AMERICAN BANKRUPTCY INSTITUTE

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Section 363 Sale Issues Involving Successor Liability and the Meaning of "Free and Clear"

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CONCURRENT SESSION

2017

Sale of Assets: Settlement of Claims and Collusion

There are cases in which a trustee desires to sell assets of the estate that include claims. Practitioners must consider the circumstances under which claims may be sold and how to present to the court a motion to sell assets that includes settlement of claims.

General Principals on Sale of Assets

Section 363(b) of the Bankruptcy Code provides authority for a trustee and, through the application of Bankruptcy Code section 1107(a), a debtor-in-possession, "after notice and a hearing, [to] use, sell or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). The authority to sell assets conferred upon a debtor by Section 363(b) "include[s] a sale of substantially all the assets of an estate." *Otto Preminger Films, Ltd, v. Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)*, 950 F.2d 1492, 1495 (9th Cir. 1991). Further, section 105(a) of the Bankruptcy Code allows the Court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a).

Section 363(f) of the Bankruptcy Code authorizes a trustee to sell property under section 363(b) "free and clear of any interest in such property of an entity other than the estate" if one of the following conditions is satisfied:

(a) applicable nonbankruptcy law permits the sale of such property free and clear of such interest;

(b) such entity consents;

(c) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(d) such interest is bona fide dispute; or

(e) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f).

The Bankruptcy Court's power to authorize a sale under section 363(b) is to be exercised at the Court's discretion. *In re WPRV-TV, Inc*., 983 F.2d 336, 340 (1st Cir. 1993); *New Haven Radio, Inc. v. Meister (In re Martin-Trigona),* 760 F.2d 1334, 1346 (2d Cir. 1985); *Comm.of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.),* 722 F.2d 1063, 1069 (2d Cir. 1983).

Courts have authorized a sale of all or substantially all of a debtor's assets pursuant to section 363(b) of the Bankruptcy Code or in the absence of a reorganization plan where there is a "sound business purpose." *In re Delaware & Hudson Ry. Co.,* 124 B.R. 169 (D. Del. 1991); *Titusville Country Club v. Penn Bank (In re Titusville Country Club)*, 128 B.R. 396 (Bankr. W.D.Pa. 1991); *In re Industrial Valley Refrigeration and Air Conditioning Supplies, Inc*., 77 B.R. 15 (Bankr. E.D.Pa. 1987). *See also, Stephens Indus., Inc. v. McClune*, 789 F.2d 386 (6th Cir. 1986); *In re Lionel Corp*., 722 F.2d at 1071 (setting forth the "sound business purpose" test in the context of a sale of assets under section 363(b) of the Bankruptcy Code).

Courts have also required that the sale price be fair and reasonable and that the sale be the result of good-faith negotiations with the buyer. *In re Abbotts Dairies of Pa.*, 788 F.2d 143, 147-50 (3rd Cir. 1986); *In re Tempo Technology Corp*., 202 B.R. 363, 367 (D. Del. 1996), *aff'd sub nom. Diamond Abrasives Corp. v. Temtechco, Inc. (In re Temtechco, Inc.),* 141 F.3d 1155 (3d

Cir. 1998); *In re Industrial Valley*, 77 B.R. at 22; *In re Stroud Ford, Inc.*, 163 B.R. 730 (Bankr. M.D. Pa. 1983); *See also In re Ewell*, 958 F.2d 276 (9th Cir. 1992) (declining to set aside or modify a sale pursuant to section 363 of the Bankruptcy Code because the price was fair and reasonable and the buyer was a good faith purchaser pursuant to section 363(m) of the Bankruptcy Code).

While the Bankruptcy Code does not define "good faith," courts have held that for purposes of section 363(m), a "good faith purchaser" is one who buys "in good faith" and "for value" and that lack of good faith is shown by fraud, collusion, or an attempt to take grossly unfair advantage of other bidders. *In re Abbots Diaries of PA.*, 788 F.2d at 147; *In re Tempo Technology Corp.*, 202 B.R. at 367.

General Principals on Settlement of Claims

A trustee bears the burden of proving that a settlement agreement is fair and equitable and in the best interests of a debtor's estate. *In re Kaiser Steel Corp*., 105 B.R. 971, 976 (D. Colo. 1989); *In re Wiley*, 2010 WL 964082, at *4 (Bankr. D. N.M. March 11, 2010); *In re Del Grosso*, 106 B.R. 165, 168 (Bankr. N.D. Ill. 1989). The trustee, as the proponent of a settlement, must show that the proposal is reasonable, that there has been sufficient discovery of the underlying claims of the parties to enable the trustee and his counsel to act intelligently, and that the number and relative interests of the parties objecting to the settlement is small. *Protective Comm. for the Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968).

A court must apprise itself of "all facts necessary to evaluate the settlement and make an 'informed and independent judgment' about the settlement." *American Reserve Corp*., 841 F.2d

at 162 (citing *TMT Trailer Ferry*, 390 U.S. at 424). A court may not simply accept the trustee's word or 'rubber-stamp' the trustee's proposal. *In re American Reserve* Corp., 841 F.2d 159, 162 (7th Cir. 1987). *Accord, Wiley*, 2010 WL 964082 at *4. In assessing whether a proposed compromise is fair, a court should compare the terms of the settlement to the likely rewards of the litigation and consider the paramount interest of the creditors with a proper deference to their reasonable views. *TMT Trailer Ferry*, 390 U.S. at 424-425; *Kaiser Steel Corp*., 105 B.R. at 977; *Wiley*, 2010 WL 964082 at *4-5.

There are certain factors that courts consider in evaluating whether to approve a settlement. These factors are:

(i) the probable success of the litigation on the merits;

(ii) any potential difficulty in collection of a judgment;

(iii) the complexity and expense of the litigation; and

(iv) the interests of creditors in deference to their reasonable views. *Kaiser Steel*, 105 B.R. at 976. *Accord, In re Kopexa Realty Venture Co*., 213 B.R. 1020, 1022 (10th Cir. BAP 1997); *Wiley*, 2010 WL 964082 at *4.

