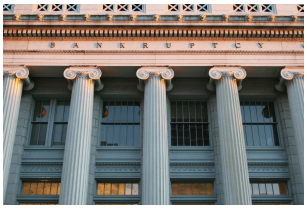

Western Texas Judge: Land Covenants Not Immune from Rejection

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Authors:

Mark A. Platt
Rebecca L. Matthews
Heather Pieper McMutry

Judge Parker of the U.S. Bankruptcy Court for the Western District of Texas recently issued an order in the case of *Hilltop SPV, LLC*, granting debtor Hilltop SPV LLC's ("Hilltop") motion to reject a Gas Gathering Agreement ("GGA") with counter-party Monarch Midstream, LLC ("Monarch").[1] This decision allows Hilltop to reject the GGA while allowing Monarch to retain the covenants that run with the land post-rejection. Judge Parker held that even though the covenants running with the land were not rejectable, the agreement itself was still an executory contract that could be rejected. While most courts have found contracts containing covenants running with the land to be immune from rejection, this decision deviates from that landscape in that Judge Parker held that a chapter 11 debtor can reject any executory contract, including those with covenants running with the land, so long as the Court approves.[2]

Background

Hilltop owns certain oil, gas, and mineral leases in the Hilltop Lakes in Texas. The GGA, originally entered into by Hilltop's predecessor and Monarch's predecessor, required Hilltop to tender natural gas to Monarch at specific points. Monarch then gathers the gas at Hilltop's wellheads, compresses it, and delivers it back to Hilltop. The GGA contained a minimum compression volume requirement of 10,000 Mcf per day. Hilltop was not meeting this requirement, producing only 3,500 Mcf per day, and thus was incurring a penalty of around $550,000 per year.

The GGA also created two property interests: (1) Hilltop granted Monarch a right-of-way and easement across Hilltop's leases to access Monarch's equipment, and (2) Hilltop dedicated to Monarch all gas reserves in, under, and produced from Hilltop's leases in a specified area, subject to Hilltop's reservations. The agreement

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explicitly states that these interests are covenants running with the land.

Hilltop filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on June 3, 2024. The next day, Hilltop commenced an adversary proceeding against Monarch and sought a declaratory judgment that the GGA was an executory contract subject to rejection. Monarch opposed the motion, arguing that the GGA was not executory and that the covenants running with the land made the agreement immune from rejection. The court expedited consideration of the motion.

Executory Nature of the GGA

The Court found that the GGA was executory because both parties had material unperformed obligations. Hilltop was required to pay fees and meet volume requirements, while Monarch had ongoing obligations to gather, compress, and distribute the gas. The Court rejected Monarch's argument that its obligations were complete.

Hilltop's Chief Restructuring Officer testified that the GGA's terms caused Hilltop to operate at a perpetual loss, making rejection necessary for the debtor's reorganization. The court found that Hilltop's decision to reject the GGA was not clearly erroneous or speculative and was in the best interest of the estate.

The rest of the opinion answered "questions of first impression" on rejecting contracts containing covenants running with the land.

Rejection of Contracts Containing Covenants Running with the Land

Judge Parker concluded that the GGA could be rejected despite containing covenants running with the land. Section 365 of the Bankruptcy Code provides a powerful tool for debtors to reject burdensome executory contracts. The rejection of an executory contract is treated as a breach, allowing the debtor to escape future obligations while the non-debtor party retains rights that would survive a breach under applicable non-bankruptcy law. Judge Parker reasoned that this meant the debtor could reject an

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executory contract containing covenants running with the land, and the effect would be that the covenants survive the rejection as they would survive a breach under non-bankruptcy law. Thus, Monarch "retains any covenants running with the land post-rejection and may have an unsecured claim for any other damages caused by Hilltop's rejection and deemed breach."

Judge Parker acknowledged that most courts, when confronted with the issue, have held that contracts containing covenants running with the land cannot be rejected. He clarified, however, that this is because those courts found that the contracts at issue were not executory. He reasoned that this is not the same as holding that an *executory* contract containing covenants running with the land cannot be rejected.

In reaching this conclusion, Judge Parker relied on *Southland Royalty Co.* and *In re Chesapeake Energy Corp.* (Delaware and Southern District of Texas cases, respectively), which held that executory contracts containing real property covenants could be rejected.[3] Judge Parker explained that Monarch's cited case, *Badlands Energy*, "stands for the proposition that covenants running with the land remain with property sold in bankruptcy.[4] It does not hold that covenants running with the land prevent a sale of the underlying property in bankruptcy – nor for the proposition that covenants running with the land in an executory contract prevent the rejection of that executory contract."

Judge Parker, quoting Judge Isgur from the Southern District of Texas in the *Sanchez* case, further explained that "Congress granted debtors the expansive right to reject any executory contract. The existence of a real property covenant does not limit the rejection power that Congress granted to debtors. If a contract is executory, a debtor may seek rejection." [5] He stated that this would not result in the property interest returning to the breaching party, but rather that the property interest would survive and the nonbreaching party would retain the property interest.

Conclusion

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The court granted Hilltop's motion to reject the GGA, allowing the debtor to sidestep its contractual obligations while maintaining the covenants running with the land. This decision underscores the power of rejection under Section 365 of the Bankruptcy Code and stands for the proposition that real property covenants in an executory contract do not prevent its rejection. This decision highlights the importance of understanding the implications of rejecting executory contracts in bankruptcy and the potential impact on real property interests.

Key Takeaways

- Executory contracts containing covenants running with the land are no longer immune from rejection, as many previously thought, at least in Judge Parker's court in the Western District of Texas.
- Real property covenants in an executory contract remain in effect post-rejection, and the non-debtor party retains any rights and interests conferred by the covenants.

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[1] Case Number 24-60308-mmp, Docket No. 138.

[2] Hilltop SPV, LLC is a Subchapter V (small business debtor) case, but there is no indication from the opinion (or the reasoning therein) that it is limited to just Subchapter V matters.

[3] *Southland Royalty Co. v. Wamsutter LLC (In re Southland Royalty Co.),* 623 B.R. 64, 89 (Bankr. D. Del. 2020), and *In re Chesapeake Energy Corp.*, 622 B.R. 274, 281–82 (Bankr. S.D. Tex. 2020)

[4] *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.),* 608 B.R. 854, 864–66 (Bankr. D. Colo. 2019)

[5] See, *Occidental Petroleum Corp. v. Sanchez Energy Corp. (In re Sanchez Energy Corp.)*, 631 B.R. 847, 851, 860 (Bankr. S.D. Tex. 2021) ("Congress granted debtors the expansive right to reject any executory contract. The existence of a real property covenant does not limit the rejection power that Congress granted to debtors. If a contract is executory, a debtor may seek rejection.")

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