

**HOMEBUILDER BANKRUPTCIES: DEPRESSED VALUES SETTLE
SOME CONTROVERSIES AND CREATE OTHERS; *TOUSA* AND
SALES FREE AND CLEAR OF RESTRICTIVE COVENANTS¹**

by Alec P. Ostrow²

Introduction

The depressed values of real estate in the current economy hardly surprises anyone. On March 12, 2009, the Federal Reserve reported that households lost \$5.1 trillion of their value in the last three months of 2008.³ Many homebuilders have filed chapter 11, including Neumann Homes, Levitt & Sons, TOUSA, Inc., and WCI Communities. Many others have suffered significant financial setbacks. Nevertheless, many of the typical issues expected to be fought over, such as disputes among entity lenders, project lenders, and mechanics lienholders, are not making their way into the case law, and appear to getting resolved. For example, on February 20, 2009, the bankruptcy court confirmed the liquidating plan for in the *Levitt & Sons* case.⁴ Perhaps the quintessential bankruptcy notion that there is not enough value to satisfy legitimate entitlements has been taken to heart in this sector. Although some fights are not occurring, others are. In particular, in the *TOUSA* case, there has been a reported

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³ See N.Y. Times, Mar. 13, 2008, N.Y. ed., at B1 col. 1.

⁴ In re Levitt & Sons, LLC, No. 07-19845-BKC-RBR (Bankr. S.D. Fla. Feb. 20, 2009) (order confirming joint liquidating plan), available on line at website of claims agent, <http://www.kccllc.net/documents/0719845/071984509022000000000000036.pdf>.

decision concerning a sale free and clear of a restrictive covenant in a housing development.

Minimum Price Restrictive Covenant

In the *TOUSA* case, the bankruptcy court approved a sale of residential real property free and clear of a restrictive covenant that had established a floor price for the sale of lots in a particular development.⁵ The contract containing the restrictive covenant had been entered into two years earlier, in 2006, with a smaller developer referred to as “Zuckerman,” and set a minimum price of \$325,000 per lot so long as Zuckerman owned lots in the development.⁶ The court accepted TOUSA’s representation that as “a result of the tumultuous real estate market, the contractual floor established in 2006 is now radically above what the market will bear: the proposed Sale Agreement, which the Debtors believe reflects a fair price after appropriate marketing, contemplates a sale price of \$150,000 per lot.”⁷ Although analyzed in the context of a free and clear sale, the court ultimately concluded that current market conditions had rendered the price restriction unreasonable and therefore unenforceable.⁸

Restrictive Covenant as an Interest in Property

The free and clear analysis naturally begins with the statute, section 363(f) of the Bankruptcy Code, which permits the court, upon satisfaction of one of five enumerated conditions, to sell property of the estate free and clear of “an interest in such property”

⁵ In re *TOUSA, Inc.*, 393 B.R. 920 (Bankr. S.D. Fla. 2008).

⁶ *Id.* at 922.

⁷ *Id.*

⁸ *Id.* at 923-24.

held by someone other than the estate.⁹ Just what constitutes an “interest” in property that may be the subject of a free and clear sale has for some time generated controversy, especially in the context of successor liability. In 1996 the Fourth Circuit permitted a bankruptcy sale of coal mining assets free and clear of a federal statute’s successor liability provision,¹⁰ which was enacted to insure to continuation of health benefits.¹¹ Because this statutory successor liability was based on the acquisition of assets from a bankruptcy estate, it was held to constitute an “interest in property” within the meaning of the Bankruptcy Code’s “free and clear” sale authority.¹² The court did not define what constitutes an “interest in property” susceptible to a “free and clear” sale, but rejected including unsecured claims and limiting the concept to in rem interests.¹³ In 2003, the Third Circuit approved a sale of the assets of Trans World Airlines free and clear of successor liability¹⁴ for various federal employment discrimination claims.¹⁵ The court based its decision on the intrinsic linkage between the successor liability claims and

⁹ 11 U.S.C. § 363(f).

¹⁰ *In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996), cert. denied, 520 U.S. 1118 (1997).

¹¹ The Coal Industry Retiree Health Benefit Act of 1992, 26 U.S.C. §§ 9701-9722. The statute provides for liability for “successors in interest,” 26 U.S.C. § 9701(c)(2); but the term is not defined.

