THE LIMITATIONS OF SECTIONS 363(f) AND 365(a) IN SEVERING RESTRICTIVE COVENANTS FROM REAL PROPERTY

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I. Introduction

Two of the most powerful tools of the Bankruptcy Code[2] are found in sections 363(f) and 365(a), which allow debtors to sell property free and clear of non-debtor interests and reject unwanted executory contracts. Typically, a debtor's decision regarding the benefits of chapter 11 is made easier when the executory contract to be rejected is a lease of non-residential real property or the interest subject to a free and clear sale is a lien or mortgage. The analysis is more complicated when a debtor (or trustee) seeks to free itself of a restrictive covenant running with the land either by seeking its rejection or by attempting to strip the covenant off through a free and clear sale.

In general, a restrictive covenant imposes a restriction on the use of land so that the value and enjoyment of adjoining land will be preserved. Typically, obligations created by a set of covenants, conditions, and restrictions affecting real property run with the land. "To run with the land, a covenant must touch and concern land, which means it must affect the parties as owners of the particular estates in land or relate to the use of land."[3] The primary characteristic of a covenant running with the land is that both liability upon it, and enforceability of it, pass with the transfer of the estate.[4] "The benefits or burdens pass by implication of law rather than under principles of contract."[5] However, if the promise is merely a "personal covenant," in other words, one not fulfilling the requisites of a covenant running with the land, it is enforceable at law only against the original parties thereto.[6]

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[2] Unless stated otherwise, all chapter and section references are to title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (the "Bankruptcy Code").

[3] Anthony v. Brea Glenbrook Club, 58 Cal. App. 3d 506, 510, 130 Cal. Rptr. 32 (1976).

[4] *Id.* at 510.

[5] *Id.* at 510. *See also* Self v. Sharafi, 220 Cal. App. 4th 483, 488, 163 Cal. Rptr. 3d 71 (2013).

[6] Berryman v. Hotel Savoy Co., 160 Cal. 559, 573, 117 P. 677 (1911).

In California, Civil Code § 1461 provides that, "[t]he only covenants which run with the land are those specified in this title, and those which are incidental thereto."[7] "A covenant can run with the land under either [Civil Code] section 1462 or [Civil Code] section 1468."[8] Section 1462 provides, "[e]very covenant contained in a grant of an estate in real property, which is made for the direct benefit of the property, or some part of it then in existence, runs with the land."[9] In turn, section 1468 provides, "[e]ach covenant, made by an owner of land with the owner of other land or made by a grantor of land with the grantee of land conveyed, or made by the grantee of land conveyed with the grantor thereof, to do or refrain from doing some act on his own land, which doing or refraining is expressed to be for the benefit of the land of the covenantee, runs with both the land owned by or granted to the covenantor and the land owned by or granted to the covenantee and shall . . . benefit or be binding upon each successive owner, during his ownership . . . ."[10]

More specifically, in order for a court to find that a restrictive covenant meets the statutory definition of "running with the land," section 1468 "requires: (1) the benefited and burdened lands must be particularly described in the instrument creating the covenant, either a deed between the grantor and grantee or an agreement between landowners; (2) the covenantor's successors must be expressly bound for the benefit of the covenantee's land; (3) the covenant must concern the use, repair, maintenance, or improvement of the property or the payment of taxes and assessments and (4) the agreement must be recorded."[11] If, a debtor's real property is impressed with a restrictive covenant which meets the statutory definition, the question turns to whether a debtor's reorganization efforts or a trustee's efforts to maximize the value of property impressed with a restrictive covenant could be impeded by the limitations imposed by sections 365(a) and 363(f), or if there are circumstances under which a debtor or trustee can sever the restrictive covenant from the affected property.

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[7] CAL. CIV. CODE § 1461.

[8] *Sharafi*, 220 Cal. App. 4th at 488.

[9] CAL. CIV. CODE § 1462.

[10] CAL. CIV. CODE § 1468.

[11] Oceanside Cmty. Ass'n v. Oceanside Land Co., 147 Cal. App. 3d 166, 174, fn. 4, 195 Cal. Rptr. 14 (1983), *disapproved on other grounds*, Citizens for Covenant Compliance v. Anderson, 12 Cal. 4th 345, 906 P.2d 1314 (1995). When a covenant does not run with the land because one of the statutory requirements is lacking, a court may nonetheless enforce the covenant as an equitable servitude. B.C.E. Dev., Inc. v. Smith, 215 Cal. App. 3d 1142, 1146, 264 Cal. Rptr. 55 (1989). Equitable enforcement of covenants may be granted in the case of affirmative obligations as well as restrictions on the use of property. Relovich v. Stuart, 211 Cal. 422, 427, 295 P. 819 (1931).