Trustee stands in the shoes of Debtor and "takes no greater rights than the debtor himself had." *In re Hedged-Investment Assoc., Inc*., 84 F. 3d 1281, 1285 (10th Cir. 1996) (quoting H.R. Rep. No. 595, 95th Cong. 1st Sess. 368, reprinted in 1978 U.S.C.C.A.N. 5963, 6323). Consequently, Trustee can only release claims which are held by Debtor and Trustee cannot release claims held by third parties.

Courts must always scrutinize whether a trustee's duty to maximize the value obtained from a sale has been fulfilled. *In re Psychrometric Systems, Inc*., 367 B.R. 670, 674 (Bankr. D. Colo. 2007). Consequently, an objection to a sale based on the fact that there is a higher offer is

a valid objection. *Psychrometric,* 367 B.R. at 676 (citing *In re Landscape Properties, Inc*., 100 B.R. 445, 448 (Bankr. E.D. Ark. 1988)).

When a motion requests approval to sell claims under Section 363, a court must evaluate the sale for a sound business purposes, and also whether the sale meets the fair and equitable standards used to analyze compromises under Fed. R. Bankr. P. 9019. *In re Nicole Energy Servs*., 385 B.R. 201 (Bankr. S.D. Ohio 2008). "Although the two standards arguably overlap in that they both take into consideration the best interest of creditors, the tests are analytically distinct and most clearly addressed separately." *Id*. at 229.

"When examining a compromise pursuant to Rule 9019, it is necessary to distinguish between a true settlement and the sale of estate property." *Nev. Bus. Credit, LLC v. Kavanagh (In re Golden Empire Air Rescue, Inc*.), 2007 Bankr. LEXIS 4880. Disposing of an asset of the estate by way of a compromise is equivalent to a sale and implicates the sale provisions under Section 363. *Id*., at 10.

Trustee Assignment of Avoidance Actions

The authority to bring avoidance actions pursuant to the Bankruptcy Code is specific to the trustee or debtor-in-possession. Once a bankruptcy case has been filed, preferences and fraudulent conveyance actions must be brought in the bankruptcy proceeding, and the power to pursue such actions is given to the trustee. *First Am. Title Ins. Co.v. Lavenhar (In re Lavenhar),* 2014 U.S. Dist. LEXIS117857 (citing *Citicorp Acceptance Co. v. Robison (In re Sweetwater)*, 884 F. 2d 1323 (10th Cir. 1989). Requests to transfer such avoidance actions to creditors are carefully scrutinized and rarely granted. *In re Milazzo*, 450 B.R. 363 (Bankr. D. Conn. 2011). Bankruptcy courts are properly hesitant to authorize the sale or assignment of a trustee's avoidance powers or cause of action to a single creditor." *Rindlesbach v. Jones (In re*

Rindlesbach), 2016 U.S. App. LEXIS 15988. In those limited cases where the authority to bring an avoidance action is transferred, creditors are essentially deputized to act on behalf of a trustee, and may not pursue avoidance actions solely on their behalf. *In re Greenberg*, 266 B.R. 45 (Bankr. E.D.N.Y. 2001). In *Greenberg*, the court determined that transferring the trustee's avoidance powers to a creditor which owned 99% of the outstanding claims would maximize value for the estate. However, in that case the creditor was restricted to pursuing claims on behalf of the estate. *Id*., at 51-52.

Collusion Between Parties

Courts, in determining if a buyer is proceeding in "good faith" generally look for evidence of misconduct, including fraud or collusion between the purchaser and other bidders or the trustee. *In re Triangle Transp.*, 419 B.R. 603, 610 (Bankr. D.N.J. 2009) (citing 3 Collier on Bankruptcy, P 363.11 (Alan N. Resnick & Henry J. Sommers eds., 15th ed. Rev)). In determining whether collusion is present between the parties, the courts will generally consider whether an agreement exists that is intended to influence the sale price of the assets, not merely agreements with an unintended consequence of affecting the sales price. *In re Edwards*, 228 B.R. 552, 564 (Bankr. E.D. Pa. 1998); *Licensing by Paolo v. Sinatra (In re Gucci)* 126 F.3d 380, 290 (2d Cir. 1997); *Lone Star Indus.v. Compania Naviera Perez Companc, S.A.C.F.I.M.A., Sudacia, S.A. (In re N.Y. Trap Rock Corp.)*, 42 F.3d 747, 752 (holding that an agreement that merely affects the sale price of assets but does not seek to directly control the price is not a collusive agreement for the purposes of 11 U.S.C. § 363(n)). For example, the court in *Edwards* held that a settlement agreement which required two creditors to use their best efforts to purchase assets of the debtor was not intended to control the price and therefore not collusive, despite the fact that the agreement resulted in a lack of competing bids on the debtor's assets.

