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Healthcare Master Leases in Bankruptcy: Out of One, Many?

By Steven G. Horowitz, Jane VanLare, Joshua Panas, and Benjamin S. Beller*

Healthcare providers often lease a number of properties in multiple locations from large property owners, and these arrangements are often structured as so-called master leases which govern multiple properties. This approach can raise important issues in the bankruptcy context, where the debtor's ability to assume or reject unexpired leases can often play a crucial role in the debtor's reorganization efforts. The authors of this article discuss the issues.

As the healthcare provider industry increasingly shows signs of distress, the impact of potential healthcare bankruptcies will be felt not only by providers, but also by their landlords, often real estate investment trusts ("REITs"). Given the large amounts of capital required to acquire real estate, most providers have moved away from the pattern of owning and operating their facilities, choosing instead to deploy their capital on operational aspects of their business and lease facilities from companies which function solely as real estate ownership entities. Already, a number of healthcare provider bankruptcies and restructurings in 2017 and early 2018 either involved the restructuring of leases of a troubled healthcare provider as a key part of the reorganization (e.g., Adeptus Health Inc. renegotiating its leases with Medical Properties Trust;[1] Genesis Healthcare's restructuring of its master leases with Sabra Health Care REIT, Inc. and Welltower, Inc.;[2] and Orianna Health Systems' restructuring deal with its landlord Omega Healthcare Investors Inc. in bankruptcy),[3] or the takeover of

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[1] https://www.businesswire.com/news/home/20170404005882/en/Medical-Properties-Trust-Describes-Plans-Restructuring-Adeptus.

[2] https://globenewswire.com/news-release/2018/02/21/1373000/0/en/Genesis-Announces-New-Financing-Commitments-and-Provides-Updates-to-Previously-Announced-Restructuring-Plans.html.

[3] *See Declaration of Louis E. Robicheaux IV in Support of Chapter 11 Petitions and First Day Pleadings*, pp. 22–26, Dkt. No. 19, Case No. 18-30777 (Bankr. N.D. Tex.) (describing debtors'

equity ownership of a healthcare provider by its landlord through bankruptcy (e.g., the takeover of HCR ManorCare by Quality Care Properties).[4] This trend is likely to continue as companies try to right the ship by reducing their large expenditures on rent and other real estate operating costs.

Because of consolidation in the ownership of healthcare facilities such as hospitals and nursing centers, an increasing proportion of such real estate is held by larger entities, especially publicly traded REITs which specialize in owning such facilities, the largest of which include Ventas Inc., HCP Inc., Healthcare Trust of America Inc., Senior Housing Properties Trust, and Healthcare Realty Trust Inc., as well as several of the entities mentioned in the paragraph above. As a result, providers often lease a number of properties in multiple locations from such large property owners, and these arrangements are often structured as so-called master leases which govern multiple properties. This approach permits both landlord and tenant to achieve scale, spreads risk across multiple properties (though more often for the owner than the tenant) and provides the additional benefit of administrative ease. But it can also raise important issues in the bankruptcy context, where the debtor's ability to assume or reject unexpired leases (or renegotiate more favorable terms in its leases) can often play a crucial role in the debtor's reorganization efforts.

TREATMENT OF UNEXPIRED LEASES IN BANKRUPTCY UNDER SECTION 365

Section 365(a) of the Bankruptcy Code authorizes a debtor to assume leases that have favorable terms or are otherwise useful to the debtor in its pursuit of a reorganization[5] and to reject (essentially terminating and relieving the debtor of its remaining obligations) those leases that are not.[6] The threat of rejection can also provide the debtor with leverage over its landlords to renegotiate unfavorable lease terms, especially rent and term. Thus, the ability to reject those leases that are not necessary or desirable for the debtor's future operations

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negotiation of and entry into a restructuring support agreement with Omega Healthcare Investors Inc.).

[4] *See Declaration of John R. Castellano, Chief Restructuring Officer of HCR ManorCare, Inc., in Support of the Debtor's Chapter 11 Petitions and First Day Motions*, Dkt. No. 2, Case No. 18-10467 (Bankr. D. Del.) (identifying Quality Care Properties, Inc. as plan sponsor pursuant to a pre-petition plan sponsor agreement and describing the terms of the proposed plan).

