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Unbundling a Bundle of Sticks

A real property asset has been described as a "bundle of sticks,"[1] but what happens when one of those sticks detracts from the value of the bundle? Covenants, whether affirmative or negative,[2] that run with the land ("real covenants") can constitute such sticks because they are considered part of the real property, and they may restrict the use of the property or require the owner to perform some act.

Justice Oliver Wendell Holmes propounded that real covenants originated in the form of easements, which are rights that, "once acquired[, are] attached to the land and [continue] with it, irrespective of privity, into all hands, even those of a disseizor."[3] In the last several years, debtors more aggressively have attacked these sticks to separate them from the bundle and increase value to their estates. This article analyzes what constitutes a real covenant, as well as tools available under the Bankruptcy Code and state law that may enable a debtor to free its real property asset of real covenants that diminish value.

Real Covenants

A real covenant is "so connected to the underlying land that the benefit and burden pass to successors by operation of law,"[4] which makes them inseparable from the land.[5] Courts apply the law of the *situs* state of the real property to determine the existence and rights for a real covenant.[6] The majority of states recognize that real covenants bind successors when the covenant (1) "touches and concerns" the land; (2) relates to a thing in existence or specifically binds the original parties and their assigns; and (3) the original parties intended the covenant to pass to successors.[7] Some states also require actual or constructive notice,[8] as well as privity (whether horizontal or vertical).[9]

Horizontal privity "refers to the relationship between the original parties to the covenant."[10] Thus, "[w]hile a conveyance of a fee-simple estate [in connection with the creation of the real covenant] satisfies horizontal privity, conveyances of lesser estates have also been found sufficient."[11] Vertical privity refers to the relationship between the original parties benefited or burdened by the covenant and the successor who is claiming the benefit or burden.[12]

The chief consideration to find a real covenant is the "touch and concern" element. For a covenant to "touch and concern" real property, it must impact the use, value or enjoyment of the real property interest:[13] "The touch-and-concern requirement is critical in distinguishing between real and personal covenants."[14] In addition, "personal covenants ... bind only the actual parties to the covenant, whereas real covenants 'run with the land' and burden or benefit successors in interests."[15]

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1 *In re Badlands Energy Inc.*, 608 B.R. 854, 874 (Bankr. D. Colo. 2019).
2 *Mendrop v. Harrell*, 103 So. 2d 418, 423 (Miss. 1958) (except for New York, other states "do not appear to make any distinction between affirmative covenants and negative or restrictive covenants").
3 *Norcross v. James*, 2 N.E. 946 (Mass.1885).
4 *Alta Mesa Res. Inc.*, 613 B.R. 90, 100 (Bankr. S.D. Tex. 2019).
5 *In re Badlands Energy Inc.*, 608 B.R. at 874; *see also In re Sanchez Energy Corp.*, 631 B.R. 847, 860 (Bankr. S.D. Tex. 2021) (explaining that real covenants cannot be "terminated by a party's breach of contract").
6 *Alta Mesa*, 613 B.R. at 99 ("When a dispute focuses on real property, the [Bankruptcy] Court ordinarily applies the law of the state where the real property is situated.").
7 *See, e.g., In re Sabine Oil & Gas Corp.*, 550 B.R. 59, 65 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869, 874 (S.D.N.Y. 2017), *aff'd*, 734 Fed. App'x 64, 65 (2d Cir. 2018); *In re Badlands Energy Inc.*, 608 B.R. at 867; *Alta Mesa Res. Inc.*, 613 B.R. at 99; *Flying Diamond Oil v. Newton Sheep Co.*, 776 P.2d 618, 622-23 (Utah 1989); *Neponsit Property Owners' Ass'n v. Emigrant I. Sav. Bank*, 278 N.Y. 248, 254-55 (N.Y. 1938); *In re Fleishman*, 138 B.R. 641, 643-44 (Bankr. D. Mass. 1992); *Mendrop v. Harrell*, 103 So. 2d at 423; *Southland Royalty Co. LLC v. Wamsutter (In re Southland Royalty Co. LLC)*, 623 B.R. 64, 80 (Bankr. D. Del. 2020).
8 *See, e.g., In re Sabine Oil & Gas Corp.*, 550 B.R. at 65; *In re Badlands Energy Inc.*, 608 B.R. at 867; *Daufuskie Island Props. LLC*, 431 B.R. 612, 623-24 (Bankr. D.S.C. 2009). Generally, the statute of frauds requires real estate transactions to be in writing, which ultimately provides successors with constructive or inquiry notice. *See Alta Mesa Res. Inc.*, 613 B.R. at 105 ("[R]ecording of an interest in real property places buyers on inquiry notice of the interest.").
9 *See, e.g., In re Sabine Oil & Gas Corp.*, 550 B.R. at 68-69; *In re Badlands Energy Inc.*, 608 B.R. 854 at 867; *In re Southland Royalty Co. LLC*, 623 B.R. at 80.
10 *Alta Mesa Res. Inc.*, 613 B.R. at 105.
11 *Id.*
12 *Id.*
13 *See, e.g., Flying Diamond Oil v. Newton Sheep Co.*, 776 P.2d 618, 624 (Utah 1989); *Westland Oil Devel. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).
14 *Flying Diamond Oil*, 776 P.2d at 624.
15 *Cloud v. Ass'n of Owners*, 857 P.2d 435, 440 (Colo. App. 1992).

