

Your Word Is Your Bond: Fifth Circuit Court of Appeals Determines Surety Bonds Are Not Executory Contracts Even Through Multiparty Approach in *In re Falcon V, LLC*

Update

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Following an August 11, 2022 opinion from the Court of Appeals for the Fifth Circuit, certain irrevocable surety bonds will not be considered executory contracts in bankruptcy, even when a court applies a functional multiparty approach to the traditional *Countryman* definition of an executory contract. In industries like oil and gas, where surety bond programs are often mandatory for market participants, the implication of this decision is that sureties will need to employ extra protective measures to avoid liability to bond obligees after a debtor determines there is no need to continue its surety program.

As background, Falcon V, LLC (“Falcon”) and its affiliates filed for chapter 11 in May 2019. As is standard for most upstream oil and gas entities, Falcon maintained a surety bond program in favor of certain third-party obligees to secure its plugging, abandonment and restoration obligations. Specifically, under Falcon’s surety bond program, Argonaut Insurance Company (“Argonaut”) provided bonds in the total amount of \$10,575,000, consisting of a \$10 million bond in favor of Hilcorp Energy I LP, a \$300,000 bond in favor of Chevron Corporation, a \$250,000 bond in favor of the Louisiana Office of Conservation, and a \$25,000 bond in favor of the United States (together, the “Bonds”). Similar to other surety bond programs, the Bonds provided that, in exchange for premium payments from Falcon to Argonaut, if Falcon failed to perform the obligations owed to the obligees, Argonaut would either pay the obligee an amount equal to the obligation or perform the obligation itself with a subsequent right of indemnification from Falcon. Importantly, however, the Bonds provided that “regardless of the payment or nonpayment by [Falcon] of any premiums owing with respect to this Bond, [Argonaut’s] obligations under this Bond are continuing obligations and shall not be affected or discharged by any failure by [Falcon] to pay any such premiums.” Accordingly, Argonaut’s obligations to Falcon to post bond were complete and irrevocable, notwithstanding Falcon’s continuing obligation to pay premiums.

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During Falcon's bankruptcy, Argonaut filed a proof of claim in the amount of the combined value of the Bonds, claiming that \$3.2 million was secured and the rest was unsecured. Further, Argonaut stated that the Bonds "may not be assumed and assigned, for among other reasons, because such agreement constitutes a 'financial accommodation,'" but reserved its rights with respect to such argument. On October 10, 2019, the bankruptcy court confirmed Falcon's plan of reorganization, which provided that all executory contracts not expressly rejected would be assumed. Notably, the Bonds were not expressly rejected.

Post-confirmation, Falcon continued to pay premiums for a short period of time but subsequently stopped. After Argonaut demanded that Falcon either release the Bonds or provide additional collateral, Falcon responded by asserting that Argonaut had violated the injunction provisions under its plan. Argonaut subsequently filed a motion seeking a declaration that the Bonds were assumed as executory contracts. The bankruptcy court held that the Bonds were not executory contracts "because Argonaut owed no continuing performance to [Falcon]" and even "if the surety bond program were executory, it is a non-assumable financial accommodation." On appeal, the district court affirmed. Argonaut subsequently appealed to the Fifth Circuit.

The Fifth Circuit first considered whether Falcon assumed the Bonds under the plan, starting with an analysis of whether the Bonds were executory contracts. Starting with the oft-cited *Countryman* definition, the Fifth Circuit noted that a contract is executory if performance remains due on both sides and if, at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract that would excuse the performance of the other party. In explaining the logic of the *Countryman* test, the Fifth Circuit cited to a recent Third Circuit opinion:

“ To facilitate the debtor's rehabilitation, the *Countryman* test attempts to foolproof the debtor's choice to assume or reject contracts; thus, the debtor only has that flexibility for executory contracts—those contracts where there could be uncertainty about whether they are valuable or burdensome. A helpful perspective is to view executory contracts as a combination of assets and liabilities to the bankruptcy estate; the performance the nonbankrupt owes the debtor constitutes an asset, and the performance the debtor owes the nonbankrupt is a liability. Under this framework, a contract where the debtor fully performed all material obligations, but the nonbankrupt counterparty has not, cannot be executory; that contract can be viewed as just an asset of the estate with no liability On the other extreme, where the counterparty performed but the debtor has not, the contract is also not executory because it is only a liability for the estate Only where a contract has at least one material unperformed obligation on each side—that is, where there can be uncertainty if the contract is a net asset or liability for the debtor—do we invite the debtor's business judgment on whether the contract should be assumed or rejected.¹

Applying this framework to the Bonds, the Fifth Circuit agreed with the lower courts that even though Falcon had a continuing obligation to pay premiums to and potentially indemnify Argonaut, Argonaut had already irrevocably posted the Bonds and owed no further performance to Falcon. Accordingly, the Bonds were not executory. In an attempt to address the functionality of the Bonds, Argonaut argued that the *Countryman* test should be modified in the context of surety bonds such that, where the surety and the principal continue to owe obligations to the obligee(s) and the principal has not satisfied its indemnification obligations to the surety, the surety bond is an executory contract.

The Fifth Circuit declined to adopt Argonaut's proposed modification and provided that this test would still not facilitate a debtor's rehabilitation under the framework described by the Third Circuit, because this interpretation would still leave no ambiguity around the fact that the Bonds were a net liability for Falcon. The Fifth Circuit did, however, agree that courts should apply the *Countryman* test to multiparty contracts in a manner that accounts for the obligations owed to all of the parties rather than exclusively between the debtor and creditor.²

The Fifth Circuit further went on to hold that, even if there were material obligations owed between Falcon and Argonaut, the Bonds failed the second half of the *Countryman* test because the Bonds were irrevocable, and Falcon's failure to pay premiums would not excuse Argonaut from its obligations to the obligees. The Fifth Circuit additionally dismissed Argonaut's argument that the Bonds "passed through" the bankruptcy and were therefore unaffected. Because the Bonds were found to be non-executory, the Fifth Circuit also noted that they were not subject to the ride-through doctrine.

Following the Fifth Circuit's opinion, sureties evaluating the executory nature of their bond programs would do well to determine if their obligations that are either irrevocable or one-sided in performance. While it is unclear if the Fifth Circuit would have reached a different result had the Bonds not been irrevocable, the opinion emphasized this factor in determining that the Bonds were non-executory. Additionally, although Argonaut was not later estopped from arguing the Bonds were executory on account of its assertions in its proof of claim, sureties should avoid taking inconsistent positions at different points in a bankruptcy.

[1] *Argonaut Ins. Co. v. Falcon V, L.L.C.*, Case No. 21-30668 at *7 (5th Cir. Aug. 11, 2022) citing *In re Weinstein Co. Holdings*, 997 F.3d 497, 504-05 (3d Cir. 2021).

[2] The Fifth Circuit proposed a scenario in which a debtor owes performance to a creditor, who owes performance to a third party, who in turn owes performance to the debtor, thus creating the requisite ambiguity to qualify as an

executory contract even where the direct counterparty does not owe a direct obligation to the debtor.