II. Rejection of Restrictive Covenants as Executory Contracts Under 11 U.S.C. § 365(a)

Although the interpretation of a restrictive covenant may be governed by state law contract principles, under which courts try to effectuate the legitimate desires of the covenanting parties, whether a contract is executory within the meaning of the Bankruptcy Code is a question of federal law.[12] Although the Bankruptcy Code does not define "executory contract," courts have generally defined such a contract as one on which performance is due to some extent on both sides.[13] In considering an executory contract dispute, courts often begin their analysis with the oft-cited "Countryman" definition: "a contract is executory if the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other."[14]

Despite the fact that restrictive covenants may have certain hallmarks of a contract, numerous courts have rejected arguments that such covenants are executory contracts subject to rejection under section 365(a).

The leading decision illuminating the distinctions between an executory contract and a restrictive covenant is the Seventh Circuit's opinion in *Gouveia v. Tazbir*.[15] In *Gouveia*, the court of appeals directly addressed whether a restrictive covenant on real property was an executory contract that could be rejected in a bankruptcy case, or whether the covenant was, in fact, a property interest. The debtor in *Gouveia* owned property in a subdivision that had a reciprocal land covenant which limited the use of the property to single-family residences with only a single story in height and a private garage for no more than two cars. The restrictive covenants also provided that the restrictions were to run with the land and were binding upon all parties claiming an interest in the land in the subdivision. Much to the dismay of her neighbors, the debtor obtained permission from the city zoning commission to build a commercial music store on her residential property site. In response, the debtor's neighbors filed suit in state

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[12] Benevides v. Alexander (*In re* Alexander), 670 F.2d 885, 888 (9th Cir. 1982).

[13] NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522, n.6 (1984).

[14] Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439, 450 (1973) (quoted in Griffel v. Murphy (*In re* Wegner), 839 F.2d 533, 536 (9th Cir. 1988)). *See also* Zurich Am. Ins. Co. v. Int'l Fibercom, Inc. (*In re* Int'l Fibercom, Inc.), 503 F.3d 933 (9th Cir. 2007) ("contract is executory, and therefore assumable under § 365, only if one party's failure to perform its obligation would excuse the other party's performance.").

[15] Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994).

court seeking enforcement of the restrictive covenant. The state trial court found that the restrictive covenant was unenforceable. On appeal, the Indiana court of appeals found that the covenant was enforceable and remanded the case to the trial court with instructions for the debtor to be permanently enjoined from building the music store.[16]

Unable to operate the business and meet her financial obligations, the debtor filed for bankruptcy relief under chapter 11. The case subsequently was converted to chapter 7. Eventually, in an effort to monetize the property, the chapter 7 trustee filed a motion to reject the restrictive covenant pursuant to section 365. The bankruptcy court denied the trustee's motion, finding that the restrictive covenant was not an executory contract under the Countryman definition because neither the debtor nor her neighbors were obligated to do some affirmative act and, as a consequence, the restrictive deed covenant was, in fact, a fully executed contract.[17]

The Seventh Circuit reasoned that, although restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. As the court noted, although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting section 365. Thus, the court decided that restrictive covenants on real estate are not executory contracts subject to termination or assumption under section 365.[18]

Another example of a court refusing to permit the rejection of a restrictive covenant can be found in *Hayes v. Water Ski Mania Estates Homeowners Ass'n (In re Hayes)*.[19] In *Hayes*, the debtors purchased lakeside property which was subject to a series of restrictive covenants among the various homeowners limiting an owner's ability to use the lake and construct new residences. The restrictive covenants limited the use of the property, had provisions for assessments, and provided for the ongoing maintenance and repair of the surrounding area. Numerous disputes between the debtors and other homeowners

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[16] *Id.* at 297.

[17] *Id.* at 298.

[18] *Id.* at 298-99.

[19] Hayes v. Water Ski Mania Estates Homeowners Ass'n (*In re* Hayes), 2007 Bankr. LEXIS 3397 (Bankr. D. Mont. Oct. 3, 2007), *aff'd in part and rev'd in part*, Water Ski Mania Estates Homeowners Ass'n v. Hayes (*In re* Hayes), 2008 Bankr. LEXIS 4668 (B.A.P. 9th Cir. Mar. 31, 2008).

ensued, particularly once the debtors decided to sell their interests. The homeowners undertook actions severely impairing the debtors' ability to sell their real property. For example, even though the restrictive covenants provided for the homeowners to have a right of first refusal, the homeowners, rather than merely stating whether they would match the offered price, made demands upon the debtors for additional documentation that is not generally made available under a first right of refusal. In addition, the homeowners made it clear to the debtors that they would frustrate their efforts to enforce the bylaws referenced in the restrictive covenants limiting the homeowners' use and enjoyment of the lake. The debtors then filed an adversary proceeding against the homeowner collective.

