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On the Edge

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How Problem Easements Can Limit Sale Rights

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It is well settled in the bankruptcy context that a debtor in possession (DIP) may — in its attempt to reorganize or liquidate — reject a disadvantageous executory contract and may also sell property free and clear of all nondebtor interests. Indeed, §§ 365 and 363 of the Bankruptcy Code are among the two most powerful tools given a debtor, allowing it to pare, shape and mold its assets into a more valuable whole.

However, what if a debtor's efforts to shed itself of unneeded property could be hamstrung? What if a debtor was not allowed to reject a disadvantageous agreement, or could only sell property subject to certain restrictive interests in that property? Would those limitations challenge the debtor's efforts at reorganization or efficient liquidation? The answer is, "Absolutely." These theoretical limitations become very real when dealing with easements, covenants running with the land and other restrictive covenants. Failing to understand the effects of these types of interests can potentially derail a case — especially when it is centered around complex real-property transactions — and cost parties-in-interest significant value.

Can Easements and Other Restrictive Covenants Be Rejected?

Section 365(a) states, in part, that a DIP may, with the court's approval, "assume or reject any executory contract ... of the debtor."[1] The question remains whether an easement, covenant running with the land or other restrictive covenant constitutes an "executory contract." If so, they (along with their restrictions) can be rejected by a debtor. If not, a debtor or its successor might be stuck with their restrictions, and any detriment to asset values those restrictions might cause.

The question of whether an easement and other covenants that run with the land constitute an "executory contract" is largely settled. While the Bankruptcy Code fails to define what contracts may be considered "executory," most courts follow the well-known Countryman definition: An executory contract is one where "the obligation of both the bankrupt and the 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."[2] "The time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed."[3]

Generally speaking, courts have found that easements and other covenants that run with the land are not executory in nature because reciprocal duties are not owed; therefore, the agreements cannot be rejected pursuant to § 365.[4] However, the Seventh Circuit seems to have gone a bit fur-

1 11 U.S.C. § 365(a).

2 *See* Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973); *see also In re Murexco Petroleum Inc.*, 15 F.3d 60 (5th Cir. 1994); *In re Texscan Corp.*, 976 F.2d 1269 (9th Cir. 1992); *U.S. v. Floyd*, 882 F.2d 235 (7th Cir. 1989); *Sharon Steel Corp. v. Nat. Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3d Cir. 1989); *In re Speck*, 798 F.2d 279, 279-80 (8th Cir. 1986); *Gloria Mfg. Corp. v. Int'l Ladies Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984); *In re Chateaugay Corp.*, 130 B.R. 162, 164 (S.D.N.Y. 1991); *but see In re Magness*, 972 F.2d 689, 693 (6th Cir. 1992) (court looked to "functional approach" to determine whether contract was executory in nature).

3 *Glosser v. Maysville Reg'l Water Dist.*, 174 Fed. Appx. 34, 36 (3d Cir. March 9, 2009) (quoting *In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 240 (3d Cir. 1995).

4 *See Glosser v. Maysville Reg'l Water Dist.*, 174 Fed. Appx. at 38-39 (holding that easement created by deed, but never independently recorded or developed, did not constitute on executory contract because "outstanding duties" to record additional documentation in chain of title were "not material" and were "ministerial" in nature; thus, easement could not be assumed and assigned under § 365); *In re Copper Creek Estates-Grand Island LLC*, Case No. BK11-40496-TJM, 2011 Bankr. LEXIS 2666 (Bankr. D. Neb. July 8, 2011) (holding that builder who placed restrictive covenant on vacant lots in exchange for providing landowner with $1 million in financing had no ongoing obligations under agreement, and that agreement was not executory in nature; thus, restrictive covenant ran with land and could not be rejected through bankruptcy); *In re Three A's Holdings LLC*, 364 B.R. 550 (Bankr. D. Del. 2007) (holding that covenants, conditions and restrictions that governed and the limited lease ran with the land under California law, and any assumption and assignment of that lease to party that did not qualify as tenant under terms of covenants, conditions and restrictions would violate California law); *In re Arden & Howe Assocs.*, 152 B.R. 971, 976 (Bankr. E.D. Cal. 1993) (court found that tenant could not "shed restrictive use covenants except by vacating. If the debtor tenant wants to stay in possession of the property, it must assume the lease, including all restrictive use provisions").