In contrast, the Third Circuit, in *Abbotts Dairies*, held that allegations of an agreement between the debtor's CEO and the purchaser were sufficient to warrant remanding the case to the bankruptcy court to make findings on the "good faith" of the purchaser. *Abbotts Dairies*, 788 F.2d at 149-51. At a hearing on the sale of the debtor's assets before the bankruptcy court, the CEO testified that he had reached an informal agreement with the purchaser of the debtor's assets to act as a consultant for the purchaser for a large salary, and an offer of a senior executive position with the purchaser following the sale. *Id.* at 145. His offer was contingent on the court's approval of the sale as well as approval of an agreement that allowed the purchaser to operate the debtor prior to the approval of the sale. *Id.* Following the approval of the sale by the bankruptcy court, the secured creditor and several bidders appealed the order to the district court. *Id.* The purchaser moved to dismiss, the appeal as moot, arguing that it was a good faith purchaser under 11 U.S.C. § 363(m). *Id.* The district court granted the motion, and the parties appealed to the Third Circuit. *Id.*

On appeal, the Third Circuit held that "when a bankruptcy court authorizes a sale of assets pursuant to section 363(b)(1), it is required to make a finding with respect to the good faith of the purchaser." *Id.* at 149-51. The Third Circuit noted that arguments were made during the hearing before the bankruptcy court that as a result of the agreement between the debtor's CEO and the purchaser, the debtor had allowed the purchaser to control the timing of its filing to necessitate a quick sale, had entered into agreements that resulted in a chilling of bids for the debtor's assets, and had allowed the purchaser to buy the debtor's assets at a significantly undervalued price. *Id.* at 149. The Third Circuit held that if the allegations were proved, there would certainly be evidence of collusion that would destroy the good faith status of the

purchaser, and therefore reversed the district court's decision and remanded the case for further proceedings on the issue of the purchaser's "good faith." *Id.* at 149, 150.

363(f) Asset Sales

I. Pre-Code-

The decision to authorize a sale of estate property free and clear of liens and interests in the Pre-Code era was within the discretion of the bankruptcy court. Appellate courts around the country routinely found that a bankruptcy court abused its discretion by authorizing a sale of estate property which would not yield a sale price greater than the amount of liens and costs of sale.

Second Circuit- In re Meyers, 24 F.2d 349, 351 (2nd Cir 1928);

Third Circuit- Vulcan Foundry, 180 F. 671, 675 (3rd Cir. 1910);

Fourth Circuit- Mound City Coal Company, 242 F. 248, 252 (4th Cir. 1917);

Fifth Circuit- Aetna Life Ins. Co. v. Leonard, 186 F. 148, 149 (5th. Cir. 1911);

Sixth Circuit- Hoehn v. McIntosh, 110 F.2d 199, 202 (6th Cir. 1940).

II. Bankruptcy Code Section 363(f)-

Section 363(f) provides for a sale of estate property free and clear of any interest in such property of an entity other than the estate if the movant can satisfy only one of the five conditions enumerated in Section 363(f)(1)-(5). The section seeks to balance the rights of secured creditors with the needs of a debtor to restructure, including the need to sell assets. The general rule regarding asset sales is that a bankruptcy court should not order estate property sold free and clear of liens unless the court is satisfied the sale proceeds will fully compensate secured lienholders and produce some equity for the benefit of the bankruptcy estate. In re WDH Howell LLC, 298 B.R. 527, 534 (B. N.J. 2003).

Section 363(f)(1) provides for the sale free and clear if applicable non-bankruptcy law permits the sale of such property free and clear of such interest. Judge Campbell determined in the case of In re Jaussi, 488 B.R. 456 (B. Colo. 2013), that 363(f)(1) should be interpreted narrowly and only applies to situations where the owner of the asset may, under non-bankruptcy law, sell an asset free and clear of an interest in such asset. The examples he cited were the sale of real estate free and clear of a restrictive covenant under state law; sale of real estate free of an unrecorded mortgage in a "pure race" recoding statute; and sale of a motor vehicle in a state with a title registration statute free of a secured lender's interest that is not noted on the title of the vehicle.

Section 363(f)(2) provides for the sale free and clear with the consent of the secured lender. The question which arises frequently here is whether the statute require express, written consent or does implied consent, by the failure to object to the motion, after proper service, suffice. The other question is what constitutes consent involving cases with a syndicate of secured lenders.

Section 363(f)(3) provides for the sale free and clear if the price at which the property is to be sold is greater than the aggregate value of all liens on such property. In Re Jaussi, supra, represents the majority view that this section requires the sale price exceed the face value of all liens on the property. A minority of jurisdictions interpret the section to mean the purchase price must exceed the economic value of the secured claims against such property. (See e.g. In re Oneida Lake Dev., Inc., 114 B.R. 352, 356-357 (B. N.Y. 1990)).

Section 363(f)(4) provides for the sale free and clear if the interest is in bona fide dispute.

Section 363(f)(5) provides for the sale free and clear if such entity could be compelled in a legal or equitable proceeding, to accept a money satisfaction of such interest. This section has been the subject much interpretation and litigation.

III. Fed.R.Bankr. P 6004© and Local Rule 6004-1-

The procedure for obtaining an order authorizing a sale free and clear is set forth in Fed.R.Bankr.P 6004© and Local Rule 6004-1. The motion, which is accompanied by a filing fee, must clearly identify by name the lienholders whose property rights are affected by the motion, such lienholders must be served with a complete set of moving papers, and the motion must demonstrate factually that it falls within one or more of the subsections of 363(f). If the motion does not satisfy these standards, it will be considered a motion to sell property subject to existing liens. Moreover, the order granting the motion must specify each lienholder whose interest is to be affected and whether such liens are being paid directly from the sale or will attach to the proceeds of the sale.

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ASSET SALES—CREDITORS AND COMMITTEES AS WATCHDOGS

By Risa Lynn Wolf-Smith

I. Timeline for Sale.

A. Is an extended marketing/bidding timeline appropriate?

1. Consider extent of pre-petition marketing efforts.

a) Have the assets been fully and fairly exposed to the market for a period of time prior to the filing of the bankruptcy case?

b) Did the debtor engage reputable professionals (broker, investment banker, investment advisor) to lead the process pre-petition?

2. Consider the additional costs to the estate.

a) What additional administrative expenses?

b) What is the cash burn of the company? Is there a need to liquidate the assets quickly?

c) What is the potential for higher and better bids if the process is slowed down?

3. Consider whether compressed milestones in DIP loan or stalking horse bid chill bidding. Beware of an insider stalking horse bid and procedures which lock it in.

