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Whether a Surety Agreement is an Executory Contract is a Crucial Determination for Both Creditors and Debtors in Bankruptcy

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Introduction

In bankruptcy, whether a surety bond is an executory contract is not a question that is often addressed by the circuit courts of appeals.¹ However, this determination is crucial for both debtors and creditors because only executory contracts can be assumed, rejected, or pass through in bankruptcy.²

“A surety bond creates a three-party relationship, in which the surety becomes liable for the principal's debt or duty to the third party obligee.”³ The term “executory contract” has not been defined within title 11 of the United States Code (the “Bankruptcy Code”), however the Supreme Court concluded that “Congress intended the term to mean a contract 'on which performance is due to some extent on both sides.’”⁴

¹ See Dan B. Prieto & Mark G. Douglas, *Fifth Circuit Embraces Flexible Approach to Countryman Test of Executoriness in Bankruptcies Involving Multiparty Contracts*, JONES DAY (Dec. 2022), <https://www.jonesday.com/en/insights/2022/12/fifth-circuit-embraces-flexible-approach-to-countryman-test-of-executoriness-in-bankruptcies-involving-multiparty-contra>.

² 11 U.S.C. § 365; see *In re O'Connor*, 258 F.3d 392, 405 (5th Cir. 2001).

³ *Ins. Co. of the W. v. United States*, 243 F.3d 1367, 1370 (Fed. Cir. 2001).

⁴ *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984) (quoting H.R. Rep. No. 95-595, 347 (1977)); S. Rep. No. 95-989, 58 (1978).

In 2022, the Fifth Circuit has provided some guidance on this issue. In *Matter of Falcon*, the Fifth Circuit held the surety bond agreement in this multiparty contract case was not executory and therefore could not be assumed under the reorganization plan.⁵ However, the court explained this holding should not preclude the possibility of future courts applying a more flexible approach when determining whether a surety agreement is an executory contract in multiparty contract cases.⁶

This article explores the question of whether a surety bond is an executory contract in a threefold approach. Part I discusses how courts determine whether a contract is executory. Part II analyzes how executory contracts are treated in Chapter 11 cases and the effects of assuming versus rejecting a contract. Part III considers what the future of surety bonds in multi-party cases may look like.

Discussion

I. An Executory Contract is an Agreement in Which Each Side has at Least one Material Unperformed Obligation at the Time of the Bankruptcy Filing.

Courts have adopted two different tests to determine whether a contract meets the requirements to be considered executory. One test is the “Countryman test” and the other is the “functional approach.” Most courts apply the Countryman test.⁷ “[T]he test for an executory contract is whether, under the relevant state law governing the contract, each side has at least one material unperformed obligation as of the bankruptcy petition date.”⁸ This definition was proposed by Professor Vern Countryman and is known as the Countryman test.⁹ While most

⁵ *In re Falcon V, L.L.C.*, 44 F.4th 348, 350 (5th Cir. 2022).

⁶ *Id.* at 356, n.9.

⁷ *Id.* at 356, n.4.

⁸ *In re Weinstein Co. Holdings L.L.C.*, 997 F.3d 497, 504 (3d Cir. 2021).

⁹ *In re Falcon V, L.L.C.*, 44 F.4th at 352–53; *see Vern Countryman, Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

courts have adopted this approach, some courts have criticized the Countryman test as an inadequate or incomplete analysis, and instead apply the “functional approach.”¹⁰ Under the functional approach, the question of whether a contract is executory is determined based on whether the assumption or rejection would produce benefits for the estate, rather than the mutual obligations requirement under the Countryman test.¹¹

Pursuant to section 365 of the Bankruptcy Code, only executory contracts may be assumed or rejected in bankruptcy.¹² “If a debtor chooses to assume the contract, it must cure all defaults under the agreement, and the agreement will ‘ride through’ the bankruptcy unaltered.”¹³ However, “if the debtor rejects an executory contract, the rejection is treated as a breach by the debtor, and the counterparty to the contract is left with a claim in the bankruptcy for rejection damages caused by the breach.”¹⁴