[5] *See N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 528, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984) (noting that "the authority to reject an executory contract is vital to the basic purpose to a chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization.").

[6] 11 U.S.C. § 365(a).

grants the debtor flexibility in developing a restructuring plan.

Although the bankruptcy court must approve assumption or rejection of an unexpired lease pursuant to Section 365(a), courts generally defer to a debtor's business judgment in such instances such that, typically, there are minimal limitations on the debtor's ability to exercise its assumption and rejection rights.[7] However, one important restriction on such exercise is that the debtor cannot pick and choose whether to assume or reject individual provisions of a single lease, but rather must assume or reject a lease as a whole.[8] While generally it is clear from the face of the agreement whether it constitutes a single "unitary" lease, answering that question may be significantly more complicated when the tenant leases multiple properties from one landlord pursuant to a master lease. Courts have consistently held that simply having one document reflecting the parties' agreements does not mean there is only one contract for purposes of the debtor's rights to assume or reject.[9] As a result, an agreement styled as a master lease may be legally viewed as "severable" into a collection of leases and instead treated as multiple leases, usually one for each subject property. Since any master lease inevitably includes properties that, from the debtor's perspective, are lower or higher performing, a debtor may be motivated to assert that its master lease is severable so that it can assume leases on better properties and reject them on worse properties. By contrast, landlords typically argue that the master lease is non-severable.

MASTER LEASE STRUCTURES IN THE HEALTHCARE INDUSTRY

Although bankruptcy law determines whether a debtor may assume or reject an unexpired lease under Section 365(a), bankruptcy courts have consistently held that the severability of the master lease is governed by the terms of the lease and the applicable state law governing that agreement.[10] Master leases are

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[7] *See, e.g., Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 29 C.B.C.2d 1341 (2d Cir. 1993).

[8] *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3d Cir. 1951); *see also In re Fleming Cos., Inc.*, 499 F.3d 300, 308 (3d Cir. 2007); *In re Hawker Beechcraft, Inc.*, 486 B.R. 264, 278 (Bankr. S.D.N.Y. 2013).

[9] *See, e.g., In re Buffets Holdings, Inc.*, 387 B.R. 115, 119 (Bankr. D. Del. 2008).

[10] *Id.*; *see also In re Adelphia Bus. Solutions, Inc.*, 322 B.R. 51, 55 (Bankr. S.D.N.Y. 2005) (holding that state law governs the interpretation of leases); *In re Wolflin Oil, LLC*, 318 B.R. 392, 397 (Bankr. N.D. Tex. 2004). *But see In re Plitt Amusement of Washington, Inc.*, 233 B.R. 83, 846 (Bankr. C.D. Cal. 1999) (articulating a separate severability test under bankruptcy law, the "business establishment test," granting a debtor the right "to assume to reject a lease independently as to each business establishment that is property of the estate"). We have not

usually governed by a single state's law, except for certain procedural provisions. Generally, a court evaluating whether to read a master lease as a single unitary agreement or as an aggregation of multiple, independent agreements will consider a number of factors relating to the master lease's terms and the parties' intent. However, because state contract law varies to some extent across jurisdictions, the standard by which bankruptcy courts will evaluate the severability of a master lease (and therefore the likely outcome of such evaluation) will not be identical in all states.

Nevertheless, bankruptcy courts tend to agree on the types of provisions in a master lease that support treatment of the master lease as a single, unitary lease (as distinct from those which lean toward treatment as an aggregation of multiple leases). It is not necessary for a master lease to contain each of these provisions. In fact, the inclusion of provisions relating to several of such factors is inconsistent with how most sophisticated master leases are drafted. Below we discuss these provisions and where greater flexibility for the terms of the master lease may be warranted without defeating unitary lease treatment given the business justifications for the inclusion (or exclusion) of various provisions in a master lease.

An Expression of the Parties' Intent That the Master Lease is a Single, Indivisible Agreement with Respect to All Leased Properties[11]

Parties to a master lease may express their intent that the lease constitute a unitary agreement in a variety of ways and courts have not required specific language to do so. However, contract parties wishing to affirm such an intent should include language in the master lease that manifests the general intent for the lease to be non-severable (with limited exceptions as discussed below) and a statement that the parties would not have entered into the master lease but for such non-severability. Examples include:

- The parties agree that for the purposes of any assumption, rejection or assignment of this lease under 11 U.S.C. Section 365 or any amendment or successor section thereof, this is one indivisible and non-severable lease dealing with and covering one legal and economic unit which must be assumed, rejected or assigned as a whole with respect to all (and only all) the leased property covered hereby.[12]

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located any subsequent decisions that have addressed or applied the "business establishment test" since the *Plitt* decision.