B. Consider whether the timing is right for a sale of the type of assets to be sold.

1. In some cases, the debtor's best move may be to wait for the market to come back (e.g. oil and gas) before attempting a sale of assets.

2. Can the debtor sustain a holding period?

II. Lender Issues.

A. Consider whether the sales process is being financed by the lender to facilitate a sale which will pay its secured loan but not the claims of unsecured creditors.

B. Beware of credit bids.

1. Potential bidders/purchasers will not want to bid against a credit bid that is not "real money."

2. Consider forcing the lender to cap its credit bid at a price which is a floor for legitimate bids, but which will not chill bidding.

3. If lender intends to credit bid, consider lien challenge.

C. Beware of DIP Loan Agreements that lock in the process.

1. Who is providing the DIP financing? The purchaser, the prepetition lender (possibly in connection with a credit bid), a new lender? Consider their motives.

2. Object to DIP milestones which prevent a fulsome sales process.

III. Bidding Procedures.

A. Is there a need for a stalking horse bid?

1. If there are already a number of competing bidders at the table, probably not.

2. If the stalking horse bidder is an insider, ensure that the assets are fully and fairly marketed to other potential bidders.

B. Break-Up Fees and Expense Reimbursement for the Stalking Horse Bidder.

1. A break-up fee should be designed to compensate the stalking horse bidder for the time and expense of structuring a baseline bid and process which will bring other bidders to the table.

2. In *In re Twenver, Inc.*, 149 B.R. 954 (Bankr. Colo. 1992), the Bankruptcy Court for the District of Colorado adopted a "business judgment" test to determine whether a break-up fee should be approved, denying approval of a 10% fee and recognizing that it would be substantially higher than the 1-2% fees approved in the majority of cases.

3. The business judgment test inquires whether the break-up fee is appropriate considering whether the relationship of the parties who negotiated the fee is marked by self-dealing or manipulation, whether the fee hampers bidding, and whether the fee is reasonable in relation to the proposed purchase price.

4. Since *Twenver,* other bankruptcy courts have applied a "best interests of the estate" analysis or a Section 503(b) administrative expense analysis which asks whether the fee benefits the estate. *See, e.g., O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999).

5. In many cases, a break-up fee is not warranted where the stalking horse bidder has not added value to the process, e.g. the debtor hired its own marketing professional, created its own data room, prepared its own asset purchase agreement.

C. Qualified Bids.

1. Require earnest money deposits that commit but don't chill bids.

2. Bidders must show financial wherewithal to close and, in some cases, demonstrate financing.

3. Creditors should want to open up the process to as many bidders as possible.

D. Sum of the Parts vs. the Whole.

1. Ensure that the process allows for bids on the business as a whole (or all assets) as well as individual assets.

2. In many cases, a process which permits the piecemeal sale of the parts will garner more bids and a more competitive process than a simple sale of all of the debtors' assets.

3. Process should allow for all permutations, e.g. purchases of blocks of assets, individual assets, all assets, and comparison of the relative values of the bids as combined.

E. Auction Procedures.

1. Consider the best process for this business and these assets. Sealed bids, open auction by a broker or professional auctioneer, on-line auction, auction in court?

2. Who attends? Creditors committee should always have a role as the official monitor.

3. Make sure that back up bids are bound for a period of time by earnest money deposits.

F. Cure Issues.

1. Who pays the cure? Creditors should ensure that purchasers, and not the debtor, pay the cure and that cure amounts are adequately noticed.

2. Crucial executory contracts and leases must be identified and assigned as part of the sale process.

3. Beware of unforeseen rejection damages and set bar dates for filing rejection damages claims.

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363(f)(3) -- Economic Value vs. Face Value

Timothy A. ("Tad") Davidson II

The following is a brief summary of research regarding how courts define aggregate value under 11 U.S.C. § 363(f)(3).

I. Circuit Split — Face Value vs. Economic Value

Courts are divided when determining the definition of "aggregate value" under 11 U.S.C. § 363(f)(3). On one hand, courts have defined aggregate value to mean economic value. On the other hand, courts in several circuits have defined aggregate value to mean face value.

A. Economic Value

The lone Fifth Circuit case to consider this issue held that aggregate value equates to economic value.[1] In that case, the court acknowledged the existing circuit split and explained the competing views before adopting the view held by the court in In Re Beker Industries.[2] That view holds that the term "aggregate value" of liens in 11 U.S.C. § 363(f)(3) means the total of the "economic" value of the claims secured by liens against the property, so that a sale free and clear could be approved only if the sale price equals or exceeds the total economic value of debts against the property. This view has been adopted by a number of courts.[3]

[1] *See* In re Terrance Gardens Park P'ship, 96 B.R. 707 (Bankr. W.D. Tex. 1989).

[2] *See* In re Beker Indus. Corp., 63 B.R. 474 (S.D. N.Y. 1986).

[3] Matter of WPRV-TV, Inc. 143 B.R. 315 (D.P.R. 1991) (First Circuit); In re Beker Indus. Corp., 63 B.R. 474 (S.D. N.Y. 1986) (Second Circuit); In re Milford Grp., 150 B.R. 905 (Bankr. M.D. Pa. 1992) (Third Circuit); In re Collins, 180 B.R. 447 (Bankr. E.D. Va. 1995); In re Terrance Gardens Park P'ship, 96 B.R. 707 (Bankr. W.D. Tex. 1989) (Fifth Circuit); In re Larson, 99 B.R. 1 (Bankr. D. Alaska 1989 (Ninth Circuit).