Stripping Real Covenants Under §§ 365(a) and 363(f)

The Bankruptcy Code provides a debtor with powerful tools to maximize estate value and effectuate a transaction, including § 365(a) (assumption or rejection of an "executory contract") and § 363(f) (sale of property free and clear of the interests).[16]

Rejection Under § 365(a)

Section 365(a) allows a debtor, subject to court approval, to assume or reject an executory contract,[17] which "enables [a debtor] ... to decide whether the contract is a good deal for the estate going forward."[18] The Bankruptcy Code does not define "executory contract," but it is well-settled that it means a contract "on which performance is due to some extent on both sides."[19] "Such an agreement represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform)."[20] However, the debtor cannot reject a real covenant because real covenants are property interests that are not extinguished by § 365(a), even though courts recognize that real covenants are also contracts.[21]

In *In re Sabine Oil & Gas Corp.*, the bankruptcy court, applying Texas law, found that the gathering agreements[22] under consideration were not covenants running with the land because they did not "touch and concern" the land and could therefore be rejected as executory contracts pursuant to § 365.[23] The court relied on three aspects of the gathering agreements to reach its decision: (1) "the debtor-producer retained the right to operate its wells without input from its gatherers"; (2) the gatherer did not connect directly to the debtors' wells but instead at gathering system receipt points; and (3) the gathering fees were triggered by the gatherers' receipt of hydrocarbons, not by the extraction of hydrocarbons from the ground.[24] The *Sabine* court also found that the horizontal privity required by Texas law had not been satisfied.[25]

Three years after *Sabine*, the bankruptcy court in *In re Badlands Energy Inc.* distinguished the subject-gathering agreements from those in *Sabine* and held that they satisfied the "touch and concern" element under Utah law because the "burdens imposed under the [gathering agreements] directly affect the Producers' use and enjoyment of its interests in the Leases."[26] Therefore, the gathering agreements became "part of the bundle of sticks" when the purchaser acquired the debtors' assets, and those sticks are not removable.[27] After *Badlands*, the bankruptcy court in *Alta Mesa Res. Inc.* found that a gathering agreement "touched and concerned" the land under Oklahoma law because "both the benefits and the burdens of the covenants affect the value of [the debtor's] real property interests."[28] Therefore, the bankruptcy court held that the gathering agreements bind the successors and cannot be rejected under § 365(a).[29]

The real covenant analyses turn on the specific language of the dedication under the real property law of the subject *situs* state. Accordingly, even similar language in the dedications may lead to different results depending on the state.

Sale Free and Clear Under § 363(f)

Section 363(f) empowers the debtor to sell its assets free and clear of the interests of third parties under the specific circumstances set forth in subsections (1)-(5). Some courts have held that real covenants are, on a fundamental level, not "interests." Therefore, a § 363 sale cannot remove them.[30] These courts are becoming outliers, as there seems to be a general consensus that "interest" under § 363(f) should be construed broadly.[31] Although it is difficult to remove a real covenant from the bundle of sticks, it is not impossible.

Section 363(f)(1) allows a free-and-clear sale of real property where nonbankruptcy law permits it.[32] Since state law defines real covenants, state law may also remove those same covenants through § 363(f)(1). In some instances, the interest may be unenforceable under state law.[33] In others, a debtor can take advantage of state laws that allow preexisting mortgagors to extinguish subsequent covenants via foreclosure, reasoning that if the mortgagee could foreclose out the real covenant, then § 363(f)(1) permits the sale free of the real covenant.[34] Further, some states subscribe to the doctrine of changed circumstances, whereby a real covenant may be unenforceable, thus satisfying § 363(f)(1), if the circumstances have changed such that enforcement of such covenant no longer serves its intended purpose.

In *Daufuskie Island Props. LLC*, the chapter 11 trustee sold real property free and clear of a real covenant (the right to repurchase the real property) because certain related rights had not run with the land and the property would likely never meet the requirements for repurchase.[35] Thus, the covenant was "valueless to the covenantee and oppressive and unreasonable as to the covenantor," and could be extinguished under South Carolina's changed-circumstances doctrine.[36]

Section 365(f)(4) allows for the sale of real property free and clear of an interest where such interest is in *bona fide* dispute (*i.e.*, there is an objective basis in law