ther in holding that even though "almost all agreements to some degree involve unperformed obligations on either side," restrictive covenants do not fall within the purview of § 365 because they grant a present right of enjoyment, are traditionally treated as running with the land and are often recorded "on the title of the encumbered property."[5] The Ninth Circuit Bankruptcy Appellate Panel (BAP) recently agreed with the Seventh Circuit's reasoning in *Gouveia v. Tazbir*, in which the court held that restrictive covenants were not "executory contracts" under § 365, even where they required the debtors to perform a number of duties, and required nondebtor landowners to keep their boats insured and abide by certain bylaws (all of which the court seemed to view as *de minimis* obligations).[6]

However, exceptions do exist. Recently, the U.S. Bankruptcy Court for the Northern District of Iowa considered whether a "Deep Water Well Lease — Water Line and Access Easement" was actually an easement subject to the provisions of § 365.[7] The court concluded that while the agreement was a "temporary easement," it was the "functional equivalent of a lease" and could be rejected pursuant to § 365. The court further concluded that rejection damages should be computed according to the "fair rental value methodology."[8]

Similarly, the Ninth Circuit BAP was tasked with determining whether a right of first refusal/purchase option that existed in an "ownership agreement" was an executory contract subject to a § 365 rejection or was a covenant running with the land.[9] The court found that (1) the right of first refusal was a "pre-emption agreement" under California state law, (2) such agreements "are consistently found to be covenants running with the land," (3) such "covenants are not a property interest but are viewed as physically attached to the land," and (4) such covenants are "enforceable against successors in interest" under contract law.[10] Despite this, the court stated that executory contracts were defined under federal, rather than state, law and — referencing a Florida case that held that a recorded options contract was executory — found that the right of first refusal qualified as an "executory contract" that could be rejected under § 365, even though it was a covenant running with the land.[11]

Can Property Be Sold Free and Clear of Easements under § 363(f)(1)?

While the majority of courts have found that a debtor may not reject an easement or covenant running with the land under § 365 of the Bankruptcy Code, this has not stopped debtors from attempting to sell property free and clear of such encumbrances through § 363(f)(1). The language of § 363(f)(1) is relatively clear: A trustee or DIP

> may sell property ... free and clear of any interest in such property of an entity other than the estate, only if
>
> 1. applicable nonbankruptcy law permits sale of such property free and clear of such interest.[12]

Unfortunately for debtors and prospective purchasers — but fortunately for those possessing these rights — many courts have shown a willingness to maintain covenants and other rights that run with the land in a § 363(f)(1) sale context, unless a party can demonstrate a specific state or federal law provision that mandates that they be released.[13] Even property interests not specifically labeled as "restrictive covenants" or "easements" have been determined by courts to "run with the land" and therefore be immune to effective dissolution under § 363(f)(1).

Recently, the Fifth Circuit found that a natural gas pipeline system could not be sold free and clear of an entity's right to transportation fees tied to the operation of the pipeline system and its consent rights to the sale or assignment of the pipeline because both were covenants that ran with the land.[14] The court in *Dundee Equity Corp.* also found that a settlement agreement between a property owner and a group of tenants to repair property that "touched and concerned the land" must be considered a covenant running with the land, and could not be disposed of through § 363(f)(1).[15]

Similarly, the court in *Pintlar Corp.* preserved ASARCO's right to deposit mining tailings into the rivers and waterways of the Coeur d'Alene River Valley — which it recognized was an essentially worthless right in light of current environmental laws forbidding such actions — absent a showing by the Environmental Protection Agency (EPA) that a law existed that specifically *severed* such rights from the property.[16] The Eighth Circuit views easement rights and other similar covenants as so inviolable that it recognized and supported a state court decision finding that a bankruptcy sale pursuant to § 363(f) could not have severed an implied covenant between the owner of the property and neighboring residents that the property be maintained as a golf course.[17]

However, some courts have been creative in finding that "nonbankruptcy law" authorizes the severance of a covenant. The U.S. Bankruptcy Court for the District of South Carolina recognized that under the doctrine of "changed circumstances" — wherein the property had deteriorated well past the point where the restrictive covenants could protect those holding that interest in the land — the restrictive covenants could be invalidated, and a sale free and clear of those covenants would be allowed pursuant to § 363(f)(1).[18] The U.S. District Court for the Western District of Missouri acted

5 *Gouveia v. Tazbir*, 37 F.3d 295, 299 (7th Cir. 1994).

6 *Water Ski Mania Estates Homeowners Ass'n v. Hayes*, 2008 Bankr. LEXIS 4668, at *29-*34 (B.A.P. 9th Cir. March 31, 2008).

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

8 *Id.* at *25-26.

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

10 *Id.* at 712-13.