B. Face Value

In contrast, other circuits that have considered the issue hold that the term "aggregate value" means the total of the face amount of the claims secured by the liens against the property, such that a sale free and clear could be approved only if the sale price exceeded the total face amount of debts against the property. This view has also been adopted by a number of courts.[4]

[4] *See* In re Perroncello, 170 B.R. 189, (Bankr. D. Mass. 1996) (First Circuit); In re Gen. Bearing Corp., 136 B.R. 361, (Bankr. S.D. N.Y. 1992) (Second Circuit); In re WDH Howell, LLC, 298 B.R. 527 (D.N.J. 2003 (Third Circuit); Matter of Stroud Wholesale, Inc., 47 B.R. 999 (E.D. N.C. 1985 (Fourth Circuit); In re Julien Co., 117 B.R. 910 (Bankr. W.D. Tenn. 1990) (Sixth Circuit); In re Terrace Chalet Apartments, Ltd., 159 B.R. 821 (N.D. Ill. 1993) (Seventh Circuit); In re Heine, 141 B.R. 185 (Bankr. S.D. S.D. 1992) (Eighth Circuit); In re Canonigo, 276 B.R. 257 (Bankr. N.D. Cal. 2002) (Ninth Circuit); In re Feinstein Family P'ship, 247 B.R. 502 (Bankr. M.D. Fla. 2000) (Eleventh Circuit).

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Timothy A. ("Tad") Davidson II

Free and Clear Issues in Oil and Gas Cases

- Environmental Claim and Obligations -- plugging and abandonment issues
    - Generally, a sale cannot exclude on going statutory environmental claims and obligations but can limit purchaser's contractual liability for certain environmental obligations, including P&A.
    - For example, debtor and purchaser could agree to divide responsibility for P&A in the PSA.
- Royalties and similar rights
    - Whether a sale is free and clear of ORRIs and NPIs depends on whether the ORRIs/NPIs are conveyances of real property or disguised financing transactions.
- Covenants running with the land - gathering agreements and dedications
    - Covenants running with the land, as interests in real property, continue.
- Rights under joint operating agreements
- State law determination
    - Section 363(f)(1) permits the sale of property free and clear of such an interest if the property could be sold free and clear of such interest under applicable nonbankruptcy law.

Intellectual Property Issues

- Section 365(n) provides protections for licensees of intellectual property related to rejection of an intellectual property license, including giving the licensees the option to retain their rights. This conflicts with debtor's right to sell property free and clear of those rights under Section 363(f). Some courts, however, allow estate property to be sold free and clear of licensee interests.
- Allowed sale free and clear of IP rights:
    - In *In re Particle Drilling Technologies, Inc.*, 2009 WL 2382030 (Bankr. S.D. Tex. July 29, 2009) (Isgur, J.), the court held that because the patents are personal property, the real property concept of a covenant running with the property does not apply to the patent royalty rights. Therefore, the patent rights were insufficient to burden the debtor's patents and did not bar a 363 free and clear sale of those patents.

- Did not allow sale free and clear of IP rights:
    - In *In re Dynamic Tooling Systems, Inc.*, 349 B.R. 847 (Bankr. D. Kan. 2006), the patent licensee sought to prevent the sale as part of a chapter 11 plan, similar to a 363(f) sale, of the underlying intellectual property free and clear of its claimed licensee interest. To protect the statutory right of debtor's licensee to elect to continue to use any licensed intellectual property, the bankruptcy court held that, the proposed sale of debtor's property free and clear did not include debtor's intellectual property.
    - *In re Ice Mgmt. Sys., Inc.*, No. BAP CC-14-1046, 2014 WL 6892739 (B.A.P. 9th Cir. Dec. 8, 2014), prior to the sale of the debtor's patents by the trustee, the patent licensee filed a notice of election under 365(n) to preserve its license rights. License agreement was deemed rejected prior to 363(f) sale. Trustee sought approval to sell patents free and clear. The appellate court upheld the bankruptcy court's ruling that the trustee's sale of the licensed patents would be subject to the licenses and other liens against the licensed patents even though the license agreement was deemed rejected prior to the sale.

Pay to Play - Interim Distributions as Part of Sale

- Distribute proceeds outside of plan pursuant to sale approval order
- Secured creditors/reserve
- American Eagle Energy (Denver)
- III Exploration (Salt Lake City)

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FREE AND CLEAR OF WHAT, EXACTLY

Christian C. Onsager

Section 363(f) of the Bankruptcy Code allows a sale to be "free and clear of any interest in" the property being sold. The Code does not define "interest in." The following is a short compendium of possible "interests in" that are not specifically addressed in a subsection of § 363(f).

1. Rights of First Refusal: *In re Fleishman*, 138 B.R. 641 (Bankr. D. Mass. 1992) (YES); *Battle Ground Plaza, LLC v. Estate of Jessen* (*In re Ray*), No. WW-08-1104, 2008 Bankr. LEXIS 4758 (B.A.P. 9th Cir. Dec. 31, 2008) (USE IT OR LOSE IT), *rev'd*, *Battle Ground Plaza, LLC v. Ray (In re Ray)*, 624 F.3d 1124 (9th Cir. 2010); *In re Olsen,* Case No. 10-39796 (Bankr. E.D. Wisc. Sept. 28, 2011) (NO) (attached).

2. Successor liability: *Elliott v. GM LLC* (*In re Motors Liquidation Co.*), 829 F.3d 135 (2d Cir. 2016) (WELL, IT DEPENDS)

3. Easements: *In re Flyboy Aviation Props.*, LLC, 501 B.R. 828 (Bankr. N.D. Ga. 2013) (NO); *Clear Channel Outdoor, Inc. v. Knupfer* (*In re PW, LLC*), 391 B.R. 25 (B.A.P. 9th Cir. 2008) (NO); *In re Metroplex on the Atl., LLC*, 545 B.R. 786 (Bankr. E.D.N.Y. 2016) (YES)

4. Labor related claims: *In re Trans World Airlines, Inc.,* 322 F.3d 283, 289, 291-92 (3d Cir. 2003) (trend in case law toward expanding the interpretation of "interest in . . . property," so NO)

