THE OBLIGEE WON’T SIGN THE TAKEOVER AGREEMENT: WHAT NEXT?

William M. Coats, Esquire
COATS, ROSE, YALE, RYMAN & LEE
1001 Fannin Street
Suite 800
Houston, Texas 77002-6707
THE OBLIGEE WON’T SIGN THE TAKEOVER AGREEMENT: WHAT NEXT?

Introduction

You have read your bond default manual, the restatement of suretyship, attended many seminars with learned speakers presenting great treatises— you’re primed, you’re fired up and ready to go. You show up at the initial meeting with the obligee after your principal has been declared in default, eloquently outline the surety’s options, scare the obligee with all your 19th century defenses and keenly discern that the obligee is going to come around, begging you to take over the contract and will do just about anything to have their problems solved. It’s time to introduce the concept of the takeover agreement, which you aptly describe as being an innocuous document, merely setting forth the basis upon which you agree to rescue and save the obligee from its terrible dilemma. The obligee’s countenance begins to change...

Ultimately, the obligee indicates that they have been through this before and it took six months to get the agreement negotiated and approved by the necessary parties, they do not understand the need for the agreement, they have a bond, they have a contract, just go do the work... You spend the next couple of hours going through fancy explanations about how it increases the exposure to the surety, it is against company policy, your boss will kill you... but, in the end, nothing works. The obligee refuses to sign a takeover agreement and is asking you when they can expect to get their project completed and is looking forward to having you at their job site in the very near future.

The above situation occurs frequently. Based upon the author’s experience, it is getting particularly difficult to obtain a takeover agreement from public owners. Several Texas municipalities and the Texas Department of Transportation have now made it strict policy that no takeover agreement will be contemplated in connection with a default and demand on a surety. What now?

Risks

The surety representative confronted with the obligee’s refusal to sign a takeover agreement has good cause for concern. In an effort to simplify the analysis somewhat, the assumption is made that the surety has determined that it is willing to take over the contract under appropriate circumstances. Meaning, it has examined the disputes asserted by the principal, if any, analyzed costs to complete/exposure and has otherwise satisfied itself with respect to controversies and/or disputes relating to the administration of the construction contract and the work prior to default. Simply stated, the surety believes it is in its best interest to arrange for and complete the work in order to control costs, avoid litigation and satisfy its obligations under the performance bond. In other words, the surety has to determine its risks in going forward without a takeover agreement and what can be done to minimize those risks.

By proceeding in the absence of a takeover agreement, the surety is confronted with, at minimum, the following problems:
1. protection of its bond penalty;

2. protection of the surety’s rights to contract balances and claims to extra compensation;

3. waiver of and/or an inability to compromise disputed matters, such as, liquidated damages, remedial work required and scope of remaining work issues.

The above certainly is not an exhaustive list of the risks to the surety in going forward without a takeover agreement, but it does represent the major issues of concern. The more subtle issues such as method and manner of payment, agreement not to set off in relation to third party claims (such as a trustee in bankruptcy, IRS, unpaid vendors), procedures to pursue claims for additional compensation, the resolution of additional expense claims, etc. are all proper elements for consideration in connection with the surety’s take over of a project. However, to be realistic, if the obligee has refused to enter into a takeover agreement, it is unlikely you are going to get these issues otherwise addressed in other than a summary fashion.

Possible Approaches

In the case of governmental entities, some have attempted to remedy the surety’s concerns in relation to not having a takeover agreement. Specifically, their standard form contracts, more particularly, the general conditions to the standard form contracts, have been modified so as to insert provisions allowing for a surety takeover without a termination of the contract and delineating the basis and terms applicable to the surety’s completion of the project. However, as you might suspect, given that the governmental entity drafted these provisions, the provisions will, generally, state that the surety will be liable for all liquidated damages, for all remedial work required in connection with correction of the work performed by the principal and allow for the set off of numerous types of additional expense claims as against any contract balances payable to the surety in connection with completion. On the other hand, these additional terms expressly set forth the limitation of the surety’s liability to the bond penalty, provide that the surety will be paid in accordance with the original contract provisions as if the surety was the contractor and otherwise address some of the more crucial elements concerning protection of the surety. In order to effectuate these terms, a modification of the original contract is often required to substitute the surety as the “contractor”. If such a modification is required, it is an opportunity for the surety to propose additional “clarifications” to be included in the modification, leading, essentially, to the development of a takeover agreement that the obligee refers to as a change order.

---

1 For an interesting example, see Copeland Sand and Gravel, Inc. v. The Insurance Company of North America, 596 P.2d 623. Compare Bill Curphy Co. v. Elliott, 207 F.2d 103 (5th Cir. 1953). Other cases addressing the issue include, Caron v. Andrew, 284 P.2d 544; McWalters and Bartlett v. U.S., 272 F.2d 291 (10th Cir. 1959). Aetna Cas. & Sur. Co. v. Butte-Neade Sanitary Water Dist., 443 N.E.2d 1308 (1983). In addition, even if you draft a bond penalty limitation into a takeover agreement, there can be trouble enforcing the limitation, United Pac. Ins. Co. v. Borough of Pleasant Point, C.A. No. 80-446 (D.N.J. 1986).