In addition to arguing that the restrictive covenants were invalid because they did not meet the necessary requirements for a covenant, the debtors argued that the covenants, if valid, could be rejected as an executory contract. In response, the homeowners contended that the restrictive covenants were valid as they constituted property rights which belonged to the homeowners association and, as such, could not be avoided or rejected in the debtors' case. Although the court agreed that the homeowners' actions were unreasonable, the court rejected the debtors' argument that they could "extinguish" the restrictive covenants by deeming them executory contracts which could be rejected. The court found that the restrictive covenants failed to meet the definition of an executory contract in the Ninth Circuit.[20]

In affirming the bankruptcy court's ruling that the restrictive covenants were not executory contracts, the Panel[21] expressly recognized that there were mutual obligations imposed on each side negating the assertion that the covenants were executory. For example, even though the homeowners argued that they had no obligations on the petition date, the debtors pointed out that there were numerous obligations imposed on the homeowners by the restrictive covenants. The Panel found that two of the alleged obligations of the homeowners (to maintain insurance on their boats and to abide by the bylaws of the ski park) were contained in the restrictive covenants, such that if a particular homeowner failed to perform these alleged obligations, the only relief available to the debtors was to request that the homeowners' association expel the offending homeowner for a set period of time. As the Panel noted, "even if the Landowners' duties contained in the Restrictive Covenants were ignored by one or more of them, Debtors were not excused from performance of their obligations under the Restrictive Covenants

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[20] *Id.* at *21.

[21] Unless stated otherwise, the reference to Panel is to the United States Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals.

for such breaches."[22] In other words, even where there may be obligatory duties imposed on two sides, a restrictive covenant will not be deemed an executory contract for purposes of section 365. Other courts have taken similar approaches in finding that restrictive covenants are not executory contracts which can be rejected.[23]

Despite the foregoing, a few courts have permitted the rejection of restrictive covenants. However, those cases are generally limited to instances where the recorded covenant was in the nature of a right of first refusal. For example, in *Steffan v. McMillan (In re Coordinated Financial Planning Corp.)*,[24] a trustee appealed the ruling of the bankruptcy court that a right of first refusal for the purchase of real property was a covenant running with the land and was not subject to rejection as an executory contract pursuant to section 365. In analyzing the bankruptcy court's decision, the Panel first noted that a right of first refusal between the parties was properly classified as a preemption agreement which gives a party the first right to buy when and if the other contracting party wants to sell.[25] In California, preemption agreements are consistently found to be covenants running with the land.[26] Since the effect of a breach (or rejection) of the right of first refusal could be alleviated by granting the aggrieved party an equitable lien, the Panel permitted its rejection under section 365.[27] Although not explicitly overruled, the Ninth Circuit in *Unsecured Creditors' Committee of Robert L. Helms Construction & Development Co. v Southmark Corporation (In re Robert L. Helms Construction & Development Co., Inc.)*,[28] questioned the

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[22] *Id.* at *33.

[23] *See In re* 523 E. Fifth St. Housing Pres. Dev. Fund Corp., 79 B.R. 568 (Bankr. S.D.N.Y. 1987) (restrictive covenant in deed requiring real property to be used for low income housing was intended to run with the land and could not be rejected as executory contract under section 365); *In re* Case, 91 B.R. 102 (Bankr. D. Colo. 1988) (condominium declarations were covenants running with the land which could not be rejected as an executory contract).

[24] Steffan v. McMillan (*In re* Coordinated Fin. Planning Corp.), 65 B.R. 711 (B.A.P. 9th Cir. 1986).

[25] *Id.* at 712 (citing Rollins v. Stokes, 123 Cal. App. 3d 701, 176 Cal. Rptr. 835 (1981)).

[26] Laffan v. Naglee, 9 Cal. 662 (1858).

[27] *See also In re* Waldron, 36 B.R. 633 (Bankr. S.D. Fla. 1984) (court held a recorded option contract to purchase real property could be rejected as an executory contract under section 365), *rev'd*, 785 F.2d 936 (11th Cir. 1986) (reversed on grounds that use of a chapter 13 for the purpose of rejecting an executory contract was an act of bad faith).