[11] *See, e.g., Byrd v. Gardinier, Inc. (In re Gardinier, Inc.)*, 831 F.2d 974, 976 (11th Cir. 1987).

[12] *See* MEDICAL_PROPERTIES_TRUST_INC_Form_10-K_EX-10.30_2.29.2016.pdf, section 40.2(a) and "Statement of Intent" (affirming the parties' intent that the lease be treated as

- Except as otherwise expressly provided herein to the contrary and for the limited purposes so provided, this Lease is and the parties intend the same for all purposes to be treated as a single, indivisible, integrated and unitary agreement and economic unit. Lessee acknowledges that in order to induce Lessor to lease the Leased Property of each Facility to Lessee pursuant to this Lease and as a condition thereto, Lessor insisted that the parties execute this Lease covering all of the Facilities in a single, indivisible, integrated and unitary agreement and economic unit, and that but for such agreement Lessor would not have leased the Leased Property of the Facilities to Lessee under the terms and conditions set forth herein.[13]

The Same Expiration Date for All Properties Under the Master Lease; Tenant Renewal Right is Limited to the Master Lease as a Whole, Not Individual Properties[14]

Although courts typically find that providing different expirations or renewal rights for different properties points against finding a master lease to be a unitary agreement, there may nevertheless be certain business and practical reasons for such provisions, so that including such provisions would not heavily weigh toward a finding of severability. For example, a landlord does not want to be faced with a portfolio-wide vacancy that would result if the expiration of the lease of all properties occurs simultaneously, and a tenant similarly does not want to face the prospect of negotiating new leases or renewal terms for its entire portfolio of leased properties under a master lease, which can often contain hundreds of properties. A master lease will therefore frequently bundle a mix of leased properties into separate property pools within the master lease and stagger the expiration dates of each pool, though the number of properties per renewal bundle varies significantly in the market. For example, one master lease that was part of a recent transaction governed 90 properties which were broken down into nine renewal pools. In another example, a master lease governing 360 properties was bundled into four renewal pools of 90 properties each. The bundling of a diverse mix of properties (e.g., by geography, economic performance and other factors) in each pool means that the tenant's decision

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"one unitary, indivisible, non-severable true lease of all the Leased Property . . . not merely for convenient reference.").

[13] *See* HCP_INC._Form_8-K_EX-10.1._EXHIBIT_10.1_7.12.2011.pdf, section 46.1; *see also* OMEGA_HEALTHCARE_INVESTORS_INC_Form_8-K_EX-10.1_10.3.2008.pdf, section 1.1.2.

[14] *See, e.g., Moore v. Pollock (In re Pollock)*, 139 B.R. 938, 941 n.6 (B.A.P. 9th Cir. 1992) (finding different terms of relevant agreements to show a "separate and distinct character"); *Kopel v. Campanile (In re Kopel)*, 232 B.R. 57, 66–67 (Bankr. S.D.N.Y. 1999).

whether or not to renew a given bundle of good and bad properties will have a more limited impact as compared to a master lease without bundled renewal options, which creates the burden for both parties of evaluating and possibly dealing with a portfolio-wide expiration. One could argue that as long as the pools are only used for this purpose, the pools should not defeat unitary lease treatment. A diverse mix of properties within each pool could also be viewed by a court as a factor favoring unitary lease treatment because it emphasizes the parties' intent to avoid cherry-picking, especially if each pool contains a sufficient number of properties with different characteristics (as described above). However, renewal rights on a property-by-property basis would likely push this boundary too far and not support unitary lease treatment.