2 See Universal Surety Company v. United States, 10 CICt.794 (1986).
Of course, in the event the obligee does not require a change order or modification, you have the opportunity to suggest one. Many times the person responsible for contract administration has the authority to enter into contract modifications, but not the authority to approve new agreements. As long as you are talking the contract administrator's language, time and money, you may be much more apt to get a “change order” than a “takeover agreement”.

In the event you are unable to obtain a change order/modification, sureties may contemplate going forward on the basis of some confirming writing. In some cases, the surety will simply elect to complete under a reservation of rights.\(^3\) Hopefully, with a little effort, a better result than a mere reservation of rights can be obtained.

Certainly, a writing is better than no writing at all. Logically, a letter issued by the obligee is better than a confirming letter by the surety. In fact, this is the approach utilized by several governmental entities in Texas. For instance, the Texas Department of Transportation will issue a letter to the surety, usually based on some negotiation of its terms, that will set forth the following elements:

- the principal has been declared in default;
- the completing contractor proposed by the surety is acceptable;
- payment for work performed in completing the project will be made directly to the surety;
- the method and manner in which communications will be handled;
- the provisions of the general conditions and specifications that will apply to completion of the work;
- an accounting of the remaining contract balances, including retainage;
- the time for completion;
- the insurance requirements in connection with completion;
- specific agreements concerning remedial work required and the limit of the surety’s liability in connection with such remedial work;
- agreed pricing on unexecuted changes;

\(^3\) In Village of Fox Lake v. Aetna Casualty and Surety Company, 534 N.E.2d 133 (Ill. 1989), the surety attempted to reserve its rights only to have such reservation deemed unenforceable with respect to the preservation of its bond penalty as a limitation of its liability.
• limit of the surety’s liability to the bond penalty.

There are some takeover agreements that are probably not as good as the letter that can be issued, with proper negotiation, by an obligee. However, before you get too confident that you have solved the problem and minimized your risk by the obligees having issued such a letter, remember that sovereign immunity may apply to the estoppel arguments that you use in the litigation that follows the dispute that caused you to abandon the work. Nevertheless, a file with the letter is better than a file without the letter.

If the obligee is unwilling to issue a letter under the signature of the authorized representative of the obligee, the surety won’t hurt itself by issuing a carefully crafted letter confirming the basis of the surety’s understanding in relation to its completion of the project. A suggested format of the letter might be as follows:

• the conditions set forth in the letter are inducements to the surety to complete the projects without the necessity of a formal takeover agreement and the corresponding administrative delay in completion of the project, which delay would not be in the best interest of the obligee, safety and...(anything you can think of specifically benefitting the obligee);

• that any alteration in these conditions would materially alter the basis and reasons for the surety’s determination to proceed, hence, the surety reserves all of its rights in relation to abandonment of the projects, disputing the claims of the obligee and/or terminating its takeover and completion of the projects, in the event of any failure of the obligee to satisfy the conditions outlined in the letter;

• the surety proceeds on the basis that its liability for all loss it incurs in connection with the procurement and performance of the remaining work under the original contract will not exceed the penal sum of the respective performance bond, notwithstanding any other provision to the contrary in the original contract;

• the obligee will execute modifications to the contract, extending the time for completion in an amount equal to the time for performance proposed to the surety by its contemplated completing contractor, plus such additional time as may be required to effectuate commencement on site, plus such additional time as would otherwise be granted under the provisions of the contracts;

• the obligee will pay directly to the surety all remaining contract proceeds, including earned retainage, as same may be adjusted for additive or deductive change orders or claims, in accordance with the terms and conditions of the original contract, without offset or deduction of any kind in relation to the timeliness or propriety of the original contractor’s performance on the projects, or on account of any claims asserted by any third parties, including, but not limited to, the Internal Revenue Service, a trustee in bankruptcy, unpaid mechanics and materialmen and/or the claims of the principal itself. Such contract proceeds will be paid to the surety as they would otherwise become progressively due under the terms and conditions of the contract;
• the specific method and manner by which remedial work will be performed and the extent of that remedial work;

• the method and manner in which the insurance requirements of the obligee will be satisfied, such as, the naming of the obligee as an additional insured on the policy of insurance provided by the completing contractor;

• an accounting of the contract balances, including amounts properly due and payable in connection with change orders, executed and unexecuted.

The confirming letter to the obligee should be sent by confirmed delivery and, if possible, receipt of same should be acknowledged by the obligee prior to commencement of completion of the contract. Thereafter, the surety should strictly adhere to the requirements of the contract in connection with the submission of request for payment, claims, dispute resolution and other terms and conditions, just as if the surety was the original contractor. Further, in the event of a disruption in payment or other dispute, the surety should act in complete conformity with its letter confirming the basis of its agreement to go forward in the absence of a takeover agreement.

In connection with any arrangement whereby the surety goes forward in completing the work in the absence of a takeover agreement, the corresponding completion agreement must be carefully drafted. Namely, a very strong termination for convenience clause needs to be included, specifically outlining the limitations of recovery for the completing contractor upon termination without cause.

Conclusion

No doubt, the surety’s completion of the obligee’s project without a takeover agreement is risky business. Nonetheless, there are circumstances where it can be a good business decision and things can be done to help minimize the risk. Given the trend of municipalities and other highly bureaucratic organizations away from takeover agreements, sureties have to and are developing guidelines for completing projects without their long time friend and security blanket, the takeover agreement.