¹² *Leckie Smokeless Coal.*, 99 F.3d at 582 (construing 11 U.S.C. § 363(f)).

¹³ *Id.* at 581-82.

¹⁴ *In re Trans World Airlines, Inc.*, 322 F.3d 283, 289-90 (3d Cir. 2003).

¹⁵ The claims involved were those under the Age Discrimination in Employment Act, 29 U.S.C. §§ 621-634; Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-17; and the Americans with Disabilities Act, 42 U.S.C. §§ 12101-12213.

the estate's airline assets that were being sold.¹⁶ Like the Fourth Circuit, The Third Circuit resisted a definition of the concept of an "interest in property" and its limitation to in rem interests.¹⁷ The court noted a trend toward an expansive construction of "interests in property" which "encompasses other obligations that may flow from ownership of the property."¹⁸

The *TOUSA* court held that the restrictive covenant was an "interest in property," relying on two decisions, one from the Eastern District of New York, *Silverman v. Ankari (In re Oyster Bay Cove, Ltd.)*;¹⁹ and one from the Seventh Circuit *Gouveia v. Tazbir*.²⁰ *Oyster Bay Cove* concerned an appeal by purchaser at a bankruptcy sale from an order forfeiting his deposit, after he had refused to close because, among other reasons, the free

¹⁶ *Trans World Airlines*, 322 F.3d at 289-90.

¹⁷ *Id.* at 289.

¹⁸ *Id.* (quoting 3 Collier on Bankruptcy, ¶ 363.06 (3d rev. ed. 2002)).

It bears noting the refusal to link an "interest in property" under section 363(f) with a traditional in rem property right is significant. The coal miners and flight attendants in the court of appeals cases do not possess what would generally be regarded as property rights in the assets authorized to be sold. It has been observed that such reasoning results in the granting of "interests in property" for the sole purpose of authorizing the sale of such assets "free and clear" of any successor liability claims. See *In re Eveleth Mines, LLC*, 312 B.R. 634, 654 (Bankr. D. Minn. 2004) (declining to follow the reasoning of the Third and Fourth Circuits in connection with a proposed "free and clear" sale with respect to a state production tax). Stated differently, providing certain persons with a fictitious property right so that a real litigation right (against the purchaser of the debtor's assets) can be taken away from them. See also Michael H. Reed, *Successor Liability and Bankruptcy Sales Revised – A New Paradigm*, 61 Bus. Law. 179, 191 (2005); Alec P. Ostrow, *Free and Clear of Successor Liability or Whose Liability is it Anyway?* 2003 Ann. Surv. Bankr. L. 119, 128-31 (both also criticizing this reasoning, but on different grounds). Nevertheless, the expansive notion of an "interest in property" for purposes of free and clear sales generally prevails.

¹⁹ 196 B.R. 251, 255-56 (E.D.N.Y. 1996).

²⁰ 37 F.3d 295 (7th Cir. 1994).

and clear order did not apply to easements in favor of a local village for a road and storm basin.²¹ The district court affirmed the bankruptcy court, and stated that a free and clear sale “has no impact on restrictions of record that run with the land.”²² This is a proposition that many would challenge today, based, in part, on the Seventh Circuit’s decision in *Gouveia*.

In *Gouveia*, an individual debtor owned real property in a residential development in Indiana with a restrictive covenant that limited the neighborhood to single-story, residential buildings. The covenant explicitly stated that it would run with the land and be binding for fifty years. Despite the covenant the debtor obtained the permission of the local zoning commission to build a commercial music store on that site. After neighbors in the development, relying on the restrictive covenant, had obtained an injunction from a state appellate court, the debtor filed a chapter 11 petition and sought authority to sell the property free and clear of the restrictive covenant, as well as to reject the restrictive covenant as an executory contract.²³ The bankruptcy court denied the relief, and the district court affirmed. After the case had been converted to chapter 7, the trustee pursued the appeal in the Seventh Circuit, which also affirmed.²⁴ Although the court held that the restrictive covenant indeed constituted an interest in property²⁵ – the holding

²¹ 196 B.R. at 253-54.

²² *Id.* at 254.

²³ 37 F.3d at 297-98. 11 U.S.C. § 365(a) authorizes the court to approve the rejection of executory contracts.

²⁴ 37 F.3d at 298.