[28] Unsecured Creditors' Comm. of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Constr. & Dev. Co., Inc.), 139 F.3d 702 (9th Cir 1998).

Panel's decision in *Coordinated Financial* and, as a result, has curtailed its usefulness to debtors and trustees.

In *Helms*, the Ninth Circuit held that an option agreement, at least one that is not in the process of being exercised at the time the bankruptcy is filed, is not an executory contract. The court's holding overturned the Ninth Circuit's earlier decision in *Gill v Easebe Enterprises (In re Easebe Enterprises)*[29] holding that an option agreement was *per se* an executory contract. In overturning *Easebe*, the Ninth Circuit adhered to the "Countryman" test in defining an executory contract. The *en banc* panel concluded that if an option was not in the process of being exercised at the time of the bankruptcy, it was not an executory contract. On the other hand, one of the situations in which an option might be executory is if it had been exercised, but closing had not taken place when the bankruptcy was filed.[30]

Following the Panel's reasoning in *Coordinated Financial*, the bankruptcy court in *In re A.J. Lane & Co.*[31] found a purchase option to be a unilateral contract until the option was exercised, and upon exercise it became a bilateral contract. As such, the court found that "[i]t is the contingency of exercise which makes the option executory for our purposes."[32] Likewise, in *In re Fleishman*,[33] the debtors purchased land subject to restrictive covenants, including a prohibition against subsequent sales unless the property association was offered a right of first refusal. The debtors filed bankruptcy petitions and the property was later sold at a public auction, after which the property association assigned its right of first refusal to a third party. Although the assignees informed the trustee of their intent to exercise their right, the trustee sought an order allowing the property's conveyance free and clear of the assignees' right. In granting the trustee's motion, the *Fleishman* court concluded that the right of first refusal was not a covenant that ran with the land under Massachusetts law, but was a personal contract right between the parties.

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[29] Gill v Easebe Enters., Inc. (*In re* Easebe Enters.), 900 F.2d 1417, 1419 (9th Cir 1990).

[30] *See also In re* Bergt, 241 B.R. 17 (Bankr. D. Alaska 1999). The court in *Bergt* held that a right of first refusal was similar to an option to sell real property, therefore, it applied the analysis of the Ninth Circuit in *Helms*. Since there was no sale pending when the bankruptcy case was filed, the *Bergt* court concluded that the right of first refusal was not executory as of the petition date and, therefore, could not be rejected under section 365.

[31] *In re* A.J. Lane & Co., 107 B.R. 435 (Bankr. D. Mass. 1989).

[32] *Id.* at 437. *See also In re* Hardie, 100 B.R. 284 (Bankr. E.D.N.C. 1989) (an unexercised purchase option constitutes an executory contract subject to rejection under section 365(a)).

[33] *In re* Fleishman, 138 B.R. 641 (Bankr. D. Mass. 1992).

According to the *Fleishman* court, the right of first refusal did not touch and concern the land and it did not confer a direct physical advantage to the occupation of the property. Nor did it relate to the mode of occupying or enjoying the land or the ability to control development or commercial use. Thus, it could not be interpreted to be inherent in or attached to the land as it only related to the contractual right of the association or its assigns to select its neighbors. Therefore, the court found that the right of first refusal did not run with the land, but was in the nature of a contractual agreement which afforded the holder an opportunity to purchase land. Hence, it met the Countryman definition of an executory contract since the parties' obligations were so far unperformed that the failure of either to perform would constitute a material breach excusing performance of the other. The trustee was therefore permitted the right to complete the sale by rejecting the right of first refusal under section 365. The fact that the right of first refusal was contained in an instrument of record which was referenced in the deed did not change the fundamental contractual nature of the right of first refusal and did not render the right of first refusal non-executory and, therefore, not subject to rejection under section 365.[34]

As these cases illustrate, the power of a debtor or trustee to reject a restrictive covenant under section 365 are limited and the obstacles are difficult to surmount, particularly once the covenant is found to have the hallmarks of a covenant as codified in section 1468 or similar state statutes. Even where the covenant is in the nature of an option or a right of first refusal (where there may be reciprocal duties owed), the burdens imposed on a debtor or trustee to satisfy the Countryman definition are daunting.