A Requirement That Base Rent Be Paid as a Lump Sum; No Allocation of Specific Rent Amounts to Individual Leased Properties[15]

Although courts have indicated that the allocation of a specific portion of master lease base rent among the master leased properties is a negative factor for unitary lease treatment, allocation of base rent among leased properties can be an important provision for several reasons and can therefore complicate the application of this factor.[16] For example, allocation of rents is critical for:

- recalculating rents if a facility must fall out of the lease due to casualty or condemnation (discussed below);
- in some cases, conducting proper operating lease accounting analysis;
- determining rent (e.g. fair market rent adjustments for renewed properties) if property pools are used as described above;
- proper application of lease severance rights (as discussed below); and
- proper application of profit sharing provisions to the extent that subleasing is permitted (as discussed below).[17]

Furthermore, the master lease will most likely be a triple net lease arrangement in which the tenant is paying property expenses directly, and such amounts will always be based on a property-specific allocation of rent. Rather

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[15] *See, e.g.*, *In re Convenience USA, Inc.*, 2002 Bankr. LEXIS 348 (Bankr. M.D.N.C. Feb. 12, 2002).

[16] *In re Buffets Holdings Inc.*, 387 B.R. at 121 (noting that there are many decisions finding non-severable contracts notwithstanding apportioned rent).

[17] In connection with a property-specific allocation of rent for such purposes, the master lease could emphasize that except for such purposes, the rent is a single, indivisible, integrated and unitary economic unit and that but for such integration the base rent payable under this lease would have been computed on a different basis.

than focusing on an allocation of rents, therefore, the critical question may be whether the aggregate amount of base rent is due and payable on each rent payment date and, relatedly, if the failure to pay such aggregate amount results in a lease-wide event of default (following applicable notice and cure).[18] If this basic test is satisfied, a separate allocation of rents may not support a finding of lease severability.

Absence of Provisions Permitting Termination of Individual Properties[19]

As evidence of a severable lease, courts have occasionally pointed to casualty and condemnation provisions permitting termination of a single property rather than the master lease as a whole. However, it would be unusual for a casualty or condemnation at a single property to permit termination of other properties under the same master lease, and no landlord or tenant would agree to such a provision. On the other hand, the landlord severance right, in which the master lease is completely severed as to an individual facility (removing all cross defaults and provisions related to the remaining master leased properties), is potentially a more challenging provision for unitary lease treatment. Such a severance right is a common landlord right in master leases designed to preserve landlord flexibility to dispose of and transfer assets to different bundles to facilitate financing and other transactions. The tenant's leasehold rights are maintained, but the tenant must start a new relationship with a different landlord (which may or may not be affiliated with the original landlord). It remains to be seen how much weight courts will give to such provisions in evaluating whether a master lease is a unitary or severable instrument.

Restrictions on the Tenant's Ability to Assign or Sublease Individual Properties[20]

A tenant's right to assign a master lease as to a particular property (rather than the master lease as a whole) would likely be treated in a manner similar to a tenant's right to sever a leased facility from the master lease. Although a landlord may have limited lease severance rights as discussed above, tenants typically are not given severance rights, in part because such a right could be detrimental to unitary lease treatment and landlords have more compelling

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[18] *In re Buffets Holdings Inc.*, 387 B.R. at 121 (finding that the limited provisions in the master lease that were not consistent with a unitary agreement were evidence that the parties intended unitary lease treatment subject only to a few well considered exceptions).

[19] *See, e.g.*, *In re Convenience USA, Inc.*, 2002 Bankr. LEXIS 348 (Bankr. M.D.N.C. Feb. 12, 2002).

[20] *See* 6A Norton Bankr. L. and Practice 2d § 157.12.

business rationales to sever properties from a master lease than tenants. Further, as a practical matter, the original tenant would not want an unrelated assignee to become a tenant under the master lease for a single property because the assignee's noncompliance with the master lease covenants could trigger a master lease default with respect to the original tenant's remaining properties.

Therefore, any assignment right would likely be as to the master lease as a whole, which supports unitary lease treatment. Another potential challenge to unitary master lease treatment is subleasing rights. There may be a number of reasons for a tenant's desire to sublease, including to address the tenant's space needs at a particular facility changing over time, the tenant desiring to put in place third party concessionaires or other ancillary operators at a facility, or the tenant needing to sublease to a licensed operator. In these arrangements, the tenant could therefore be viewed as simply addressing its facility-specific needs rather than taking a position on the severability of the master lease.