²⁵ *Id.*

relied on by the *Tousa* court – it neither met the criteria for a free and clear sale,²⁶ nor constituted a rejectable executory contract.²⁷

Section 363(f) Criteria and Section 363(e) Adequate Protection

Two important aspects of a free and clear sale must also be addressed. First, after establishing an “interest in property,” authorization of a free and clear sale of such interest requires the satisfaction of one of the following criteria:

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity [the holder of the interest] consents;
- (3) such interest is a lien and the price at which the property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.²⁸

²⁶ The criterion relied on was § 363(f)(5). The court held that state law did not compel the beneficiaries of the covenant to accept damages, if they could establish their entitlement to an injunction. 37 F.3d at 299-300; accord *In re 523 E. 5th St. Housing Preservation Dev. Fund Corp.*, 79 B.R. 568, 576 (Bankr. S.D.N.Y. 1987) (no § 363(f)(5) authorization to sell free and clear of restrictive covenant requiring real estate be used for low income housing). But see *In re Signature Devs., Inc.*, 348 B.R. 758, 764, 767 (Bankr. E.D. Mich. 2006) (distinguishing *Gouveia* and holding that for the restrictive covenant in that case, requiring future homes in the development to use the same contractor, a money satisfaction could be compelled).

²⁷ 37 F.3d at 298. In particular, the contract was “fully executed” and therefore not executory. *Id.* But see *Signature Devs.*, 348 B.R. at 765 (distinguishing *Gouveia* and holding that for the restrictive covenant in that case, requiring future homes in the development to use the same contractor, the contract remained executory).

²⁸ 11 U.S.C. § 363(f).

Second, assuming that one of these five criteria has been satisfied, and that a free and clear sale can be ordered, the holder of the “interest in property” has the right to demand some form of compensation. Section 363(e) provides in relevant part:

at any time, on request of an entity that has an interest in property . . . sold . . . or proposed to be sold . . . , the court, with or without a hearing, shall prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest.²⁹

The term “adequate protection,” of course, is not defined in the Bankruptcy Code, but it is illustrated.³⁰ It is generally understood as that which will prevent or compensate for the diminution in value of interest in question.³¹ In bankruptcy sales, when the interest in question is a lien on the property to be sold, the common method of providing adequate protection is the granting of a replacement lien against proceeds of the sale.³² If the lien in question is subject to a bona fide dispute, the dispute would remain, with the sale proceeds replacing the specific property as the collateral. Significantly, it is incumbent on the holder of the interest to request adequate protection at the time of the sale. The failure to make such a request may result in a forfeiture of the right to adequate protection.³³ If the request is made, the trustee in bankruptcy or debtor in possession who

²⁹ 11 U.S.C. § 363(e).

³⁰ 11 U.S.C. § 361 provides illustrations of adequate protection, such as (1) “a cash payment or periodic cash payments”; (2) “an additional or replacement lien”; and (3) “the realization of . . . the indubitable equivalent.”

³¹ See *United Sav. Ass’n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370 (1988).

³² See Daniella Saltz & Jose J. Bartolomei, *Sales Free and Clear of Liens and Interests Under Section 363(f)*, in Richard N. Tilton, *Business Bankruptcy Acquisitions*, ¶ 4.09 (2d ed. Am. Bankr. Inst. 2006)

³³ See *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 541, 548 (7th Cir. 2003) (allowing a sale of real property free and clear of leasehold, and lessee

is proposing the sale has the burden of proof on the issue of adequate protection,³⁴ while the holder of the “interest in the property” has the burden of proof on the issue of the “validity, priority, or extent” of such “interest.”³⁵

The TOUSA Court’s Reasoning

It is in these two aspects of section 363 that the *TOUSA* decision is lacking in analysis. The *TOUSA* court begins by observing that the restrictive covenant at issue was not recorded.³⁶ Such a failure to record an interest in real property might ordinarily render that interest subject to a “bona fide dispute,” one of the criteria for authorizing a free and clear sale. A common construction of “bona fide dispute” is that there is an objective basis for a factual or legal dispute.³⁷ A resolution of the dispute is not necessary; it is sufficient to determine that it exists.³⁸ The *TOUSA* court, however, does not rely on this ground. Rather, it rejects the ground, stating that because *TOUSA* was a party to the restrictive covenant, it had notice of the covenant.³⁹ This reasoning ignores case law that holds that the knowledge of the debtor in possession is irrelevant under the avoidance

who failed timely to claim adequate protection had its interest extinguished, and was left with no compensation).