III. Sales Free and Clear of Restrictive Covenants Under 11 U.S.C. § 363(f)

Presuming that restrictive covenants cannot be rejected under section 365(a), the next possible avenue for a debtor is to seek to use section 363(f) to sell the real property free and clear of the covenant. This may be viewed as a more acceptable option, particularly in light of the language of section 363(f)(1) permitting a free and clear sale "if applicable nonbankruptcy law permits sale of such property free and clear of such interest."[35] The majority of courts, however, have refused to allow a trustee or debtor in possession to use the free and clear

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[34] *Id.* at 645-47. *Cf. In re* Nevel Props. Corp., 2012 Bankr. LEXIS 551 (Bankr. N.D. Iowa Feb. 17, 2012) (court found that a temporary easement was not a covenant running with the land, but was similar in style to a lease and subject to rejection).

[35] 11 U.S.C. § 363(f)(1).

provisions of section 363(f) to strip covenants and other rights that run with the land, unless a party can demonstrate a specific state or federal law that provides for the covenants to be found invalid or otherwise "disconnected" from the property.[36]

For example, the Fifth Circuit in *Newco Energy v. Energytec, Inc. (In re Energytec, Inc.)*,[37] held that a debtor could not utilize section 363(f) to sell a natural gas pipeline system free and clear of a third party's right to transportation fees tied to the operation of the pipeline system and the requirement that a sale or assignment of the pipeline could only take place with the consent of the third party. The Fifth Circuit based its ruling on the fact that the third party's rights were covenants that ran with the land under Texas law. Similarly, the court in *In re Pintlar Corp.*[38] preserved ASARCO's right to deposit mining tailings into the rivers and waters of the Coeur d'Alene River Valley absent a showing by the EPA that a law existed that specifically severed such rights from the property. In the same way, the Eighth Circuit in *Mid-City Bank v. Skyline Woods Homeowners Ass'n (In re Skyline Woods Country Club)*,[39] found 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 section 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.

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[36] *See* Mancuso v. Meadowbrook Mall Co. Ltd. P'ship, 2007 U.S. Dist. LEXIS 23308, at *29-30 (Bankr. N.D.W. Va. Mar. 28, 2007) (holding that certain "use covenants" governing what type of restaurant and signage could be utilized on certain parcels of land were restrictions that ran with land, and debtor could not sell property free and clear of those covenants under section 363(f), even though purchaser attempted to show that covenants could be avoided under the law of eminent domain); *Fifth St. Housing* (deed restriction requiring that property be used for low-income housing was a covenant that ran with land, and property could not be sold free and clear of such restriction through section 363(f)); *In re* Inwood Heights Hous. Dev. Fund Corp., 2011 Bankr. LEXIS 3251 (Bankr. S.D.N.Y. Aug. 25, 2011) (holding that debtor could not use section 363(f) to obviate compliance with any sale restrictions contained in deed, including restriction that property could not be sold for certain number of years without city's consent); *In re* Dundee Equity Corp., 1992 Bankr. LEXIS 436 (Bankr. S.D.N.Y. Mar. 6, 1992) (section 363(f) did not allow sale of apartment building free and clear of tenants' rights under housing settlement agreement because such stipulations were property interests which ran with the land and were enforceable against subsequent purchasers).

[37] Newco Energy v. Energytec, Inc. (*In re* Energytec, Inc.), 739 F.3d 215 (5th Cir. 2013).

[38] *In re* Pintlar Corp., 187 B.R. 680 (Bankr. D. Idaho 1995).

[39] Mid-City Bank v. Skyline Woods Homeowners Ass'n (*In re* Skyline Woods Country Club), 636 F.3d 467 (8th Cir. 2011).

The court in *Heatherwood Holdings, LLC v. First Commer. Bank (In re Heatherwood Holdings, LLC)*[40] also refused to allow a debtor to sell free and clear of recorded covenants through a section 363(f) sale. In *Heatherwood*, although a club and adjacent residential lots were marketed as a golf course community, the club and course were later sold, and then resold to a company under an agreement requiring it to be operated as a golf course for 25 years. The debtor, an entity created by the acquiring company, accepted a general warranty deed for the club and also assumed the company's obligations under the prior agreements. Despite the debtor's investment in major renovations, the club was never profitable. Concluding that the property was inherently unsuitable for golf course use, the debtor proposed a sale free of any limitations. The bankruptcy court denied the debtor's request to use section 363(f) to strip off the covenants, concluding that the property was, in fact, subject to an "implied restrictive covenant" limiting it to use as a golf course. The court rejected the debtor's arguments that it did not have notice of such restriction, or that a showing of changed circumstances was sufficient to terminate any restrictions.

What, then, can a trustee or debtor do to invoke section 363(f)(1) and convince a court to sell property free and clear of restrictive covenants. The answer may be found in the doctrine of "changed circumstances," which was ineffective in *Heatherwood*.