All Defaults, Even Those that are Property-Specific, Constitute an Automatic Master Lease Default and Require Termination of the Lease as a Whole[21]

If a default relates directly to a leased facility (for example, failure to repair), the landlord would typically have the right to terminate the master lease as to the defaulted property rather than being forced to terminate the lease as a whole. However, a court may not rely heavily on such flexibility as a factor pointing toward severability assuming most other defaults are master lease defaults as to the entire lease. For example, for the reasons discussed above, a failure to pay base rent is arguably a master lease default, not a property-specific default at the landlord's option. Nevertheless, the more property-specific defaults that permit a landlord to selectively terminate individual master leased properties, the greater the risk that the master lease could be treated as a severable instrument.

Economic Interdependence of the Lease Properties[22]

The economic interdependence of the leased properties may be another element considered by courts in evaluating whether such leases are severable,

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[21] *In re Convenience USA, Inc.*, 2002 Bankr. LEXIS 348 (Bankr. M.D.N.C. Feb. 12, 2002) (noting that under lease, if one property is condemned or destroyed, the entire lease is not terminated, and such provisions reflect an intent to have a divisible contract).

[22] *In re Karfakis*, 162 B.R. 719, 725 (Bankr. E.D. Pa. 1993) (identifying the central inquiry of economic interdependence as "whether the parties assented to all of the promises as a single whole, so that there would have been no agreement whatever if any promise or set of promises were struck out.").

although this prong is more often a factor in instances where the court evaluates whether a lease agreement is divisible from a related non-lease agreement (e.g. a franchise agreement). In some cases, interdependence is easy to establish. For example, the bankruptcy court in the *Karfakis* case analyzed whether a Dunkin' Donuts franchise agreement and the lease for the commercial space in which the franchise was operated were interdependent, concluding that they were because "one agreement is of no utility without the other" where the franchise agreement permitted the franchisee "to operate a specific Franchise Store at a specific location which is simultaneously leased to the Debtor/Franchisee by a Dunkin' Donuts affiliate as Lessor."[23] For master leases, however, this type of connection is not always clear. The leased properties may have a common operator which achieves business efficiencies, but in many cases a facility could theoretically fall out of a master lease without a disproportionate impact on the remaining facilities. Thus, this factor is not likely to be present (and may not be as relevant) in many healthcare master leases.

CONSEQUENCES AND CONSIDERATIONS FOR LANDLORDS AND TENANTS IN HEALTHCARE BANKRUPTCIES

As healthcare providers continue to face significant financial challenges and begin to explore restructuring options, those companies with large quantities of leases with the same landlord will likely begin to focus on their ability to renegotiate such leases. This trend has already begun, with a number of cases, including the ones mentioned above, revolving around the distressed company's real estate agreements. Crucial to a tenant's ability to renegotiate more favorable terms is whether its leases are bundled in a master lease and whether that master lease is likely to be subject to assumption or rejection as a whole under Section 365(a) in a bankruptcy case. As a result, landlords and tenants alike must be sure to review their master leases and related arrangements to understand prior to a filing how the lease is likely to be treated in the event of a bankruptcy.

The factors discussed above are just some of the key factual issues a court will evaluate in determining whether to view a master lease as severable. A court may also take into account any other evidence of the facts and circumstances demonstrating the parties' intent as to the severability of the master lease. In the end, if the master lease is read as a unitary agreement, then the debtor will not be able to cherry-pick properties to continue to use for its operations; if it is read as a collection of individual leases, a debtor will have much greater flexibility in deciding which leases it will assume or reject in furtherance of its reorganization.

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[23] *Id.*

Landlords and tenants in the healthcare space should also consider planning in advance to address a tenant's financial difficulties before a bankruptcy becomes the only option. If the master lease is likely to be treated as a unitary agreement, a landlord may be in a favorable negotiating position, given the restraint in bankruptcy on a debtor's ability to cherry-pick parts of an integrated lease. On the other hand, a debtor with a master lease likely to be characterized as a collection of leases may try to use its ability to cherry-pick in a bankruptcy case as leverage to renegotiate the master lease to obtain more favorable terms. Parties to master leases governing healthcare properties therefore should be prepared for such negotiations and understand their negotiating position to achieve the best outcome, whether that is to renegotiate the terms of the lease in the hopes of avoiding the tenant's bankruptcy filing or pursue a more aggressive approach in the event a bankruptcy case is commenced.