³⁴ 11 U.S.C. § 363(p)(1).

³⁵ 11 U.S.C. § 363(p)(2).

³⁶ *TOUSA*, 393 B.R. at 922.

³⁷ *In re Collins*, 180 B.R. 447, 452 (Bankr. E.D. Va. 1995); *In re Milford Group, Inc.*, 150 B.R. 904, 906-07 (Bankr. M.D. Pa. 1992); *In re Octagon Roofing*, 123 B.R. 583, 590 (Bankr. N.D. Ill. 1991).

³⁸ *Octagon Roofing*, 123 B.R. at 590.

³⁹ *TOUSA*, 923 B.R. at 922 (citing *South Motor Co. v. Carter-Pritchett-Hodges, Inc.* (In re MMH Automotive Group, LLC), 385 B.R. 347, 367-68 (Bankr. S.D. Fla. 2008)).

power granted to a trustee under section 544(a)(3) of the Bankruptcy Code for interests in real property voidable by a bona fide purchaser.⁴⁰

TOUSA holds that a restrictive covenant setting a minimum sales price, although reasonable at the time of the contract, becomes unreasonable, and therefore unenforceable, because of the precipitous drop in real estate values.⁴¹ In doing so, it relies on a standard doctrine in the law of contracts that unreasonable restraints on alienation are unenforceable.⁴² It is significant that the court found Depression Era precedents that allowed, based on changed circumstances, the measurement of reasonableness to occur at the time of alienation, as opposed to the time of contract.⁴³

Having found the restraint on alienation unenforceable, the court permitted the free and clear sale, without either specifying which of the five criteria in section 363(f) was satisfied, or considering the question of adequate protection under section 363(e). To be sure, upon adjudicating that the restrictive covenant was unenforceable, there was no need to analyze the issue under section 363(f) at all. With a properly-commenced adversary proceeding, the court could have issued an injunction or a declaration quieting title. Such a proceeding, however, may not qualify as a core proceeding enabling the

⁴⁰ See *McCannon v. Marston*, 679 F.2d 13, 16 (3d Cir. 1982); *Hardway Restaurant, Inc. v. Once Upon a Stove, Inc.* (In re *Hardway Restaurant, Inc.*), 31 B.R. 322, 328-29 (Bankr. S.D.N.Y. 1983).

⁴¹ *TOUSA*, 393 B.R. at 922-23.

⁴² *Id.* (citing *Iglehart v. Phillips*, 383 So.2d 610, 614-15 (Fla. 1980); *Davis v. Geyer*, 9 So.2d 727 (Fla. 1942)).

⁴³ *Id.* (citing *Port St. Joe Dock & Terminal Ry. v. Maddox*, 191 So. 775 (Fla. 1939); *Osius v. Barton*, 147 So. 862 (Fla. 1933)).

bankruptcy court to issue such a judgment.⁴⁴ Because the issue arose in the context of a sale, and indeed, an emergency application in connection with the sale,⁴⁵ a plenary adjudication could not be accomplished, and the court resorted to a summary determination under section 363(f). But when section 363(f) is invoked, as it clearly, properly was, the court should have carried through the requisite statutory analysis and addressed both the satisfaction of the particular statutory criteria, and the issue of adequate protection.

Conclusion

Even though lacking in analysis under section 363, ultimately, the *TOUSA* court reached an eminently practical and justifiable result. The substantial change in market conditions – the substantial deterioration in housing values – does turn “boom time” floor prices into unreasonable restraints on alienation. Any contrary result either precludes the disposition of property and the realization of any value, or permits the beneficiaries of such restrictive covenants to enjoy unwarranted “hold up” value. This case, and the lack of the general lack of fighting over other battles in homebuilder cases, shows that bankruptcy courts and practitioners know when to settle and when to fight when values drop.

⁴⁴ See *Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099-1101 (2d Cir. 1993) (plenary, non-core proceeding needed to determine enforceability of key man provision in licensing agreement sought to be assumed), cert. dismissed, 511 U.S. 1026 (1994).

⁴⁵ *TOUSA*, 393 B.R. at 922.