A. *The Fifth Circuit Adopts a Flexible Approach to the Countryman Test.*

Under the Countryman test, a surety agreement is executory if it satisfies these two prongs: “[(1)] ‘performance remains due to some extent on both sides’ and [(2)] if ‘at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing the performance of the other party.’”¹⁵

In *Matter of Falcon*, prior to Falcon (debtor) filing for bankruptcy, it had entered into a \$10.5 million surety agreement with Argonaut (creditor) in which \$3.2 million of it was secured and the rest was unsecured.¹⁶ Argonaut posted four irrevocable bonds guaranteeing Falcon’s

¹⁰ See *In re Gen. Dev. Corp.*, 84 F.3d 1364, 1374 (11th Cir. 1996).

¹¹ *Id.* at 1375 (internal quotations omitted); see *In re Arrow Air, Inc.*, 60 B.R. 117, 121–22 (Bankr. S.D. Fla.1986).

¹² See 11 U.S.C. § 365.

¹³ Julia Frost-Davis & Andrew J. Gallo, *ASSUMPTION AND REJECTION OF MIDSTREAM CONTRACTS IN BANKRUPTCY*, MORGAN LEWIS (June 10, 2021), <https://www.morganlewis.com/pubs/2021/06/assumption-and-rejection-of-midstream-contracts-in-bankruptcy>.

¹⁴ *Id.*

¹⁵ *In re Provider Meds*, 907 F.3d 845, 851 (5th Cir. 2018) (internal citations omitted).

¹⁶ *In re Falcon V, L.L.C.*, 44 F.4th 348, 351 (5th Cir. 2022).

obligations to various third-party obligees.¹⁷ In exchange, Falcon and Argonaut entered into an indemnity agreement, stating that Falcon would pay Argonaut premiums and "indemnify Argonaut for any payments Argonaut makes under the [b]onds."¹⁸ The Fifth Circuit concluded that because Argonaut had already posted the irrevocable bonds, it did not owe any further performance to Falcon and therefore, the surety bond agreement was not an executory contract.¹⁹

However, if the surety bond agreement had been found executory, it would have been assumed under the reorganization plan, which stated Falcon "deemed to have assumed each executory contract ... to which it is a party."²⁰ As stated above, if assumed, all amounts due under the contract as of the petition date must be cured by the debtor. Under the assumption that the surety agreement was an executory contract and therefore would be assumed and protected, Argonaut did not object to the plan's terms prior to its confirmation.²¹ However, the court disagreed, and given that only executory contracts may be assumed, Argonaut was unable to recover the \$7.3 unsecured claim as a cure claim against Falcon.²²

Argonaut argued that courts should adopt a modified version of the Countryman test to account for all obligations in a multiparty agreement.²³ Although the Fifth Circuit declined to adopt Argonaut's proposed version, it agreed that the Countryman test should be applied in a flexible manner "that accounts for the various obligations owed to *all* of the parties, rather than focusing exclusively on the flow of obligations between the debtor and the creditor."²⁴

Accordingly, when applying the Countryman test to this case, the court considered "not just the

¹⁷ *Id.* at 350.

¹⁸ *Id.* at 351.

¹⁹ *Id.* at 355.

²⁰ *Id.* at 351.

²¹ See Lisa Tancredi & Laura Murphy, *Awaiting Critical Bankruptcy Decision For Surety Industry*, LAW 360 (June 17, 2022, 1:54 PM), <https://www.law360.com/articles/1503836/awaiting-critical-bankruptcy-decision-for-surety-industry>.

²² *In re Falcon V, L.L.C.*, 44 F.4th at 350.

²³ *Id.* at 354.