5. Setoff and recoupment: *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, J.V.*, 209 F.3d 252 (3d Cir. 2000)

6. Lis Pendens-partition claim: *In re Mundy Ranch, Inc.*, 484 B.R. 416 (Bankr. D. N.M. 2012)

7. CERCLA (environmental claims): *Coated Sales, Inc. v. First Eastern Bank, N.A.*, 144 B.R. 663 (Bankr. S.D.N.Y. 1992) (NO); *In re GMC*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009) (yes/no)

A few other interesting issues:

a. Sub Rosa Plan: *Ind. State Police Pension Trust v. Chrysler LLC* (*In re Chrysler LLC*), 576 F.3d 108 (2d Cir. N.Y. 2009), *vacated as moot*, *Ind. State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009).

b. Free & clear sales in receiverships: *John T. Callahan & Sons, Inc. v. Dykeman Elec. Co.*, 266 F. Supp. 2d 208 (D. Mass. 2003)

c. Free & clear sales in assignments for the benefit of creditors: *Anderson v. J.A. Interior Applications, Inc.*, No. 97-C-4552, 1998 U.S. Dist. LEXIS 15971 (N.D. Ill. Sept. 28, 1998)

d. Sale order binding as to non-parties: *Battle Ground Plaza, LLC v. Estate of Jessen* (*In re Ray*), No. WW-08-1104, 2008 Bankr. LEXIS 4758, at *28 (B.A.P. 9th Cir. Dec. 31, 2008) (citing *Regions Bank v. J.R. Oil Co.*, LLC, 387 F.3d 721, 732 (8th Cir. 2004) ("[a] bankruptcy sale under 11 U.S.C. § 363, free and clear of all liens, is a judgment that is good as against the world, not merely as against parties to the proceedings" (internal citations omitted))), *rev'd*, *Battle Ground Plaza, LLC v. Ray (In re Ray)*, 624 F.3d 1124 (9th Cir. 2010); *Gekas v. Pipin (In re Met-L-Wood Corp.)*, 861 F.2d 1012, 1017 (7th Cir. 1988) ("A proceeding under section 363 is an *in rem* proceeding. It transfers property rights and property rights are rights good against the world, not just against parties to a judgment or persons with notice of the proceeding.")

Problems in the Code

By Mark Pfeiffer

Will the Pipeline Continue to Flow After *Sabine*?

Oil and Gas Bankruptcies Expose Limitations in § 365

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A wave of oil and gas bankruptcies is in progress as commodity prices are near their lowest points in 20 years and supply exceeds demand. Oil and gas producers are using bankruptcy to reject and renegotiate "midstream" pipeline, processing and gathering contracts. This is problematic for midstream companies because their own debt service may be dependent on legacy contract revenue levels, and they could default if that revenue is curtailed.

Billions of dollars in investments might be affected with the potential for cascading fallout for lenders to the industry. From the producer's perspective, contract rejection may be a high-stakes bluff because the oil and gas leases usually terminate if production stops for an extended period, and the producers need the pipelines in order to continue production.

These bankruptcies raise fundamental and unresolved questions about the interplay between rejection under § 365 of the Bankruptcy Code and covenants running with the land that expose a gap in § 365. Bankruptcy Judge **Shelley C. Chapman** (S.D.N.Y.) recently issued the first opinions addressing some of the issues in *In re Sabine Oil & Gas Corp*.[1] The *Sabine* decisions do not resolve anything other than to point out that a rejection proceeding under § 365 is probably not the appropriate method of divesting a restrictive covenant. Debtors will likely look for alternatives, and future battles may be waged in § 363(f) sales.

Industry Structure

The oil and gas industry is structured vertically with landowners at the top. The landowners and producers enter into oil and gas leases, which grant surface rights to the producers and permit drilling and exploration. These leases also give the producers mineral rights that are usually considered real property interests under local law. The owner is compensated partly with a royalty for the minerals produced by the well.

Pipelines and processing plants are required to convert the raw minerals to finished products and transport them from the well to market. This infrastructure is usually owned by separate "midstream" companies, which build the facilities based on exclusive gathering, pipeline and processing agreements with the producer. These agreements typically "dedicate"[2] all of the minerals from the leases to the midstream companies' facilities in exchange for a fee. Debtors are trying to use rejection under § 365 to renegotiate or terminate these midstream agreements.

Financing Structure

Production and exploration costs are financed with leasehold mortgages and other liens on the producer's interest in the surface and mineral rights. If the producer enters into a development joint venture, the operating agreement[3] may also create liens in favor of the operator over the nonoperator's mineral interest to secure the nonoperator's obligations under the agreement. The senior liens against the real property and mineral rights frequently leave the midstream companies to rely on the dedication as a means of protecting their investments. There is little industry standardization for midstream contracts, and the dedications are not always recorded in the real property records or Uniform Commercial Code (UCC) filings.

Rejection of Midstream Agreements

To date, midstream companies facing rejection motions have opposed them, saying that the dedication is a covenant running with the land that cannot be rejected. Section 365(a) was designed to deal with contractual rights and not property interests,[4] and as a result, the key issue for rejection is whether a dedication creates a property interest or merely a contractual right.

Courts are struggling to determine the meaning of "dedications."[5] There is little (if any) case law dealing with dedications or what (if any) property interests are created. A dedication may create a lien,

1 *In re Sabine Oil & Gas Corp.*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016).

2 As discussed herein, "dedications" in the oil and gas context are not well defined in the law.

3 An operating agreement is an agreement between two producers, which provides for one of them to drill and operate wells for the benefit of both. If the operating agreement meets the definition of "farmout" agreement in § 101(21A) of the Bankruptcy Code, then the hydrocarbons of the "farmee" are not property of the estate. 11 U.S.C. § 541(b)(4).

4 *See* discussion in *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245 (Bankr. C.D. Cal. 1995).

