By Risa Lynn Wolf-Smith

Shedding Burdensome Restrictive Covenants in Real Estate Sales

Real property sales in bankruptcy are often saddled by burdensome restrictive covenants, a legally enforceable promise to do or not do something to a piece of real property. In essence, covenants are private agreements among landowners that dictate how a property can or cannot be used that are intended to "run with" the property from landowner to landowner.

Covenants can range from trivial to oppressive and come in all varieties: requiring land to be used for agricultural purposes; specifying setbacks a certain distance from property boundaries; limiting the height or number of stories of buildings; restricting rental of property; mandating certain types of businesses or prohibiting commercial use altogether; and/or requiring stucco, brick or a certain color of paint. In many cases, these covenants may reduce the value of the property to be sold or impede its sale altogether. However, a bankruptcy filing presents an opportunity to shed burdensome covenants, especially those that constitute unreasonable restraints on the alienation of the property. This article explores the circumstances under which a bankruptcy court may order a sale of real property free of these so-called equitable restrictions.

Risa Lynn Wolf-Smith
Holland & Hart LLP
Denver

Risa Lynn Wolf-Smith is a partner and chair of the Bankruptcy and Creditors' Rights Group at Holland & Hart LLP, a regional law firm with offices throughout the Rocky Mountain West.

General Treatment of Restrictive Covenants in Bankruptcy

A starting point in bankruptcy law is that real property may not be sold free and clear of recorded restrictive covenants, easements and other so-called "equitable servitudes" that run with the land.[1] This baseline rule relies on the principle that these types of property interests must be specifically enforced and that those who benefit from such "property interests" cannot be compelled to forego equitable relief.

In the often-cited *Gouveia v. Tazbir*, the Seventh Circuit Court of Appeals ruled that the debtor could not set aside a restrictive, reciprocal land covenant limiting property owners within a neighborhood to single-story residences.[2] The court reasoned that the interests of adjoining property owners were property rights that could not be extinguished in bankruptcy and that a monetary remedy would be inadequate.

However, the analysis of interests labeled as "restrictive covenants" or "restrictive easements" is not always so simple, and a court ought not abort its analysis of an agreement just because the parties have used the words "restrictive covenant." In many cases, a contract, even if recorded and labeled as a "restrictive covenant," might be something much more and might be susceptible to rejection as an executory contract or an interest for which a sale free and clear is warranted.

Rejection of Restrictive Covenants as Executory Contracts

Restrictive covenants, like restrictive easements, have traditionally been viewed as an encumbrance on a title. For a covenant to run with the land, the parties to the covenant must intend that it do so and the covenant must touch and concern the land.[3] Yet restrictive covenants are also contracts.[4] Moreover, land covenants come in two types: negative (or restrictive) and affirmative.[5] Affirmative covenants, which impose a duty on a landowner to perform an affirmative act in the future, are more narrowly construed, and the requirements for a covenant to run with the land are more strictly applied to affirmative covenants than negative covenants.[6] Further, affirmative covenants are disfavored in the law because of the fear that this type of obligation imposes an undue restriction on alienation or an onerous burden.[7]

For bankruptcy sales purposes, restrictive covenants may also be deemed executory contracts under the well-established "Countryman definition." Under that standard, an executory contract "is a contract under which the obligation of both the bank-

1 *See, e.g., Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994); *In re 523 E. Fifth St. Housing Pres. Dev. Fund*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987); *Skyline Woods Homeowners Ass'n Inc. v. Broekemeier*, 758 N.W.2d 376, 392 (Neb. 2008); *but see* Basil H. Mattingly, "Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy," 4 *Am. Bankr. Inst. L. Rev.* 431 (1996).

2 *Gouveia*, 37 F.3d at 295 (7th Cir. 1994); *but see In re Signature Development Inc.*, 348 B.R. 758 (Bankr. E.D. Mich. 2006) (authorizing sale free and clear of recorded covenants under 11 U.S.C. § 363(f)(5) where court could compel damages in lieu of equitable enforcement and where restriction is more like executory contract).