²⁴ *Id.*

obligations that Falcon [] and Argonaut owe to each other but also their respective obligations to the third-party obligees.”²⁵ However, even under this flexible approach, the surety agreement still failed the second prong of the Countryman test, and therefore was not an executory contract.²⁶

B. An Obligation to pay Premiums does not Make a Surety Agreement an Executory Contract.

The *Falcon* court is not alone in finding that an obligation to pay premiums does not make a surety agreement executory.²⁷ “It is ‘well-established’ that ‘where all elements of performance have been accomplished leaving only an obligation to pay money,’ there is no executory contract.”²⁸

For example, the United States Bankruptcy Court for the Western District of Pennsylvania “determined the contract between the debtor and surety was not executory because (1) the bond was posted and irrevocable, meaning that the surety owed no further duty to the debtor and (2) when the only obligation under a contract is to pay money, the contract is not executory.”²⁹ Similarly, the United States District Court for the Middle District of Tennessee held a surety bond was not an executory contract because the debtor’s “obligation under the Bond agreements was to pay the premiums and [the creditors] obligation was to post Bonds.”³⁰

²⁵ *Id.*

²⁶ *Id.*

²⁷ *See id.* at 356, n.10 (listing cases that concluded similar surety bond agreements were not executory); *but see In re Evans Prods. Co.*, 91 B.R. 1003, 1005–06 (Bankr. S.D. Fla. 1988) (concluding without explaining why the surety agreement at issue was “clearly executory”).

²⁸ *In re Dunes Casino Hotel*, 63 B.R. 939, 948 (D.N.J. 1986).

²⁹ *In re James River Coal Co.*, No. 306-0411, 2006 WL 2548456, at *4 (M.D. Tenn. Aug. 31, 2006) (quotation omitted).

³⁰ *Id.* at *4.

“The Bonds were posted and irrevocable.”³¹ “As such [the debtor] owed no further performance to [the creditor].”³²

C. *The Sixth and Eleventh Circuit Have Adopted the Functional Approach.*

When determining whether a contract is executory, the Sixth and Eleventh Circuit have expanded the definition of “executoriness” beyond the fixed definition laid out by Vern Countryman in the Countryman test and have instead applied the “functional approach.”³³ Under the functional approach, “the question of whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate.”³⁴ The Eleventh Circuit stated that the language and legislative history of section 365 indicate that it is not always required that there be an “outstanding obligation on the part of both parties to a contract in order for a contract to be deemed executory.”³⁵ The functional approach, “when considered in light of Congress’ refusal to adopt the ‘mutual obligations’ definition in all circumstances . . . suggests that, in the final analysis, executory contracts are measured not by a mutuality of commitments but by the nature of the parties and the goals of reorganization.”³⁶

Similarly, the United States Bankruptcy Court for Eastern District of Washington concluded that under the functional approach the purpose for allowing the debtor to reject or assume an executory contract “is to enable . . . a troubled debtor to take advantage of a contract that will benefit the estate by assuming it or alternatively, to relieve the estate of a burdensome contract by rejecting it.”³⁷ Thus, the Eleventh Circuit concluded “[e]ven though there may be material obligations outstanding on the part of only one of the parties to the contract, it may

³¹ *Id.*

³² *Id.*

³³ *See In re Gen. Dev. Corp.*, 84 F.3d 1364, 1374 (11th Cir. 1996).

³⁴ *Id.* at 1375 (internal quotations omitted).

³⁵ *In re Arrow Air, Inc.*, 60 B.R. 117, 121–22 (Bankr. S.D. Fla.1986).

³⁶ *Id.* at 122 (citing *In re Booth*, 19 B.R. 53, 56 (Bankr. D. Utah 1982)).