5 During a recent oral argument on a rejection motion in the *Quicksilver Resources Inc.* bankruptcy, Judge **Laurie Selber Silverstein** asked, "What does 'dedication' mean? ... I'm not sure either party told me." None of the parties were able to provide an answer in the oil and gas context. *In re Quicksilver Res. Inc.*, No. 15-10585, Doc. 1233 (Bankr. D. Del. March 7, 2016).

a real property interest or merely a contractual right without any property interest. The issues are complicated by the transformative nature of the property, making the identification of any property interest difficult.

Before extraction, the mineral rights are generally considered real property interests. Once the minerals pass the wellhead,[6] they become personal property and the midstream company may acquire an interest in them through a sale or the pledge of a security interest under Articles 2 and 9 of the UCC. Even after extraction, it might be difficult to determine who owns the minerals. The midstream contracts are sometimes structured as sales, service agreements or hybrids of both, thus making it difficult to distinguish sales transactions covered by the UCC and service transactions covered by general contract law. The contracts are governed by state laws, which may vary by jurisdiction.

In *Sabine*, Judge Chapman authorized the debtor to reject the agreements that were "subject to rejection."[7] However, she declined to make a final determination on whether the dedications were covenants running with the land because there were contested factual issues that could not be decided in a summary rejection proceeding.[8] After receiving an incomplete remedy in the rejection proceeding, the debtor filed an adversary proceeding seeking a binding determination that there was no covenant running with the land. In a subsequent opinion in the adversary proceeding, Judge Chapman ruled that the dedications did not run with the land[9] and do not "touch and concern" the land because they relate to extracted gas, which is considered to be personal property under Texas law. The court also concluded that there was no "horizontal privity of the estate," which is arguably required under Texas law.[10]

The *Sabine* opinions may not universally resolve the critical issues facing the industry because of the lack of uniformity in the documentation of midstream contracts and potential variance of state laws. However, two practical points may be derived from *Sabine*. First, it is unlikely that a covenant running with the land can be rejected in a summary rejection proceeding, and an adversary proceeding is probably required to adjudicate the property rights. Second, the rejection/adversary proceeding approach used in *Sabine* only provides debtors with a complete remedy if the court makes a final determination that there is no covenant running with the land.[11] A debtor's goal is not to obtain an academic determination about the nature of a dedication; the point is to terminate the dedication, whether or not it runs with the land, and debtors will try to find more sure-fire ways to do it.

Is § 363(f) an Option for Debtors?

Section 363(f) of the Bankruptcy Code might be a tool available to debtors to accomplish the divestiture, either through a standalone third-party sale or a sale conducted in connection with a confirmed plan.[12] So far, none of the oil and gas cases have addressed whether a restrictive covenant dedication can be divested in a § 363(f) sale.[13] Generally, the Code permits sales free and clear of "interests" in the property being sold, provided that the sale satisfies the requirements of § 363(f).[14] The threshold question is whether a dedication is an "interest" that may be divested by § 363(f). Some courts define "interests" narrowly to include only *in rem* property rights, while others employ a broader definition that includes other obligations flowing from ownership of the property.[15]

> **The *Sabine* decisions do not resolve much, although they do point out the limitations to terminating oil and gas dedications using § 365.... Until the Bankruptcy Code is amended or the law is more firmly established, parties to midstream contracts will face uncertainty concerning their rights.**

If a dedication is a covenant running with the land, it probably falls within either of the definitions and could be divested in a sale. If it is only a contractual right, it is not an "interest" under the narrow view and may not be divested. However, this begs the question of whether a non-interest needs to be divested.[16] If the dedication is only a contractual right that does not follow the land, can the midstream company enforce it against the buyer?[17] The answer is probably analogous to the successor liability risk faced by § 363(f) buyers, who get an order stating that the sale is free and clear of all interests in the property but that this does not necessarily stop claims that could end up being litigated in front of a state court judge who may not respect the free-and-clear language of the sale order.

If the dedication is an interest that could be divested, the likely mechanisms are § 363(f)(1), which authorizes divest-

6 *See* comment to 13 Pa.C.S.A. § 9102(a); *RPITA LLC v. Mfrs. & Traders Trust Co.*, 122 A.3d 441 (Pa. Super. Ct. 2015).

7 *In re Sabine Oil & Gas Corp.*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016).

8 *Id.* at 73 (discussing *Orion Pictures Corp. v. Showtime Network*, 4 F.3d 1095 (3d Cir. 1993)). *Orion* appears to represent the prevailing view nationwide.

9 *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings LLC (In re Sabine Oil & Gas Corp.)*, Adv. Pro. No. 15-11835, Doc. 22 (Bankr. S.D.N.Y. May 3, 2016).

10 Horizontal privity requires "simultaneous existing interests or mutual privity between the original covenanting parties as either landlord and tenant or grantor and grantee." *In re Sabine Oil & Gas Corp.*, 547 B.R. at 66 (Bankr. S.D.N.Y. 2016) (internal quotations omitted).

11 *See Banning Lewis Ranch Co. v. City of Colorado Springs (In re Banning Lewis Ranch Co.)*, 532 B.R. 335 (Bankr. D. Colo. 2015) (rejection of executory contract would not terminate covenant running with land); *Beeter v. Tri-City Prop. Mgmt. Servs. Inc. (In re Beeter)*, 173 B.R. 108 (Bankr. W.D. Tex. 1994) ("interests" in property are not contracts that may be rejected). At least one circuit court determined that a restrictive covenant is a property right and may not be rejected under § 365. *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994).

12 There is little (if any) case law dealing with divesting restrictive covenants through a plan pursuant to the free-and-clear language of § 1141 of the Bankruptcy Code. *See In re Eastport Golf Club Inc.*, 373 B.R. 446, 452 at fn.13 (Bankr. D.S.C. 2007).