3 *Restatement (Third) of Property (Servitudes)* § 1.3 (2000).

4 *Wright v. State Farm Fire & Cas. Co.*, 2014 U.S. App. LEXIS 3155, *7 (restrictive covenant is private agreement between property owner and some other person interested in property); *In re Coordinated Fin. Planning Corp.*, 65 B.R. 711, 712 (B.A.P. 9th Cir. 1986) ("Covenants are promises to do or refrain from doing certain things relating to the use of land."). *See also Beineke Chem. Waste Mgmt. of Ind. LLC*, 868 N.E.2d 534, 538 (Ind. Ct. App. 2007) (restrictive covenants are defined as contracts between private parties who, in exercise of their constitutional right of freedom of contract, can impose whatever lawful restrictions upon use of their lands that they deem advantageous or desirable); *May Dep't Stores v. Montgomery County*, 702 A.2d 988, 997 (Md. 1997); *aff'd as modified sub nom.*, *Montgomery County v. May Dep't Stores Co.*, 721 A.2d 249 (Md. 1998) ("[C]ovenants were contractual obligations."); *Seabrook Island Prop. Owners Ass'n v. Pelzer*, 356 S.E.2d 411, 414 (S.C. 1987) ("Restrictive covenants are contractual in nature and bind the parties in the same manner as any other contract.").

5 *Restatement (Third) of Property (Servitudes)* § 1.3 (2000). *See also Hills v. Greenfield Village Homes Ass'n Inc.*, 956 S.W.2d 344 (Mo. Ct. App. 1997) (holding that affirmative covenant, as opposed to restrictive one, does not restrict use of land in question, but instead imposes duty on party to perform affirmative act).

6 *Midsouth Golf LLC v. Fairfield Harbourside Condominium Ass'n Inc.*, 187 S.E.2D 378, 385 (N.C. Ct. App. 2007); *McGinnis Point Owners Ass'n Inc. v. Joyner*, 152 S.E.2d 378 (N.C. Ct. App. 1999) ("Covenants [that] impose affirmative obligations on property owners are strictly construed.").

7 *Eagle Enter. Inc. v. Gross*, 349 N.E. 2d 816, 820 (N.Y. 1976).

rupt and other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing [the] performance of the other."[8] In *Gouveia*, the appellate court considered whether the covenant restricting neighborhood property to single-story residences constituted an executory contract. It observed that the covenant was not "the typical executory contract [in which] the Debtor's obligation is to do some affirmative act in the *future*" and that there was "nothing further to be done by either party, [as] the contract (if it be so characterized) was fully executed."[9]

However, other courts have treated restrictive covenants as executory contracts and permitted their rejection. For example, in *In re Coordinated Financial Planning Corp.*, the Ninth Circuit Bankruptcy Appellate Panel held that even though a recorded right of first refusal was a covenant running with the land and enforceable against the covenantors' successor-in-interest under California law, it was also an executory contract that was subject to rejection by the trustee.[10] Likewise, a restrictive-use covenant barring nightclubs that ran with the land was rejected by a chapter 7 trustee. Furthermore, the court held that § 365(h)(2) pre-empts all state remedies (an injunction, in this instance) for the breach of the restrictive-use covenant by the trustee and his successors.[11]

In another case, a right of first refusal contained in a recorded deed to property was rejected as an executory contract because it was deemed to be more in the nature of a personal contractual obligation.[12] Similarly, an easement in a document entitled "Well Lease and Easement" was determined to be a lease subject to rejection after an analysis of the "full economic substance of the transaction."[13] In short, whether a restrictive covenant is an "executory contract" for purposes of § 365 will be determined based on federal bankruptcy law — not state law. In addition, each contract must be analyzed based on its substance and individual characteristics and not just the labels assigned to it. Some covenants are executory, and some are not.

