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TRO for Indemnitors' Deposit to Court Reversed

NELL M. HURLEY

A Texas state trial court recently granted a temporary restraining order ("TRO") prohibiting indemnitors' transfer of assets and mandating its deposit of collateral into court pending adjudication of a surety's case against them. On appeal, the Court of Appeals of Texas ruled that the application of a higher standard of proof for the court deposit meant that the trial court had abused its discretion by ordering it, but left intact the terms that barred transfer of the indemnitors' assets.[1]

In the case, the surety issued multiple surety bonds relating to gas and oil interests and the indemnitors executed general indemnity agreements with industry-standard collateral and indemnification terms. Later, claims were made on the bonds and the surety demanded collateral and indemnity from the indemnitors, which were not provided. The surety then paid over $3 million in bond claims. The surety had evidence that the indemnitors were actively dodging the surety, selling assets in which the surety had a prior security interest.

The surety filed a combined petition and application for injunctive relief alleging these circumstances and asserting claims for indemnification, specific performance of the collateral security obligation, and breach of contract. In addition to a TRO preventing the dissipation of indemnitors' assets (a type of prohibitive relief), the surety sought to compel the indemnitors to deposit into court all proceeds from the sale of any assets (a type of mandatory relief). The indemnitors argued that the surety failed to show imminent irreparable harm, an inadequate remedy at law, and failed to meet the heightened mandatory injunction standard as to the deposit to the court. The trial court not only granted the TRO prohibiting the dissipating of assets, it compelled the indemnitors to deposit $3.6 million into the court within 30 days of the order.

On appeal, with no Texas state court opinions addressing preliminary injunctive relief to a surety suing on an indemnity agreement, the court looked to conflicting federal court decisions for guidance. Regarding an inadequate remedy at law, the court was persuaded by cases finding that the risk of loss to a surety that is party to an indemnity agreement is unique and that, even if a surety's loss is monetary and only temporary, the fact that it must assume a primary obligor's obligation at all is a harm for which there is no adequate remedy at law. In situations such as these, the court reasoned, injunctive relief protects three interests of the surety:

(1) the bargained-for benefit of collateral security;

(2) avoidance of present exposure to liability during pending litigation against indemnitors; and

(3) avoidance of risk that, should indemnitors become insolvent, the surety will be left as a general unsecured creditor, frustrating the purpose of the indemnity agreement.

Protection against these risks to the surety is precisely what the collateral security provision is meant to secure and no amount of future damages provides an adequate remedy for harm resulting from present exposure, said the court.

As to irreparable injury, the court found that evidence of the indemnitors selling assets and evading financial obligations supports a reasonable inference of a deteriorating financial

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Executory Contracts in Bankruptcy: A Challenge for Sureties

BRIAN M. STREICHER

Recent decisions in a Louisiana bankruptcy matter stir the pot on the definition of "executory contracts" under Section 365 of the Bankruptcy Code ("Section 365") as applied to surety bonding. They also highlight the importance of the surety's legal strategy in the plan confirmation and claim allowance processes of a Chapter 11 reorganization, given this lack of clarity. In *In re Falcon V, L.L.C.*[1] ("*Falcon*"), the bankruptcy court applied the so-called Countryman ("*Countryman*") test to hold that a surety bond is not an executory contract that can be assumed or rejected by a Chapter 11 debtor-in-possession. The district court affirmed on appeal,[2] and that decision was appealed to the Fifth Circuit.

In *Falcon*, the surety sought to have its bonds deemed assumed executory contracts after a confirmed Chapter 11 plan of reorganization, when the debtor-principal failed to continue paying bond premiums post-confirmation. The surety demanded that the debtor post additional collateral to secure the bonds as required by the indemnity agreement, which the debtor then claimed violated the discharge injunction in the plan. The surety argued that its surety bonding program, which included the bonded contracts and indemnity agreements, were executory contracts under Section 365 that were assumed by the debtor in the plan. The debtor said the bonds were not executory

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NELL M. HURLEY

Despite settled New York case law holding that Section 3 notice provisions of the AIA A312 Performance Bond are express conditions precedent to the surety's obligations under Section 4, obligees continue to knock loudly on the door of the surety without having complied. This time, a performance bond claim was made more than nine years after the bonded contract was completed, based upon the principal's subcontract indemnification obligations.[1] The obligee also asserted a claim on the associated payment bond. Neither claim was successful, but nonetheless required a surety motion to dismiss, which the court granted.