16 11 U.S.C. §§ 363, 365.
17 11 U.S.C. § 365(a).
18 *Mission Prod. Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652, 1658 (2019).
19 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984).
20 *Mission Prod. Holdings Inc.*, 139 S. Ct. at 1658.
21 *May Dep't Stores v. Montgomery Cnty.*, 702 A.2d 988, 997, 458 (Md. Ct. Spec. App. 1997), *aff'd sub. nom.*, 352 Md. 183, 194 (Md. App. 1998) ("[C]ovenants [are] contractual obligations."); *In re Southland Royalty Co. LLC*, 623 B.R. at 88 ("Real covenants are contractual obligations.").
22 Gathering agreements are oil and gas contracts between production companies and midstream service providers whereby a producer dedicates production from certain wells or acreage to a gathering system. These dedication provisions provide midstream companies with assurances for continuous throughput and producers with guaranteed capacity on a system to transport and process their production.
23 *In re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016).
24 *Alta Mesa Res. Inc.*, 613 B.R. 90, 101 (Bankr. S.D. Tex. 2019) (explaining *In re Sabine Oil & Gas Corp.*, 550 B.R. at 59).
25 *In re Sabine Oil & Gas Corp.*, 550 B.R. at 68.
26 *In re Badlands Energy Inc.*, 608 B.R. 854, 869 (Bankr. D. Colo. 2019).
27 *Id.* at 874.
28 *Alta Mesa Res. Inc.*, 613 B.R. at 102.
29 *Id.* at 95.
30 *See, e.g., In re Badlands Energy Inc.*, 608 B.R. at 874 (holding that under Utah law covenants "are not subject to elimination utilizing § 363(f)").
31 *Compare In re Oyster Bay Cove Ltd.*, 196 B.R. 251, 255 (E.D.N.Y. 1996) (holding that easements are not interests under § 363), *with In re Metroplex on the Atl. LLC*, 545 B.R. 786, 793 (Bankr. E.D.N.Y. 2016) (criticizing *Oyster Bay Cove* and holding that easement is "interest," and property may be sold free and clear of that easement if it can be classified under one of § 363(f)'s subsections).
32 11 U.S.C. § 363(f)(1).
33 *In re TOUSA*, 393 B.R.920, 923-24 (Bankr. S.D. Fla. 2008) (applying Florida law)
34 *In re Southland Royalty Co. LLC*, 623 B.R. at 99 (applying Wyoming law holding that subsection (1) does not require debtor to have ability or standing to make such foreclosure, only that such foreclosure is possible under nonbankruptcy law); *In re Dulgerian*, 06-10203JKF, 2008 WL 220523 at **4-5 (Bankr. E.D. Pa. Jan. 25, 2008) (applying Pennsylvania law).
35 *In re Daufuskie Island Props. LLC*, 431 B.R. at 626.
36 *See also In re Midsouth Golf LLC*, 549 B.R. 156, 179 (Bankr. E.D.N.C. 2016) (holding that underlying covenant seeking to be stripped did not run with land, but if it did, it could be terminated as in *Daufuskie*).

or fact as to the validity of the interest).[37] Thus, "this standard does not require that the Court resolve the underlying dispute or that it determine the probable outcome of the dispute; rather, it only requires a determination that such a dispute does, in fact, exist."[38]

Section 363(f)(5) allows for the free-and-clear sale where state law can compel the covenantee to accept monetary relief. State law defines whether the covenantee may be forced to accept monetary relief. Examples of such covenants include an unpaid connection-fee surcharge that runs with the land.[39] Courts turn to state law and treatises thereon to determine whether monetary satisfaction can be compelled.[40] Where state law provides the covenantee with the option of enforcement of the real covenant or monetary damages, courts have held this to be insufficient to compel the covenantee under § 363(f)(5).

The Seventh Circuit noted that there is a difference between the availability of monetary damages and compulsion for monetary damages. A real covenant with an enforcement provision that allows both equitable relief and monetary relief does not automatically mean that the covenant-holder can be compelled to accept the monetary option.[41] The inquiry will always return to state law and policy for enforcement of the unique covenant.[41] Again, whether § 363(f) empowers a sale free and clear of a real covenant depends on applicable state law to satisfy one of subsections (1)-(5).

Conclusion

The issue of real covenants detracting from the value of a debtor's assets is not likely to go away anytime soon. Over recent years, debtors have attacked real covenants more aggressively, applying §§ 365(a) and 363(f) and applicable state law in an attempt to increase value to the estate. As courts address these issues, the jurisprudence, albeit potentially state-specific, will continue to develop. abi

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37 *In re Daufuskie Island Props. LLC*, 431 B.R. at 626, 646.
38 *Id.*
39 *In re Vista Mktg. Grp. Ltd.*, 557 B.R. 630, 635 (Bankr. N.D. Ill. 2016) ("[O]ne would be hard-pressed to present a clearer example of a situation where the interest-holder could be compelled to accept a money satisfaction of its interest under subsection (f)(5).").
40 *Southland Royalty Co.*, 623 B.R. at 98 (holding that Wyoming law and *Restatement (Third) of Property: Servitudes* grants courts discretion to select appropriate remedy for covenant enforcement action); *In re Signature Devs. Inc.*, 348 B.R. 758, 766 (Bankr. E.D. Mich. 2006) (analyzing Michigan's policy of enforcing real property restrictions by injunction and concluding that monetary damages were easily applicable).
41 *Gouveia v. Tazbir*, 37 F.3d 295, 299 (7th Cir. 1994).
42 *See Signature Devs.*, 348 B.R. at 767 (disagreeing with *Gouveia*, but noting that covenant at issue in *Signature Developments* was more suitable to monetary remedies than covenant in *Gouveia*).