IV. Can a Change of Circumstances Alter the Apparent Difficulty in Shedding a Restrictive Covenant

Although debtors and trustees face an uphill battle in convincing a bankruptcy court that a restrictive covenant can be rejected or stripped from a parcel of property, there are limited instances where such an approach might be blessed by a court. In order to convince a court to allow a debtor to reject or dispose of a burdensome covenant, a debtor typically will need to demonstrate that (i) a change of circumstances has occurred which has severely impacted the original intent of the restriction, or (ii) the covenant is an improper restraint on alienation.

In this regard, the established rule in California is that "[restrictive] covenants will be construed strictly against persons seeking to enforce them, and in favor of the unencumbered use of the property."[41] Nevertheless, to demonstrate

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[40] Heatherwood Holdings, LLC v. First Commer. Bank (*In re* Heatherwood Holdings, LLC), 454 B.R. 495 (Bankr. N.D. Ala. 2011).

[41] Biagini v. Hyde, 3 Cal. App. 3d 877, 880, 83 Cal. Rptr. 875 (1970); Ezer v. Fuchsloch, 99 Cal.

a change of circumstances, the general rule is that the change must be of such a dimension "that it is no longer possible to accomplish the original purpose intended by the restriction," or the enforcement of the restrictive covenant "would be inequitable, or unreasonable, or oppressive."[42] In addition, "whether there has been such a change of conditions as to warrant a refusal to enforce, or a cancellation of, restrictions, the courts give greater weight to the changes occurring within the restricted area than to those occurring without the area."[43] Thus, changes within a contiguous tract are more likely to render the original purposes of the restriction obsolete and may add the additional equity of waiver to the calculus. Yet, changes wholly outside the tract can suffice. Where the changes render the restricted property valueless, equity may side with the party who seeks to lift the restriction despite evidence that enforcement would benefit the other properties in the tract.[44]

However, the mere fact that property has become more desirable or valuable for business than for residence purposes, where the restriction, notwithstanding the change of conditions, still is of substantial advantage to the dominant property, will not necessarily defeat application for equitable relief.[45] In other words, there must be substantial evidence that the changed circumstances render the purpose of the covenant unattainable.[46] And a number of courts have held that a lack of profitability or a mere change in economic conditions does not, in and of itself, translate to a change of circumstances which will permit the

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App. 3d 849, 861, 160 Cal. Rptr. 486 (1979); Terry v. James, 72 Cal. App. 3d 438, 443, 140 Cal. Rptr. 201 (1977); Lincoln Sav. & Loan Ass'n v. Riviera Estates Ass'n, 7 Cal. App. 3d 449, 463, 87 Cal. Rptr. 150 (1970).

[42] County of Butte v. Bach, 172 Cal. App. 3d 848, 867, 218 Cal. Rptr. 613 (1985). *See also* Gladstone v. Gregory, 95 Nev. 474, 498, 596 P.2d 491, 494 (1979) ("[c]hanged conditions sufficient to justify nonenforcement of an otherwise valid restrictive covenant must be so fundamental as to thwart the original purpose of the restriction." "[R]espondents had the burden to show the changed conditions have so thwarted the purpose" so that "it would be inequitable or oppressive to enforce the restriction.").

[43] 20 AM. JUR. 2D, Covenants, Conditions, etc., § 284, p. 849.

[44] Downs v. Kroeger, 200 Cal. 743, 254 P. 1101 (1927).

[45] Strong v. Shatto, 45 Cal. App. 29, 37, 187 P. 159 (1919) (reversing a judgment granting relief from residential use restriction). *See also* Lincoln Sav. & Loan Ass'n v. Riviera Estates Ass'n, 7 Cal. App. 3d 449, 460, 87 Cal. Rptr. 150 (1970).

[46] Welshire, Inc. v. Harbison, 33 Del.Ch. 199, 204, 91 A.2d 404, 406-07 (1952) ("a mere change in economic conditions rendering it unprofitable to continue the development subject to the restrictions originally imposed is not itself a change sufficient to justify the court in disregarding or abrogating the restrictive covenant."). *See also* Murphey v. Gray, 84 Ariz. 299, 304, 327 P.2d 751, 754 (1958).

evisceration of a restrictive covenant.[47] Thus, a restrictive covenant will be enforced even though unrestricted use of the property would be more profitable to its owner.[48] In short, more than economic harm is needed to present a valid changed conditions argument.[49]

Even courts that have authorized the severance of a covenant under the doctrine of "changed circumstances" have done so only where it was demonstrated that the property had worsened well beyond the point where the restrictive covenants could protect those benefitting from the covenant. For instance in *In re Daufuskie Island Props., LLC*,[50] the bankruptcy court found that a chapter 11 trustee could sell property subject to a real covenant that ran with the land free and clear of that covenant pursuant to either the doctrine of changed circumstances, or by reason of a *bona fide* dispute regarding the covenant's validity. But in reaching its decision, the *Daufuskie* court, and others allowing sales free and clear of a covenant, first held that the term "interest" contained in section 363(f)(1) should be interpreted broadly. Therefore, the court determined that if the estate assets could be sold free and clear of the restrictive covenant under South Carolina law, the court could authorize the sale pursuant to section 363(f)(1).