Sales Free of Restrictive Covenants under § 363(f)(1) and the Doctrine of Changed Circumstances

Section 363(f)(1) of the Bankruptcy Code permits a trustee or debtor in possession to sell property free and clear of an interest of another entity if applicable nonbankruptcy law permits the sale of the property free and clear of such interest. The doctrine of changed circumstances is recognized in most states to provide that a restrictive covenant may be determined to be unenforceable when circumstances have changed so that its enforcement no longer serves its intended purpose.[14] Further, under state law in most states, unreasonable restraints on the alienation of property are also unenforceable.[15]

Bankruptcy courts have adopted these state law doctrines to hold restrictive covenants unenforceable and to authorize sales free and clear of covenants under certain circumstances. Thus, in *In re Daufuskie Island Properties LLC*, a bankruptcy court determined that the trustee could sell the property free and clear of a repurchase right that was a restrictive covenant running with the land because the circumstances met the changed conditions doctrine under South Carolina law.[16] Further, the court opined that allowing the covenant to continue to block any proposed sale was an oppressive and unreasonable restriction, and was therefore unenforceable. In the same fashion, in *TOUSA*, a bankruptcy court authorized a sale free and clear of a restrictive covenant granting a property owner the right to insist that the debtor/developer not sell for a price of less than a certain minimum. The court reasoned that the restriction was an unreasonable restraint on the alienation of a property and that intervening circumstances rendered the covenant infeasible and unenforceable.[17]

Conclusion

Before jumping to conclusions based on the labels given to or contained in a contract, consider the true nature of the agreement in question. "Restrictive covenants" can in fact be rejected or extinguished under the right circumstances. Ask the following questions: Is the covenant more in the nature of an affirmative executory obligation than a restraint on the use of property? Have circumstances changed to make the covenant unreasonable, oppressive or a restraint on the alienation of the property?

If so, the restriction — even if it has been recorded and is intended to run with the land — may not be so ironclad after all. A bankruptcy sale free and clear of the restriction might not only be possible, but the best — or only — way to maximize the value of real property. abi

8 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984); *In re Johnson*, 501 F.3d 1163, 1174 (10th Cir. 2007); *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib.*, 872 F.2d 36, 39 (3d Cir. 1989).

9 *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994).

10 *In re Coordinated Fin. Planning Corp.*, 65 B.R. 711, 713 (B.A.P. 9th Cir. 1986).

11 *In re Arden & Howe, Assoc. Ltd.*, 152 B.R. 971, 976 (Bankr. E.D. Cal. 1993).

12 *In re Fleishman*, 138 B.R. 641, 644 (Bankr. D. Mass. 1992).

13 *In re Nevel Props. Corp.*, Bankr. No. 09-00415, 2012 Bankr. LEXIS 551 at *25 (Bankr. N.D. Iowa Feb. 17, 2012).

14 *Dunlap v. Beaty*, 122 S.E.2d 9, 15 (1961) (holding that under south Carolina law, when such significant change occurs with regard to servient property so as to render covenant valueless to covenantee and oppressive and unreasonable as to covenantor, it can be annulled, viewed as unenforceable, and determined ineffective and invalid); *Schneider v. Drake*, 44 P.3d 256, 261 (Colo. App. 2001) ("[A] court may exercise its equitable powers when a restrictive covenant no longer serves the purpose for which it was imposed or when the circumstances have changed and the enforcement would impose an oppressive burden."); *Zavislak v. Shipman*, 188; 362 P.2d 1053, 1055 (Colo. 1961) (holding that court may cancel restrictive covenants when they no longer serve purpose for which they were imposed); *Port St. Joe Dock & Terminal Railway Co. v. Maddox*, 191 So. 775, 116 (Fla. 1939) (holding that restrictive covenant relating to price floor on structural development would not be enforced because of certain changed circumstances).

15 *See, e.g., Iglehart v. Phillips*, 383 So.2d 610, 614-15 (Fla. 1980); *Malouff v. Midland Fed. Sav. and Loan Ass'n*, 509 P.2d 1240 (Colo. 1973).

16 *In re Daufuskie Island Properties LLC*, 2010 Bankr. LEXIS 5533, at *47-*55 (Bankr. D.S.C. 2010).

17 *In re TOUSA Inc.*, 393 B.R. 920, 924 (Bankr. S.D. Fla. 2008).