The case involved subcontractor bonds provided by International Fidelity Insurance Co. (the "surety") for a large municipal construction project, with Prismatic Development Corp. ("Prismatic") as the general contractor and bond obligee. The bonded subcontract was completed without a default or termination. Some years later, a different subcontractor, EIC Associates ("EIC") sued Prismatic alleging that it was owed money by Prismatic for having to work around or complete the bonded subcontractor's work on the project.

After its claims were denied, Prismatic sued the surety on the bonds. Prismatic claimed that the subcontract indemnification provision, incorporated by reference into the bonds, required the surety to defend and indemnify it against the EIC action as part of its performance bond obligation. Prismatic further argued that the surety was obligated under the payment bond to compensate EIC for the additional costs EIC incurred performing work under the bonded subcontract, and thus was required to defend and indemnify Prismatic from the EIC claims. The surety moved to dismiss.

The court first noted the three requirements of Section 3 of the performance bond, requiring that obligee has *inter alia*:

(1) Notified the surety that it is considering declaring a default;

(2) Declared a default and terminated the principal's right to complete; and

(3) Agreed to pay the contract balance to the surety.

These actions have been held to be conditions precedent that require strict compliance, the court explained, and must occur before any surety obligation arises under the performance bond's paragraph 4. The court rejected Prismatic's unsupported assertion that the Section 3 provisions are irrelevant to the enforcement of a surety's post-completion indemnity obligations, and apply only to the completion of work on an unfinished contract.

Likewise, the court rejected Prismatic's alternative argument that it had satisfied the Section 3 obligations with a letter to the bonded subcontractor's counsel six years after subcontract completion. This purported "notice" deprived the surety of the ability to investigate or remedy the immediate consequences of the alleged default, the court said, and the subcontract was never terminated. Since there was no compliance with the Section 3 conditions precedent, the surety was not obligated under the performance bond, the court held.

Prismatic's payment bond claim was similarly dismissed by the court stating:

> "[t]he flaw in Prismatic's claim is that EIC's work was not "in the performance of the [bonded subcontract]." The payment bond covers only work ordered or directed by the [bonded subcontractor]."

Here, the court observed, EIC is not asserting claims based on non-payment or underpayment by the bonded subcontractor.[2] Rather, EIC alleges that it was underpaid by Prismatic for work that Prismatic directed. This is not the obligation undertaken by the surety under the payment bond, the court opined, which instead covers bills for labor and materials actually used by the bonded subcontractor in its completion of the subcontract. A payment bond is not intended to provide a financial recovery to the obligee, and "case law generally disfavors such a suit," the court noted.

Thus, the surety's motion to dismiss Prismatic's bond claims was granted in its entirety, as would likely have been predicted. On the one hand, this gives comfort to the surety and its counsel that courts will enforce the bonds as written. On the other hand, that such claims continue to be made, despite the clear bond language and case law, remains a needless and expensive thorn in the surety's side. E&D

1 *Prismatic Dev. Corp. v. International Fid. Ins. Co.*, 2022 N.Y. Misc. LEXIS 967 (Sup. Ct., N.Y. Cnty Feb. 28, 2022).

2 EIC had already sued and settled with the bonded subcontractor in a separate action.

Among those celebrating E&D founding partner Bill Ernstrom's receipt of the AGC NYS Distinguished Service Award on May 4, 2022 in Albany, NY were (L to R) E&D's Brian Geary, Brian Streicher, John Dreste, Kevin Peartree, Bill Ernstrom, Todd Braggins, Clara Onderdonk, and Martha Connolly.

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contracts and thus were not assumed, meaning it had no obligation to post collateral.

"Executory contract" is not defined by Section 365. The bankruptcy court followed Fifth Circuit precedent, applying the *Countryman* definition of executory contract that "a contract is executory if performance remains due to some extent 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, thereby excusing the performance of the other party."[3] Despite acknowledging that the "relationship among a surety, principal, and claimant is tripartite," the court applied the test to the surety bond alone and held that, since the surety fulfilled its obligation to issue bonds prepetition, it owed no further duties to the principal; its only remaining duties were to the obligees. The district court affirmed the decision on these grounds.

The surety, and the Surety & Fidelity Association of America ("SFAA") as *amici*, argued that the application of the *Countryman* test, and its examination of only bilateral contractual duties, is incongruous with the tripartite surety bonding regime, which includes the bond, the bonded contract, and the indemnity agreement. Importantly, the indemnity agreement, and all rights contained therein (e.g., the right to demand collateral security), is an essential component of the consideration given by the principal in exchange for the bond. The *Countryman* test has been widely criticized, but a prevailing alternative has not been adopted by the federal courts.[4]

In *Falcon*, for example, the surety's indemnity claims were deemed contingent, unliquidated, and disallowed under Bankruptcy Code Section 501(e)(2)(B).[5] By both rejecting the assumption of the bonds by the reorganized debtor and the contingent indemnity rights of the surety, the court effectively severed the indemnity agreement and the bargained-for collateral protections contained therein. Such a severance could result in tougher underwriting standards, heavier front-end collateral, and higher premiums, shrinking the market of viable government contractors and ultimately hurting taxpayers through less competitive bids, said the SFAA.