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[47] Shalimar Ass'n v. D.O.C. Enters, Ltd., 142 Ariz. 36, 43, 688 P.2d 682, 691 (1984) ("A mere change in economic conditions rendering it unprofitable to continue the restrictive use is not alone sufficient to justify abrogating the restrictive covenant."). In *Shalimar*, the residents of Shalimar Estates purchased individual residential homes in a community with a golf course "which was intended as an integral part of the general plan for the development and improvement of all the Shalimar property." The developer also recorded restrictions on the residential land referring to a golf course repeatedly. The developer sold the residential homes with representations that the golf course would be maintained and operated for a period of between 39 and 65 years. The court found that the homeowners had a right to rely on the language of the recorded restrictions and the developer representations, and that an implied easement existed for their benefit. Further, the court held that while recorded documents would suffice to put the successor purchaser on constructive notice, the purchaser had actual notice of the use restrictions because of, in part, the existence and operation of a golf course. In rejecting the efforts of the developer to strip the covenants from the property, the court rejected two economic arguments of the successor purchaser: (i) that requiring them to operate a golf course, at a loss amounted to "outright bondage," and (ii) that the court could not constitutionally require the purchaser to maintain the property in a certain manner. The court specifically recognized that the property was to be maintained and operated as a golf course.

[48] Williams v. Butler, 76 N.M. 782, 784, 418 P.2d 856, 858 (1966) (citing Marra v. Aetna Constr. Co., 15 Cal. 2d 375, 101 P.2d 490 (1940)).

[49] Wolff v. Fallon, 44 Cal. 2d 695, 697, 284 P.2d 802, 803 (1955).

[50] *In re* Daufuskie Island Props., LLC, 431 B.R. 626 (Bankr. D.S.C. 2010).

In *Daufuskie*, a lone creditor objected to the sale, contending that it had the right to a reconveyance of the property under a recorded Transfer Agreement whereby the debtor purchased the property from the creditor. The creditor asserted that the agreement was a covenant running with the land which could not be stripped by the sale. In rejecting the objection, the court found that not only were certain portions of the Transfer Agreement not covenants running with the land, but that no purpose would be served by permitting the restrictive covenant to continue since by doing so "it would create no value for the homeowners, would cause issues with the title to all property left to be sold and developed, and would interfere with lending as indicated by the course of this case."[51] Furthermore, the court based its decision on testimony from the trustee showing that "allowing the repurchase right to remain in place as a restrictive covenant would not only block the proposed Sale, but it would likely lead to the closing of all operations on the property, which would defeat the objectives of the Transfer Agreement and expose the Estate, the creditors, [the objecting creditor], and surrounding property owners to potentially disastrous consequences."[52] The court therefore found that a changed condition existed under state law supporting a sale free and clear of the restrictive covenant under section 363(f)(1).

Likewise, in *In re TOUSA, Inc.*,[53] the debtors sought authority to enter into a sale agreement for the sale of 20 residential lots located in a community known as Meadow Run. The debtors proposed to sell the property in bulk for $3,000,000, or $150,000 for each parcel. The debtors were parties to an agreement with Zuckerman which provided that "TOUSA [Homes] hereby agrees that for so long as Zuckerman owns any Lots within the Property, TOUSA [Homes] shall not sell any Lot within the Property for a purchase price of less than $325,000.00."[54] Although the Zuckerman contract was not recorded, the court found that the debtors were a party to the agreement and thus always had notice of the restrictive covenant. In response to the debtors' motion, the court recognized the Seventh Circuit's holding in *Gouveia* that a restrictive covenant generally creates an interest in property that prevents courts from permitting a section 363 sale free and clear of all liens, claims, interests, and encumbrances as sought by the debtors.[55] However, Florida state law rendered the specific

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[51] *Id.* at 645.

[52] *Id.* at 645.

[53] *In re* TOUSA, Inc., 393 B.R. 920 (Bankr. S.D. Fla. 2008).