³⁷ *Id.* (quoting *In re Norquist*, 43 B.R. 224, 225 (Bankr. E.D. Wash. 1984)).

nevertheless be deemed executory under the functional approach if its assumption or rejection would ultimately benefit the estate and its creditors.”³⁸

II. Executory Contracts may be Assumed, Rejected, or Pass-Through in Bankruptcy.

Only executory contracts may be assumed, rejected, or pass-through in bankruptcy.³⁹

“Section 365(a) of the Bankruptcy Code, as made applicable to a debtor-in-possession by Section 1107(a) of the Bankruptcy Code, permits a debtor to ‘assume or reject any executory contract or unexpired lease of the debtor.’”⁴⁰ If the debtor assumes the contract, it is agreeing to perform the obligations of the executory contract; if the contract is rejected, “it is treated as if the contract had been breached immediately before the date of the bankruptcy petition's filing; any claim arising from that breach is therefore a prepetition claim.”⁴¹ “The bankruptcy court's confirmation of a plan of reorganization discharges the debtor from liability on such claims, leaving the creditor with only a distribution under the plan of the pro rata value of the claim.”⁴²

A. Assumption Gives Right to a Cure Claim While Rejection Leaves Creditors with an Unsecured Damages Claim.

To assume or assign a contract, the debtor “must cure all monetary defaults and give adequate assurance of its ability to perform under the contract.”⁴³ “The assumption of a contract thus gives rise to a cure claim.”⁴⁴ “All amounts due under the contract as of the petition date must be cured by the debtor, generally through an immediate cash payment of such amounts.”⁴⁵ This is true “even if general unsecured creditors receive no distributions until later in the case or

³⁸ *Id.*

³⁹ *See* 11 U.S.C. § 365.

⁴⁰ *In re* Gen. Dev. Corp., 84 F.3d 1364, 1373–74 (11th Cir. 1996).

⁴¹ *Route 21 Assocs. of Belleville, Inc. v. MHC, Inc.*, 486 B.R. 75, 85 (S.D.N.Y. 2012); *see* 11 U.S.C. § 502(g)(1).

⁴² *Route 21 Assocs. of Belleville, Inc. v. MHC, Inc.*, 486 B.R. at 85; *see* 11 U.S.C. § 1141(d)(1)(A).

⁴³ Michael Friedman, et al., *Cure claims in bankruptcy - Delphi bankruptcy case Raises Issues*, RICHARDS KIBBE & ORBE LLP (Jan. 25, 2008), <https://www.lexology.com/library/detail.aspx?g=c422cc92-4444-4185-b6de-b70de8666cf2>.

⁴⁴ *Id.*

⁴⁵ *Id.*

receive less than the full amount of their claims or receive consideration other than cash.”⁴⁶ “In effect, the debtor’s decision to assume an executory contract or unexpired lease elevates the priority of the claim related to the contract.”⁴⁷

“The assumption of an executory contract results in an administrative expense status for all obligations under the contract, regardless of whether the expenses arose pre- or postpetition.”⁴⁸ “Rejection makes other party to the contract simply an unsecured creditor.”⁴⁹ Therefore, it is generally within the creditor’s best interest to have the contract assumed.

Additionally, “[e]xecutory contracts that are not assumed or rejected ‘ride through’ the bankruptcy unaffected by the bankruptcy proceedings.”⁵⁰ In *Matter of Falcon*, Argonaut argued that even if Falcon did not assume the surety bond agreement, this surety agreement was still enforceable because it passed through the bankruptcy unaffected under the ride through doctrine.⁵¹ This argument was unsuccessful because, as the *Falcon* court stated, non-executory contracts are not subject to the ride through doctrine.⁵²

III. The Fifth Circuit Suggests that a Modified or Functional Approach may be Appropriate for Analyzing Future Multi-Party Contracts.

While the Fifth Circuit concluded that the Countryman test, flexibly applied, was sufficient to determine whether the surety bond agreement in *Matter of Falcon* was an executory contract, it recognized that it may make sense for courts to modify the test for future multiparty

⁴⁶ *Id.*

⁴⁷ *Id.*; see *In re Weinstein Co. Holdings L.L.C.*, 997 F.3d 497, 506 (3d Cir. 2021) (stating that when a contract has not been assumed in bankruptcy, the creditor is only left with an “unsecured claim against the debtor, on which it can typically expect to recover merely cents on the dollar”).

