

# The Bankruptcy Code's Inherent Limitations for Struggling Golf Courses

## *Part One of a Two-Part Article*

A simple Web search will unearth countless privately-owned golf courses that have closed, are for sale, or have sought bankruptcy protection as an avenue toward a financial restructuring or redevelopment. However, there are limitations on what the owner of a golf course can accomplish in Chapter 11 when the property is burdened with restrictive covenants limiting the use of the property.

BY DANIEL A. LEV  
SEPTEMBER 2018

A simple Google or LoopNet search will unearth countless privately-owned golf courses that have closed, are for sale, or have sought bankruptcy protection as an avenue toward a financial restructuring or redevelopment. However, there are limitations on what the owner of a golf course can accomplish in Chapter 11 when the property is burdened with restrictive covenants limiting the use of the property.

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." *Anthony v. Brea Glenbrook Club*, 58 Cal. App. 3d 506, 510, 130 Cal. Rptr. 32 (1976). 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. *Id.*, at 510

For example, in California, in order for a court to find that a restrictive covenant runs with the land, it must be shown that: 1) the benefited and

burdened lands are 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 is recorded. *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). However, even when a covenant does not run with the land because one of the necessary requirements is lacking, a court may nonetheless enforce the covenant as an equitable servitude. *B.C.E. Development, Inc. v. Smith*, 215 Cal. App. 3d 1142, 1146, 264 Cal. Rptr. 55 (1989).

## **Limitations Under the Code**

Therefore, if, a debtor's property is impressed with a restrictive covenant limiting its use to a golf course and associated amenities, the question turns to whether a debtor's reorganization efforts will be impeded by the limitations imposed by sections 365(a) and 363(f) of the Bankruptcy Code, or if there are circumstances under which a debtor can sever the restrictive covenant from the affected property.

A debtor's first effort might be to seek the rejection of the restrictive covenant as an executory contract under section 365(a). However, courts are virtually unanimous in rejecting this approach to shred a covenant from golf course property. Although the interpretation of a restrictive covenant may be governed by state law contract principles, whether a contract is executory within the meaning of the Bankruptcy Code is a question of federal law. *Benevides v. Alexander (In re Alexander)*, 670 F.2d 885, 888 (9th Cir.

1982). And although the Bankruptcy Code does not define “executory contract,” courts have generally adopted the so-called “Countryman” definition, which provides that a contract is executory if performance is due to some extent on both sides such that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other. *See, Vern Countryman, Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 450 (1973); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522, fn. 6 (1984). 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).

## **Executory Contract vs. Restrictive Covenant**

The leading decision illuminating the distinctions between an executory contract and a restrictive covenant is the Seventh Circuit’s opinion in *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994), where a debtor attempted to avoid a 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. Although the debtor obtained permission from the city zoning commission to build a commercial music store on her property, the debtor’s neighbors filed suit seeking enforcement of the covenant. 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. Unable to operate the business and meet her financial obligations, the debtor filed Chapter 11.

After the case was converted to Chapter 7, the trustee sought to reject the covenant pursuant to section 365. The bankruptcy court denied the motion, finding that the restrictive covenant was not an executory contract. *Id.*, at

297. 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. *Id.*, at 298-299. *See also, Hayes v. Water Ski Mania Estates Homeowners Ass'n (In re Hayes)*, 2007 Bankr. LEXIS 3397 (Bankr. D. Mont. 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. 2008) (restrictive covenants could not be extinguished by deeming them executory contracts which could be rejected); *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).

## **Right of First Refusal**

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. *See, Steffan v. McMillan (In re Coordinated Financial Planning Corp.)*, 65 B.R. 711 (B.A.P. 9th Cir. 1986). 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.)*, 139 F.3d 702 (9th Cir 1998), questioned *Coordinated Financial* and, as a result, has curtailed its usefulness to debtors. 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)*, 900 F.2d 1417, 1419 (9th Cir 1990) holding that an option agreement was *per se* an executory contract.

In overturning *Easebe*, the Ninth Circuit adhered to the Countryman test and 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. *See, In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (right of first refusal was similar to an option to sell real property, however, since there was no sale pending when bankruptcy case was filed, the right of first refusal was not executory as of the petition date and, therefore, could not be rejected under section 365). *Cf., 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)); *In re Fleishman*, 138 B.R. 641 (Bankr. D. Mass. 1992) (right of first refusal, even if contained in an instrument of record, was not a covenant that ran with the land under Massachusetts law, but was a personal contract right between the parties subject to rejection); *In re A.J. Lane & Co.*, 107 B.R. 435 (Bankr. D. Mass. 1989) (purchase option was a unilateral contract until the option was exercised, and upon exercise it became a bilateral contract, as such, the court found that it was the contingency of exercise which made the option executory); *In re Nevel Props. Corp.*, 2012 Bankr. LEXIS 551 (Bankr. N.D. Iowa 2012) (a temporary easement was not a

covenant running with the land, but was similar in style to a lease and subject to rejection).

As these cases illustrate, the power of a debtor to reject a restrictive covenant under section 365 is limited and the obstacles are difficult to surmount, particularly once the covenant is found to have the hallmarks of a covenant under applicable state law. 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 to satisfy the Countryman definition are daunting.

## **Selling Free and Clear**

Presuming that restrictive covenants cannot be rejected under section 365(a), the next possible path 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."

The majority of courts, however, have refused to allow a debtor (or trustee) to use the free and clear 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. *See, Mancuso v. Meadowbrook Mall Co. Ltd. Partnership*, 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 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, supra*, (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. 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); *Newco Energy v. Energytec, Inc. (In re Energytec, Inc.)*, 739 F.3d 215 (5th Cir. 2013) (debtor could not utilize section 363(f) to sell natural gas pipeline system free and clear of third party's right to transportation fees tied to the operation of pipeline system and requirement that sale or assignment of pipeline could only take place with consent of the third party since third party's rights were covenants that ran with the land under Texas law); *In re Pintlar Corp.*, 187 B.R. 680 (Bankr. D. Idaho 1995) (court preserved ASARCO's right to deposit mining tailings into rivers and waters of Coeur d'Alene River Valley absent showing by the EPA that law existed that specifically severed such rights from the property); *Mid-City Bank v. Skyline Woods Homeowners Ass'n (In re Skyline Woods Country Club)*, 636 F.3d 467 (8th Cir. 2011) (easement rights and other similar covenants were so inviolable that court recognized and supported state court decision finding that a bankruptcy sale pursuant to section 363(f) could not have severed an implied covenant between the owner of property and neighboring residents that property be maintained as a golf

course); *Heatherwood Holdings, LLC v. First Commer. Bank (In re Heatherwood Holdings, LLC)*, 454 B.R. 495 (Bankr. N.D. Ala. 2011) (court refused to allow debtor to sell golf course and adjacent residential lots free and clear of recorded covenants through section 363(f) sale since property was, in fact, subject to an “implied restrictive covenant” limiting it to use as golf course).

What, then, can the owner of property restricted to use as a golf course 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 state court doctrine of “changed circumstances,” which was ineffective in *Heatherwood* and will be discussed in part two of this article next month.

**Daniel A. Lev** is a member of SulmeyerKupetz, A Professional Corporation. He specializes in business reorganization, financial restructuring, and other insolvency matters and related litigation.