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Running With the Land

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A long-honored concept in real property, that of "covenants running with the land," is finding its way into the bankruptcy courts. If a covenant (a promise) runs with the land then it burdens or benefits particular real property and will be binding on the successor owner; if that covenant does not run with the land then it is personal and binds those who promised but does not impose itself on a successor owner. In some cases, bankruptcy courts are now holding that preexisting contracts containing covenants that provide that they run with the land can be rejected and that such covenants will not be binding on the bankruptcy estate.

While options to purchase have not fared well and are often rejected in bankruptcy pursuant to section 365 of the Bankruptcy Code, the analogous preferential purchase right or right of first refusal may survive especially if contained in a contract earlier in the chain of title (but also applicable in the case of current contracts). This is because of the notion that the bankrupt's title to any particular property must be taken as it existed at the time of filing and the estate takes its property rights subject to any conditions or burdens existing thereon. Though there is precedent that preferential rights are executory contracts subject to rejection, the more recent trend is that rights created by state law in specific assets are not avoidable by rejection.[1]

Likewise, a burden imposed on a transportation agreement may survive bankruptcy. In the *Energytec* case, Newco held an interest in a transportation fee to be paid by the producer based on the amount of gas flowing through the pipeline.[2] The producer went bankrupt and tried to sell the asset free and clear of Newco's interest in the transportation fee. The Fifth Circuit analyzed the burden as a covenant running with the land and found that Newco's interest would continue in the hands of the purchaser out of bankruptcy.

However, most recently, Bankruptcy Judge Shelley Chapman, who is presiding over the *Sabine* bankruptcy in the Southern District of New York, has ruled on a non-binding basis[3] that the gathering agreements Sabine had entered into with various gatherers do not contain covenants running with the land and could, therefore, be rejected pursuant to Bankruptcy Code section 365.[4] The two points relied upon by Judge Chapman are that (a) the parties lacked horizontal privity of estate with each other and (b) the covenants at issue did not "touch and concern" the land. Further, Judge Chapman took care to distinguish *Sabine* from *Energytec*, though recognizing that if the proper test is met, a covenant may not be able to be rejected pursuant to section 365.

Texas law on covenants running with the land was addressed in the *Westland* case.[5] In *Westland*, the Texas Supreme Court was faced with an area of mutual interest agreement which was not of record, but the agreement containing the AMI was referenced by another document in the chain of title. Finding that the AMI agreement was binding on successors, and noting that the rule originated in England in 1583, the court laid out the following requirements

1. The covenant must be binding on assigns;
2. The covenant must "touch and concern" the land;
3. Privity of estate must exist between the parties to the covenant; and
4. The parties must intend the promise to run with the land. This requirement also yields the requirement that successors must have notice of the obligation.

Generally, the most problematic issue is whether it touches and concerns the land. Courts have avoided describing the analysis needed to reach a conclusion; it seems the courts "know it when

they see it" and have added to the definition that the covenant must be beneficial or burdensome to the owner of the estate as owner of the estate or performance or nonperformance must affect the nature, quality, or value of the property independent of collateral circumstances. For instance:

- An easement grant to a railroad contained a requirement to build a fence if the tracks crossed grantor's land: held to run with the land.
- An irrigation district agreed to build an irrigation channel for land surrounding a canal purchased from Biggs. A grantee from Biggs sought to enforce the covenant: held to run with the land since the benefit came only to the owners of the land.
- A supply contract for natural gas to run irrigation pumps for a certain tract of land: held to run with the land.
- A filling station proprietor agreed to buy all of its gasoline from C. The station was sold and the new owner decided to guy gasoline elsewhere; C sued to enforce the promise: held the contract was personal to the original owner and did not run with the land.

Because of the recent ruling in *Sabine*, no matter how comfortable a party may be with their contractual covenants, in a situation where a counterparty is in financial distress, a party should take the opportunity to examine what financial assurance may be available. Further, such a party should be aware of the probability that it will be subjected to a motion to reject in bankruptcy, and should address commercial realities attendant to such rejection accordingly.

For more detailed information, please contact the authors.

Endnotes

1 *See, e.g., In re Bergt, 241 B.R. 17 (Bankr. D. Ak. 1999) (holding that a right to first refusal is not executory and therefore that section 365(a) of the Bankruptcy Code could not be used to avoid the contractual right of first refusal).*
2 *Newco Energy v. Energytec, Inc. (In re Energytec, Inc.), 739 F.3d 215 (5th Cir. 2013).*
3 *Judge Chapman recognized that her Sabine ruling was not binding due to the procedural posture of the dispute under Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.), 4 F.3d 1095, 1098 (2d Cir. 1993), as interpreted in In Re The Great Atlantic & Pacific Tea Co., 544 B.R. 43 (Bankr. S.D.N.Y. 2016).*
4 *In re Sabine Oil & Gas Corp., No. 15-11835, 2016 WL 890299 (Bankr. S.D.N.Y. Mar. 8, 2016).*
5 *Westland Oil Dev. Co. v. Gulf Oil Corp., 637 S.W.2d 903 (Tex. 1982).*

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