[54] *Id.* at 922.

[55] *See* Silverman v. Ankari (*In re* Oyster Bay Cove, Ltd.), 196 B.R. 251, 255 (E.D.N.Y. 1996).

restriction unenforceable since it was found to be a direct restraint on alienation because it attempted to limit or penalize sales of the property in question.

However, in *In re Eastport Golf Club, Inc.*,[56] the bankruptcy court adopted a different approach. In *Eastport*, the debtor proposed a plan which provided for redevelopment of a debtor's golf course property to include condominiums. The homeowner's association, acting on behalf of residents who resided in neighborhoods which were part of the same development as the golf course, objected to the plan on the ground that the condominiums would violate a restrictive covenant and impair homeowners' claims. The debtor in *Eastport* was confronted with a recorded covenant of the development which ran with the land and limited the use of the debtor's property to the golf course and related facilities. The debtor contended that the proposed condominiums were related to the golf course because development of the units was the only way that the golf course could operate as an economically viable enterprise. Nevertheless, the court held that the debtor's plan violated the restrictive covenant since the condominium units did not constitute facilities related to the golf course.[57] The units did not relate to the use of the property as a golf course and were not intrinsically related to the recreational and social activities commonly associated with the sport of golf. Rather, the units were inherently private and existed for the basic purpose of providing shelter, and the development plan indicated that the golf course property was reserved for recreational rather than residential use.

Particularly important is the following discussion from the *Eastport* court:

> Perhaps more important than the term "facilities" is the unambiguous restriction that the Property is for "golf course use only." This provision appears to restrict the entire portion of the Property to use as a golf course and associated facilities. The development of any portion of the Property into condominium units, as proposed by the Plan, is not using the Property as a golf course but rather sub-dividing the Property for private residential use, thereby diminishing the Property's availability for recreational and social uses associated with the sport of golf. The deeds appear to prohibit this redevelopment. Such an interpretation of this restriction in the deeds is supported by the general plan of development set forth in the

[56] *In re* Eastport Golf Club, Inc., 373 B.R. 446 (Bankr. D.S.C. 2007).

[57] *Id.* at 453.

> Declaration, which specifically segregates the residential portion of the Eastport Community, referred to in the Declaration as "Neighborhoods," from the Property. This plan of development provides further indication that the Property was not to be developed for residential use but was specifically reserved for recreational use.[58]

Similarly, in *Skyline Woods Homeowners Ass'n, Inc. v. Broekemeier*,[59] Skyline Woods, an owner of the Chapel Hills Farm and Golf Course, developed a residential neighborhood abutting the golf course and sold the lots advertising the proximity and existence of the golf course. The golf course was later sold, and re-sold, eventually being owned by Skyline Woods County Club, L.L.C. ("Skyline LLC"). Skyline LLC soon declared bankruptcy, and sold the course to Liberty. The owners of Liberty then informed the homeowners abutting the course that it was not required to honor their golf membership agreements, and it began to shut down the course. In response, the homeowners sought injunctive relief. The Supreme Court of Nebraska relied on *Shalimar* as a basis for finding an implied easement in favor of the homeowners due primarily to representations made during the sale of the residential homes.[60] The court further held that the bankruptcy sale to Liberty did not extinguish the covenant, and upheld the enforcement of the implied covenant that the property be used only as a golf course.

Both *Eastport* and *Skyline Woods* reinforce the approach adopted by numerous courts rejecting a change of circumstances argument based largely, if not totally, on the proposition that the property would be more valuable or profitable if the covenant was severed.

V. Conclusion

If reorganization is entirely dependent on whether a restrictive covenant can be rejected under section 365(a) or discarded by section 363(f), debtors (as well as trustees) must take special note of the underlying characteristics of the covenant. As illustrated, the prevailing view is that restrictive covenants which touch and concern the affected parcel will remain affixed to the estate's property post-petition, regardless of whether the covenant has features of a contract and there are reciprocal duties imposed on both sides. And even when changed

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[58] *Id.* at 473.

[59] Skyline Woods Homeowners Ass'n, Inc. v. Broekemeier, 758 N.W.2d 376 (Neb. 2008).

[60] *Id.* at 390.

circumstances arguably exist, unless there is substantial evidence demonstrating that the covenant presents an unlawful restraint on alienation or the circumstances have changed well beyond the point where the restrictive covenant could protect those benefitting from the covenant, neither section 365(a) nor section 363(f) will permit the rejection or evisceration of the covenant. Merely arguing that the property will be more profitable to the estate without the covenant will be insufficient.