13 The issue appeared to be lurking in the *Quicksilver Resources Inc.* bankruptcy in Delaware because the bankruptcy court issued an order allowing Quicksilver to sell the wells and the oil and gas leases free and clear of any interests pursuant to § 363(f). The Quicksilver sale was not contested by the midstream companies that reserved their rights with respect to any subsequent rejection motion. However, the rejection motion was withdrawn shortly after the first *Sabine* opinion was issued and was not decided by the court. *In re Quicksilver Res. Inc.*, No. 15-10585, Doc. 1297 (Bankr. D. Del. 2016).

14 To the extent that the sale occurs in connection with a confirmed plan, the debtor may not need to satisfy the § 363(f) requirements. *See In re Nagy*, No. 10-10404-TPA (Bankr. W.D. Pa. Jan. 29, 2013).

15 *See* discussion in *In re Trans World Airlines Inc.*, 322 F.3d 283 (3d Cir. 2003).

16 *See In re Hassen Imps. P'ship*, 502 B.R. 851, 858 (C.D. Cal. 2013) (noting that there would have been no need for bankruptcy court to authorize sale free and clear unless right runs with land).

17 *See In re MidSouth Golf LLC*, No. 13-07906-8-SWH, Doc. 344 (Bankr. E.D.N.C. March 29, 2016) (recognizing distinction between personal covenants enforceable at law between contracting parties and real covenants, which create servitude upon land for benefit of another).

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ment as permitted by nonbankruptcy law, and § 363(f)(4) if there is a *bona fide* dispute.[18] Although § 363(f)(1) is not commonly used in bankruptcy sales, it is possible to terminate a restrictive covenant based on changed circumstances in many jurisdictions, including a number of the key oil and gas-producing states.[19] The depressed prices may provide debtors with a basis to terminate a restrictive covenant based on changed circumstances, particularly if the operation is unprofitable.[20] However, in some jurisdictions, a mere change in economic condition is insufficient to justify abrogating a restrictive covenant, and a debtor may need to show other factors, including frustration of purpose, impossibility or impracticability.[21]

The debtor may not need to sustain the high burden of invalidating the dedication. Section 363(f)(4) permits a sale free and clear of any interest that is in *bona fide* dispute.[22] It may be tantalizing for a debtor to take the position that there is a *bona fide* dispute given the unclear nature of midstream dedications and the possibly changed conditions based on the low commodity prices. There is authority that disputes concerning the validity of the interest are within the scope of § 363(f)(4).[23] However, there is also authority indicating that the dispute cannot concern validity of the interest. Instead, the dispute must involve the validity of debt.[24]

Whether or not a dispute concerning the validity of the interest falls within the scope of § 363(f)(4), debtors may favor § 363 over the adversary proceeding required by *Sabine*. Once a court determines in an adversary proceeding that the dedication runs with the land, there may no longer be a *bona fide* dispute that can be used to divest the interest.

Conclusion

The *Sabine* decisions do not resolve much, although they do point out the limitations to terminating oil and gas dedications using § 365. These limitations may drive debtors to seek alternative means of terminating the dedications, and § 363(f) might be an attractive option. However, neither Code section clearly identifies what interests may be rejected and divested, and the Code would benefit from amendments that provide more clarity. Until the Bankruptcy Code is amended or the law is more firmly established, parties to midstream contracts will face uncertainty concerning their rights.

However, even if the dedications could be terminated, it may only be an academic exercise because the viability of the wells depends on transporting the hydrocarbons to market, and the most efficient way to do that is to use the existing midstream facilities. As a result, negotiated resolutions are likely to occur, as producers and midstream companies have too much at stake. abi

18 *See Silverman v. Ankari (In re Oyster Bay Cove Ltd.),* 196 B.R. 251 (E.D.N.Y. 1996). Section 363(f)(5) of the Bankruptcy Code authorizes sale free and clear of interests if the holder of the interest could be compelled to accept a money satisfaction of the interest in a legal or equitable proceeding. However, this section may not be a prime candidate to effectuate a divestment of the interest. *See In re Hassen Imps. P'ship*, 502 B.R. 851 (C.D. Cal. 2013); Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994).

19 *See, e.g., TX Far West Ltd. v. Texas Inv. Mgmt. Inc.*, 127 S.W.3d 295 (Tex. App. 2004); *Vernon Twp. Volunteer Fire Dept. Inc. v. Connor*, 855 A.2d 873 (Pa. 2004); *Brown v. Huber*, 88 N.E. 322 (Ohio 1909); *Kytle v. Peck*, 330 P.2d 189 (Okla. 1958); *Winston v. 524 W. End Ave. Inc.*, 233 App. Div. 5, 251 N.Y.S. 96 (App. Div. 1st Dept. 1931).

20 *See, e.g., In re TOUSA Inc.*, 393 B.R. 920 (Bankr. S.D. Fla. 2008) (restrictive covenant setting minimum sale price for real estate is impractical given intervening collapse in real estate market).

21 *See, e.g., Heatherwood Holdings LLC v. First Commercial Bank*, 61 So. 3d 1012 (Ala. 2010); *City of Bowie v. MIE Props. Inc.*, 922 A.2d 509 (Md. 2007); *Old Taunton Colony Club v. Medford Twp. Zoning Bd. of Adjustment*, No. A-5134-11T2, 2013 WL 2420354 (N.J. Super. Ct. App. Div. June 5, 2013).

22 *See In re Daufuskie Island Props. LLC*, 431 B.R. 626 (Bankr. D.S.C. 2010) (court does not need to resolve dispute in connection with sale).

23 *Id.*; *see, e.g., In re Daufuskie Island Props. LLC*, 431 B.R. 626 (Bankr. D.S.C. 2010).

24 *See Baylake Bank v. TCGC LLC*, 2008 WL 4525009 at *9, fn.6; *Bridges Restaurant Assocs. v. The Meadowbrook Mall Co.*, No. 1:06CV53, Doc. 18 (N.D. W.Va. March 28, 2007).

Feature

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.

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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).