

Sales Free and Clear: What About Restrictive Covenants?

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Heatherwood Holdings, LLC v. HGC, Inc. (In re Heatherwood Holdings, LLC), 746 F.3d 1206 (11th Cir. 2014) –

A chapter 11 debtor owned property that had always been used as a golf course and club. When it requested that it be allowed to sell the property free and clear of encumbrances, an objection was filed on the basis that the property was subject to covenants that restricted the property to use as a golf course. **The bankruptcy court found that the property was subject to the restrictive covenants; the district court affirmed; and the issue was appealed to the 11th Circuit.**

The centerpiece of a subdivision developed in the 1970s and 1980s was an 18-hole golf course. The original covenants applicable to the subdivision referenced the golf course, required each residential lot to have a “golf cart storage area,” barred fences adjacent to the fairways, tees or greens, and required the initial purchasers of the homes to become members of the golf club.

Promotional materials marketed the development as a “planned residential and golf community.” They also noted that the original developer intended to sell the club by (1) giving the club members the right to buy the club for \$1.5 million by a specified date, which was supported by payment of certain amounts by home buyers and other club members into an escrow account to fund the purchase, (2) if they did not exercise the option, the developer could “sell the facilities to others,” or (3) the developer could exercise an option to sell the facilities to club members as-is for the amount in the escrow account.

The covenants were modified over the years. They always included various provisions relating to the golf course, although the golf course itself was never encumbered by a specific use restriction. In 1999 members of the club formed an entity to acquire and operate the club (HGC). The deed transferring the property did not include any use restriction.

Subsequently HGC transferred the club to an entity with a reputation for running golf courses (Heatherwood). Although the deed transferring the property did not include any use restrictions, there was a recorded a side agreement that committed the purchasers to operate the property as a golf course for at least 25 years.

The golf course did not fare well and eventually Heatherwood filed a chapter 11 bankruptcy. Shortly after filing, the debtor sought a determination that it could sell the golf course property free and clear of all encumbrances and restrictions. HGC filed an objection, contending that the property was subject to an implied covenant running with the land restricting its use to operation as a golf course.

Prior to making a decision, the bankruptcy court certified several questions to the applicable State Supreme Court, including whether state law would recognize or imply a restrictive covenant with respect to a golf course constructed as part of a residential development. The State Supreme Court responded in the affirmative, explaining that there are at least five methods for establishing that the original grantor intended a common scheme of development, including (1) written restrictions in all of the deeds, (2) restrictions in a substantial number of the deeds, (3) filing a plat showing restrictions, (4) actual conditions in the subdivision, or (5) acceptance of the actual conditions by the lot owners. Based on this guidance and the facts of the case, the bankruptcy court found that there was an implied restrictive covenant that the property would be used as a golf course.

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On appeal the 11th Circuit agreed. The development was used exclusively as a golf course community for over 20 years. Homeowners were induced to buy based on the golf course. And the developer always intended it to be a golf course community.

As to whether the purchaser was bound by the restrictive covenant:

- The 11th Circuit supported the bankruptcy court's finding that the buyers had actual, constructive and inquiry notice of the restrictive covenant.
- It also supported the bankruptcy court's rejection of an argument based on the doctrine of estoppel by deed. This defense failed because it requires "knowing representation or concealment relied upon by the other party to his or her detriment."
- Similarly the 11th Circuit agreed with rejection of the doctrine of integration. Regardless of the scope of the agreement between the seller and buyer, the seller did not represent every homeowner that was relying on the restrictive covenant. So it could not have been destroyed by agreement between the buyer and seller.
- As to the doctrine of changed circumstances, the court agreed with the bankruptcy court that the homeowners' benefit from the continued covenant outweighed the detriment to the debtor.

Consequently the 11th Circuit affirmed the lower court judgment.

Restrictive covenants can be a murky area. Are they part of an executory contract that can be rejected? Are they interests such that the property can be sold free and clear of the covenants if one of the conditions set forth in Section 363 is met? Are they interests that can be avoided using the strong arm powers of a bona fide purchaser? Regardless, the first issue is to identify that there is an issue, and you simply ignore express or implied restrictive covenants at your peril.

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