11 *Id.* at 713 (citing *In re Waldron*, 36 B.R. 633 (Bankr. S.D. Fla. 1984)). The Ninth Circuit has since reversed a later decision stating that all options contracts were executory, but technically left intact the BAP's decision in *Coordinated Financial Planning. See Unsecured Creditors' Comm. v. Southmark Corp.*, 139 F.3d 702, 706 (9th Cir. 1998).

12 11 U.S.C. § 363(f)(1).

13 *Mancuso v. Meadowbrook Mall Co. Ltd. P'ship*, 2007 U.S. Dist. LEXIS 23308, at *29-30 (Bankr. N.D. W.Va. March 28, 2007) (holding that certain "use covenants" governing what type of restaurant and signage could be utilized on certain parcel of land were restrictions that ran with land, and that debtor could not sell property free and clear of these covenants pursuant to § 363(f)(1), even though purchaser attempted to show that covenants could be avoided under "nonbankruptcy law" governing eminent domain, and reasoning that "the mere possibility of eminent domain does not authorize a trustee sale free and clear under the narrow conditions listed in § 363(f)"); *In re 523 E. Fifth St. House Preservation Dev. Fund Corp.*, 79 B.R. 568, 574-75 (Bankr. S.D.N.Y. 1987) (holding that deed restriction requiring that property be used for low-income housing was a covenant that ran with land, and that property could not be sold free and clear of such restriction through § 363(f)(1)); *In re Inwood Heights Hous. Dev. Fund Corp.*, Case No. 11-13322 (MG), 2011 Bankr. LEXIS 3251(Bankr. S.D.N.Y. Aug. 25, 2011) (holding that debtor could not use § 363(f)(1) "to obviate compliance with any sale restrictions contained in the Deed" granted by city of New York to debtor, including restriction that property could not be sold for certain number of years without city's consent).

14 *Newco Energy v. Energytec Inc.*, 739 F.3d 215 (5th Cir. 2013) (holding that sale free and clear of these interests under § 363(f)(1) was not possible).

15 *In re Dundee Equity Corp.*, 1992 Bankr. LEXIS 436 (Bankr. S.D.N.Y. March 6, 1992).

16 *In re Pintlar Corp.*, 187 B.R. 680, 682 (Bankr. D. Idaho 1995).

17 *Mid-City Bank v. Skyline Woods Homeowners Ass'n*, 636 F.3d 467 (8th Cir. 2011) (stating Nebraska Supreme Court decision that property could not have been sold free and clear of implied covenant that it be maintained as golf course had preclusive effect on bankruptcy court, and bankruptcy court was within its discretion to refuse to reopen case to allow an attack on Nebraska Supreme Court decision).

18 *In re Daufuskie Island Props. LLC*, 431 B.R. 626, 642-45 (Bankr. D.S.C. 2010).

similarly in ruling that Missouri law would allow a trustee to sell real property free and clear of a life estate pursuant to § 363(f)(1), as long as certain proceeds from the sale were apportioned to the holder of that estate.[19] However, the trend toward creativity has not been extended to the doctrine of eminent domain, as the court in *Mancuso* specifically found that the latent threat of eminent domain, where no proceeding had been initiated, was insufficient to allow a sale under § 363(f)(1) because that possibility exists in almost every case, and at all times.[20]

How Can Parties Protect Themselves?

If courts in most jurisdictions find that easements, covenants that run with the land and other restrictive-use covenants cannot be rejected, and that property cannot be sold free and clear of such interests under § 363(f)(1), what is a debtor to do? Simply put, there is little that can be done if an easement or other similar covenant finds its way into an agreement and the party granting the interest ends up in bankruptcy. Property owners must proactively manage their restrictive covenant portfolio, work to limit those covenants in time and scope, or avoid granting them altogether. It appears that once one is granted, the only way to sever such interests may be through a mutual agreement of the parties.

Similarly, potential purchasers of property must be very proactive in performing due diligence prior to a § 363 sale proceeding. Performing thorough title searches and reviewing all deeds and other agreements related to the property — whether or not they are recorded — should be standard procedure for any entity attempting a § 363 purchase of real estate. The failure to discover an interest running with the land could have dire financial ramifications — as with the substantial transportation fee at issue in *Newco Energy*. In this sense, an ounce of prevention can really be worth a pound of cure. abi

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19 *In re Rose*, 113 B.R. 534, 538-39 (W.D. Mo. 1990).
20 *Mancuso*, 2007 U.S. Dist. LEXIS 23308, at *29-30.