Recently, the U.S. Bankruptcy Court for the Western District of Pennsylvania recognized the limitation of both the property test and the lease test when applied to facilities that serve a dual purpose as a residence and business enterprise, such as senior living and health care facilities. If the court was constrained by precedent to select between the two tests, the court found the property test more persuasive, as it focuses on the actual use of the premise and provides a conclusion more aligned with the plain language of the statute and the practical realities at hand.[16]

However, if controlling authority is absent on the issue, the court believed that a totality-of-the-circumstances analysis should be applied when determining whether a lease is "nonresidential" or "residential."[17] Factors to be considered under a totality-of-the-circumstances analysis include, but are not limited to: (1) the primary use of the property; (2) the intended purpose as expressed in the lease agreement; (3) the nature of occupancy by residents; (4) applicable regulatory requirements; (5) the economic and commercial aspects of the lease; (6) the relationship between the residents and the property; and (7) the legislative history and statutory interpretation of § 365.[18] Under either test, the property test or the totality-of-the-circumstances test, the court found that the property was residential.[19]

Conclusion

Under § 365(d), whether a lease is "residential" or "nonresidential" is a critical distinction, and which of the foregoing tests a court applies may have a substantial impact on the rights of lessors, lessees and other parties in health care bankruptcy cases.

---

[1] *In re PNW Healthcare Holdings LLC*, 617 B.R. 354, 362 (Bankr. W.D. Wash. 2020).

[2] *Id*.

[3] *Id*.

[4] *In re Indep. Vill. Inc.*, 52 B.R. 715, 722 (Bankr. E.D. Mich. 1985).

[5] *In re Care Givers Inc.*, 113 B.R. 263, 267 (Bankr. N.D. Tex. 1989).

[6] *Id*.

[7] *See In re Memory Lane of Bremen LLC*, 535 B.R. 901 (Bankr. N.D. Ga. 2015) (holding that senior long-term-care-facility leases are not nonresidential real property leases); *In re Texas Health Enterprises Inc.*, 255 B.R. 181 (Bankr. E.D. Tex. 2000) (concluding that nursing home leases are residential leases).

[8] *In re Passage Midland Meadows Operations LLC*, 578 B.R. 367, 378 (Bankr. S.D. W.Va. 2017).

[9] *See id*. (referring to "income test"); *In re Guardian Elder Care at Johnstown LLC*, 665 B.R. 270, 274 (Bankr. W.D. Pa. 2024) (referring to "economic test").

[10] *In re Passage*, 578 B.R. at 379-80.

[11] *Id*. at 380.

[12] *Id*. at 381.

[13] *Id*.

[14] *Id*.

[15] *In re Sonora Convalescent Hosp. Inc.*, 69 B.R. 134, 136 (Bankr. E.D. Cal. 1986).

[16] *In re Guardian Elder Care at Johnstown LLC*, 665 B.R. 270, 276 (Bankr. W.D. Pa. 2024).

[17] *Id*.

[18] *Id*. at 277.

[19] *Id*. at 278.

Committees

Real Estate

Bankruptcy Tags

Health Care

Real Estate

Gemma Jo
Maslon LLP; Minneapolis

Michael A. Rosow
Maslon LLP; Minneapolis

Links:

[1] https://www.abi.org/terms/committees/real-estate [2] https://www.abi.org/terms/journal-article-tags/health-care [3] https://www.abi.org/terms/journal-article-tags/real-estate [4] http://www.maslon.com/ [5] http://www.maslon.com/