⁴⁸ U.S. DEP’T OF JUST., Executory Contracts in Bankruptcy – Assumption and Rejection, Civil Resource Manual, <https://www.justice.gov/jm/civil-resource-manual-60-executory-contracts-bankruptcy>; see *In re U.S. Metalsource Corp.*, 163 B.R. 260, 269 (Bankr. W.D. Pa. 1993).

⁴⁹ *Id.*

⁵⁰ *ASARCO, L.L.C. v. Mont. Res., Inc.*, 858 F.3d 949, 959 (5th Cir. 2017) (quotations omitted).

⁵¹ *In re Falcon*, 44 F.4th 348, 355 (5th Cir. 2022).

⁵² *Id.*

contract cases.⁵³ The court explained it could imagine cases where a more flexible approach would be appropriate such as a situation where a “debtor might wish to assume a tripartite agreement under which it owes performance to a creditor, the creditor owes performance to a third party, and the third party owes performance to the debtor.”⁵⁴ Additionally, the *Falcon* court stated that although the functional approach was not applied in this case (neither party asked the functional approach to be applied), “future courts should not consider foreclosed the possibility that the functional approach should be adopted for multiparty contract cases.”⁵⁵

Another approach for determining whether a contract is executory has been proposed by Professor Jay L. Westbrook and Kelsi S. White.⁵⁶ This approach is known as the ‘modern contract analysis’ and abolishes the ‘material breach rule’ of the Countryman test, and instead proposes the following analysis:

(1) Determine under state contract law if the contract contains some obligations that remain to be performed; and if not, it cannot be assumed or rejected; (2) If there is nothing remaining under the contract except obligations owed by the debtor (*e.g.*, payment), assumption or rejection is not necessary because there is nothing left to do except payment and discharge through the bankruptcy process; (3) If some obligations remain other than mere payment, consider whether the net benefit to the estate from performance by both parties (assumption) exceeds the net benefit from the estate's breach of the contract and payment of the breach (rejection) claim; and (4) The court should approve the course of action resulting in net benefit to the estate, unless some other specific provision in section 365 requires a different conclusion.⁵⁷

However, this approach has not yet been adopted by any courts.

⁵³ *Id.* at 356, n. 9.

⁵⁴ *Id.* at 354.

⁵⁵ *Id.* at 356, n. 9.

⁵⁶ Dan B. Prieto & Mark G. Douglas, *Fifth Circuit Embraces Flexible Approach to Countryman Test of Executoriness in Bankruptcies Involving Multiparty Contracts*, JONES DAY, (Dec. 2022), <https://www.jonesday.com/en/insights/2022/12/fifth-circuit-embraces-flexible-approach-to-countryman-test-of-executoriness-in-bankruptcies-involving-multiparty-contra>.

⁵⁷ *Id.* (citing Jay L. Westbrook & Kelsi S. White, *The Demystification of Contracts in Bankruptcy*, 91 AM. BANKR. L.J. 481, 489 (Summer 2017)).

Conclusion

Going forward, while it is not clear what tests the Fifth Circuit (and other courts) will apply when determining whether a contract is executory, the outcome of *Matter of Falcon* provides an important lesson for both debtors and creditors alike. For debtors, it emphasizes the significance of the discharge injunction and the importance of properly tailoring a reorganization plan.⁵⁸ For creditors, it is a message to not assume that a contract is executory, and it also highlights the importance of carefully reviewing plan terms.⁵⁹

⁵⁸ See John Baxter, *Is it an Executory Contract? Don't Be So Sure(ty)!*, JDSURPA (Oct. 19, 2021), <https://www.jdsupra.com/legalnews/is-it-an-executory-contract-don-t-be-so-6638634/>.

⁵⁹ See *id.*