Unpersuaded, the bankruptcy court also noted the surety's inconsistent positions before and after its post-petition demand for collateral in holding the surety bound to the plan. The surety initially claimed that the bonds were non-assumable, non-assignable "financial accommodations," and the debtor's plan was confirmed that way, with its indemnity claims listed as contingent and unliquidated. But when the debtor sought the protection of the discharge injunction, the surety then argued that the bonds were assumed executory contracts.

While the application of the *Countryman* test in this situation could be revised on appeal, sureties and practitioners should be mindful of the need to consider and monitor the potential future ramifications of their positions in the confirmation and allowance processes in order to avoid the possible loss of important rights post-confirmation. E&D

1 620 B.R. 256 (M.D. La. 2020).

2 *See Argonaut Ins. Co. v. Falcon V, LLC*, 2021 U.S. Dist. LEXIS 188686 (M.D. La. Sept. 29, 2021).

3 *See Matter of Provider Meds, L.L.C.*, 907 F.3d 845, 851 (5th Cir. 2018).

4 *See* SURETY ASPECTS OF BANKRUPTCY LAW AND PRACTICE 178-89 (Chad L. Schexnayder & Michael E. Collins eds., ABA TIPS Section, 2021)

5 The logic behind this provision is that to allow a contingent, unliquidated claim could create a double-liability for the debtor in the form of claims owed to both the obligee and the surety for the same obligation.

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condition that would affect the surety's ability to satisfy a money judgment, and constitutes irreparable harm by placing it in the position of an unsecured creditor. Thus, the prohibitive injunctive relief granted by the lower court was not an abuse of discretion, the court found.

The court dismissed the indemnitors' efforts to cast the prohibitive relief granted as violative of a general rule under Texas case law that forecloses resort to injunctive relief "simply to sequester a source of funds to satisfy a future judgment." Such a rule, the court said, does not control where, as here:

> "...there is a logical and justifiable connection between the claims alleged and the act sought to be enjoined or where the plaintiff claims a specific contractual or equitable interest in the assets it seeks to freeze."

The mandatory injunction compelling immediate payment into the court was another story. The court stated that for this relief, the surety must show that not granting it would result in irreparable injury or extreme hardship, unless it could demonstrate that the mandatory provision is "a part of or incidental to" the prohibitive injunctive relief granted. This the surety failed to do, the court observed, and thus the higher standard applied. And since the surety also failed to show that the court deposit was "necessary to prevent irreparable injury or extreme hardship," granting that relief was an abuse of discretion by the trial court, and must be reversed.

On the bright side, there is now Texas case law specifically addressing and granting prohibitive injunctive relief to a surety where indemnitors have failed to collateralize per the indemnity agreement. But sureties and their counsel should take note of potential differing standards for temporary prohibitory and mandatory relief, and ensure a record for meeting each standard, or qualifying for any exceptions. E&D

1 *31 Holdings I, LLC v. Argonaut Ins. Co.*, 2022 Tex. App. LEXIS 1176 (5th Dist. Dallas Feb. 17, 2022).

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Ernstrom & Dreste, LLP also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

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FIRM NEWS

Todd Braggins is co-authoring a chapter entitled "*Complementary Provisions of the Indemnity Agreement*" to appear in the Fidelity & Surety Law Committee's upcoming book, *The Surety's Indemnity Agreement: Law and Practice, 3d Edition*.

Brian Streicher will be a speaker at the Pearlman Association Annual Conference in Woodinville, Washington, September 7-9, 2022, presenting on the topic "*Ethics: Joint Defense Agreements and the Common Interest Privilege.*"

Kevin Peartree will attend the AGC NYS Summer Meeting August 4-7, 2022 at The Sagamore Resort in Bolton Landing, New York.

Ernstrom & Dreste has been named a Tier 1 firm in Rochester, New York for Construction Law by *U.S. News - Best Lawyers*® "Best Law Firms" in 2022.

Brian Streicher (above) recently became a Partner at Ernstrom & Dreste, LLP. Brian is an experienced commercial litigator representing clients in all types of surety and construction disputes.